January 2, 1973

To Our Clients

Accounting Matters

Three recent Releases, 33-5342, 3 and 4, propose requiring supplemental disclosures with respect to the impact of changes in accounting principles and material changes in the amount of discretionary expenditures. Also, the effect of use of different accounting principles would be required to be discussed. These proposals are further efforts by the SEC to end "creative accounting". The long run effect on financial analysis and investment philosophy should be considered.

The Chief Accountant of the SEC has written to the AICPA asserting the SEC's position that when sale of control of a corporation takes place purchase accounting based on allocation of the consideration paid for control should thereafter be followed in the financial reports for the corporation. This would appear to have particular significance in situations such as the IT&T divestitures through public offerings of Avis and Canteen. To the extent that the consideration received on sale of the stock exceeds net worth, there may have to be a write-up of depreciable assets or the recognition of goodwill with a consequent reduction in earnings as a result of the increased depreciation or amortization.

The SEC on November 24 issued informally for discussion purposes only guidelines with respect to disclosure of arrangements with respect to compensating balances. The new SX regulations require actual segregation of cash in the case of formal arrangements for compensating balances and the guidelines would require comprehensive disclosure with respect to formal and informal compensating balance arrangements. For some months the staff of the SEC has been requesting disclosure in registration statements with respect to compensating balance arrangements and it has become standard