

Amendments to Rules 417 and 418.  
Elimination of surprise audits permitting preliminary work by independent public accountants prior to the audit date.  
Conforming Exchange audit rules with those of the SEC.

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February 5, 1974

SUMMARY MEMORANDUM

On January 3, 1974 the Board of Directors approved in principle amendments to Rules 417 and 418 - audit requirements. The proposed amendments were submitted to the SEC on January 4, 1974. The SEC in its letter of reply (Exhibit A) made two minor suggestions:

- (1) That we not delete the words, "pursuant to SEC Rule 17a-5 and," from page 1 of Rule 417, as shown on page 1 of Exhibit B; and
- (2) That language be inserted to specify that when preliminary audit procedures are performed Part III of the financial questionnaire must be filed not more than 45 days following commencement of the audit procedures. The additional language now appears in the rule as shown on page 5 of Exhibit B and is identified by two parallel lines.

These suggested changes serve to further conform Exchange audit requirements with those of the SEC. Therefore, it is recommended that the Board of Directors give final approval to the amendments of Rules 417 and 418 with the minor changes requested by the SEC.

Department of Regulatory Development

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

DIVISION OF  
MARKET REGULATION

January 30, 1974

Mr. James E. Buck  
Secretary  
New York Stock Exchange, Inc.  
Eleven Wall Street  
New York, New York 10005

Dear Mr. Buck:

This is in response to your letter of January 4, 1974 in which you submitted, pursuant to Rule 17a-8 under the Securities Exchange Act of 1934, copies of proposed amendments to New York Stock Exchange, Inc.'s ("NYSE") Rule 417 and Rule 418 to conform with the NYSE's audit requirements with those of the Commission and to eliminate the NYSE's requirement for mandatory annual surprise audits. We have the following comments on the proposed amendments.

In the introductory paragraph to the supplementary material you have deleted the words "pursuant to SEC Rule 17a-5 and". Since all the requirements of Rule 17a-5 which must be met in order for exchange members to be able to file the NYSE's financial questionnaire with the Commission in lieu of Form X-17A-5 may not necessarily be encompassed within Form X-17A-5, the broader language which you have deleted should be retained.

In paragraph .10 of the supplementary material you have indicated that the independent public accountant may perform audit procedures preliminary to the audit date; however, there is no reference following this paragraph to indicate that if such procedures are performed, a preliminary report must be filed with the Commission and with the exchange within 45 days after such procedures are commenced by the independent public accountant.

The Division has no further comments.

Sincerely,

Nelson S. Kibler  
Assistant Director  
Broker-Dealer Financial Responsibility  
and Securities Transactions

## PROPOSED AMENDMENTS TO RULE 417

New language underlined – Deleted language in brackets [ ]

## Audit

Rule 417. The Exchange may require any member or member organization to cause to be made as of the date of an answer to a financial questionnaire an audit, by an independent public accountant, of his or its accounts and assets, including securities held for safekeeping, in accordance with such regulations as shall be prescribed and to file a statement to the effect that such audit has been made and whether it is in accord with the answer to the questionnaire. Such statement shall, in the case of each member not a partner or a stockholder in a member organization, be signed by such member and, in the case of each member organization, shall be signed by each member and allied member thereof unless, for good cause shown, the signature of one or more of them is waived by the Exchange provided, however, that the signatures of only two members or allied members shall be required if the answer to such financial questionnaire is made available to all members and allied members of the organization. Such statement shall in all cases be attested by the auditors, and the original report of the audit signed by the auditors shall be retained as part of the books and records of the member or organization.

Amendments.

December 19, 1955, effective January 4, 1956.

. . . Supplementary Material:

## REGULATIONS PRESCRIBED FOR AUDIT UNDER AUTHORITY OF RULE 417

(Except for the identifying initials (SEC) preceding Securities and Exchange Commission rules, and explanatory footnote[s] (A) [~~and (B)~~], these regulations are identical with those prescribed by the Securities and Exchange Commission [~~pursuant to SEC Rule 17a-5 and~~] in its financial questionnaire, Form X-17A-5.)

.10 The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the response to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date. Based upon such audit, the accountant shall

comment upon any material inadequacies found to exist in the accounting system, the internal accounting control, ~~and~~ procedures for safeguarding securities, the practices and procedures employed in complying with (SEC) Rule 17a-13, and in the resolution of securities differences, and shall indicate any corrective action taken or proposed. [~~These comments may be submitted in a supplementary certificate and filed pursuant to (SEC) Rule 17a-5(b)(3). (See Note (A).)~~]

The independent public accountant may perform audit procedures at any time which he may deem appropriate; however, if the procedures prescribed in Items 2, 3, 4 and 6(c) through (g), excluding Item 6(e) (v), are performed at a date other than the audit date, then all such aforementioned procedures shall be performed as of the same date, which shall not be more than 190 days prior to the financial statement date.

The scope of the audit shall include the following procedures, but nothing herein shall be construed as limiting the audit or permitting the omission of any additional audit procedures which an independent public accountant would deem necessary under the circumstances. As ~~of the~~ part of his audit [date] the independent public accountant shall:

(1) Compare ledger accounts with the trial balances obtained from the general and private ledgers and prove the aggregates of subsidiary ledgers with their respective controlling accounts.

(2) Account for by physical examination and comparison with the books and records: all securities, including those held in segregation and safekeeping; material amounts of currency and tax stamps; warehouse receipts; and other assets on hand, in vault, in box or otherwise in physical possession. Control shall be maintained over such assets during the course of the physical examination and comparison.

(3) Verify securities in transfer and in transit between offices of respondent.

(4) Balance positions in all securities and spot and future commodities as shown by the books and records at the audit date.

(5) Reconcile balances shown by bank statements with cash accounts. After giving ample time for clearance of outstanding checks and transfers of funds, the independent public accountant shall obtain from depositaries bank statements and cancelled checks of the accounts and by appropriate audit procedures substantiate the reconciliation as of the audit date.

(6) Obtain written confirmations with respect to the following (see Note):

- (a) Bank balances and other deposits.
- (b) Open contractual positions and deposits of funds with clearing corporations and associations.
- (c) Money borrowed and detail of collateral.
- (d) Accounts, securities, commodities and commitments carried for the respondent by others.

(e) Details of: (i) Securities borrowed (ii) Securities loaned (iii) Securities failed to deliver (iv) Securities failed to receive (v) Contractual commitments (See General Instructions B. 11.)

(f) Customers', partners', officers', directors', and respondent's accounts. Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of money balances, securities and/or commodities positions, and open contractual commitments (other than uncleared "regular way" purchases and sales of securities) accompanying the first request for confirmation mailed by the independent public accountant. Customers' accounts without balances, position or commitments, and accounts closed since the last prior audit shall be confirmed on a test basis.

(g) Borrowings and accounts covered by "satisfactory subordination agreements" (The procedure to be performed at the preliminary audit date may be limited to obtaining written confirmation of borrowings of securities covered by subordination agreements and securities held as collateral to notes receivable related to subordinated borrowings. As of the audit date confirmation of both money balances and securities positions shall be obtained.)

(h) Guarantees in cases where required to protect accounts guaranteed as of audit date.

(i) All other accounts which in the opinion of the independent public accountant should be confirmed.

Note:

Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests, together with such auditing procedures as may be necessary; provided, however, that with respect to customers' accounts closed since the last prior audit the accountant may use either positive or negative confirmation requests; and it is further provided that with respect to periodic investment plans sponsored by member firms of a national securities exchange, whose members are exempted from (SEC) Rule 15c3-1 by paragraph (b)(2) thereof, the independent public accountant examining the financial statements of the originating member firm may omit direct written confirmation of such plan accounts with customers when, in his judgment, such procedures are not necessary, if (1) the originating member firm does not receive or hold securities belonging to such plan accounts and does not receive or hold funds for such accounts, except the initial payment which is promptly transmitted to the custodian; (2) the custodian is a member firm of such national securities exchange and files certified reports complying with (SEC) Rule 17a-5 in connection with which the customers' accounts are confirmed by an independent public accountant; and (3) funds and securities held by the

custodian for each such customer's account are reconciled with the records of the originating member firm as of the date of the most recent audit of the custodian.

(7) Obtain a written statement from the proprietor, partner (if a partnership) or officer (if a corporation) as to the assets, liabilities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent.

(8) Verify the computation of the ratio of aggregate indebtedness to net capital at the audit date and review the procedures followed in making the periodic computations required under the provisions of (SEC) Rule 17a-3(a)(11). (See Note (A) [~~(B)~~].)

(9) Review the practices and procedures employed for the making of the securities examinations, counts, verifications, comparisons and the recordation of differences required by (SEC) Rule 17a-13, and the methods employed in the resolution of the differences uncovered.

Notes:

~~[(A)—Refers to separate “confidential” filing of such comments with the Securities and Exchange Commission where respondent is subject to filing answers to financial questionnaires under SEC Rule 17a-5(a).]~~

(A) [(B)] Compliance with audit requirement (8) will be met by verifying the computation of the ratio of aggregate indebtedness to net capital at the audit date in accordance with New York Stock Exchange, Inc. Rule 325 and review of procedures followed by member organizations in making their monthly computations under this rule.

(It should be noted that the provisions of (SEC) Rule 17a-5 require that the reports of certain brokers and dealers be audited by a certified public accountant or public accountant who shall be in fact independent. With respect to qualifications of accountants, accountant's certificate, opinions to be expressed, and exceptions, please refer to (SEC) Rule 17a-5).

## SPECIAL INSTRUCTIONS OF THE NEW YORK STOCK EXCHANGE, INC.

.11 Any condition disclosed by the audit that would cause the capital or net worth of the member or member organization to be less than that prescribed by the Board of [~~Governors~~] Directors shall be reported to the [~~Department of Member Firms~~] Member Firm Surveillance Division by the member or member organization immediately upon the ascertainment of such facts.

A written report of the independent public accountant shall be submitted to the member organization in which he shall attest that THE REQUIREMENTS OF THE AUDIT REGULATIONS HAVE BEEN OBSERVED IN THE CONDUCT OF THE AUDIT and such report shall also include, specifically, the following:

1. A comment that he has made a review of the member organization's accounting system, internal accounting control and procedures for safeguarding securities; including such tests thereof for the period since the prior examination date as he considered necessary in the circumstances; and
2. Comments relative to any material inadequacies found to exist in the accounting system, the internal accounting control, [and] procedures for safeguarding securities, the practices and procedures employed in complying with (SEC) Rule 17a-13 and in the resolution of security differences and shall indicate any corrective action taken or proposed. [~~(If any comments are made with respect to this item 2, they may be submitted in a supplementary report accompanying the answers to the financial questionnaire.)~~]

Within 60 [~~45~~] days after the date of the audit, or such other period as the Exchange may individually require, a signed copy of such report shall be forwarded with the answers to the financial questionnaire by the independent public accountant in a sealed envelope addressed to the Exchange.

If preliminary audit procedures prescribed in items 2, 3, 4 and 6(c) through (g) excluding item 6(e)(v) are performed at a date prior to the audit date, an accountant's report on Part III of the financial questionnaire shall be forwarded with the answers to Part III by the independent public accountant in a sealed envelope addressed to the Exchange within 45 days after the date such preliminary audit examination commences, or such other period as the Exchange may individually require.

[Chief Examiner  
~~New York Stock Exchange, Inc.~~  
~~Department of Member Firms~~  
~~4 New York Plaza, New York, N.Y. 10004]~~

A copy of the answer to each financial questionnaire, all statements and reports and all working papers and memoranda covering the answer should be retained for at least three years. (Working papers, etc., must be made available for audit and review by a representative of the New York Stock Exchange, Inc. at the office of the respondent.)

.12 All statements and reports besides the answer to the financial questionnaire, which are required to be filed with the Securities and Exchange Commission under its Rule 17a-5 shall be simultaneously filed with the Exchange.

Amendments.

November 16, 1967, effective November 30, 1967.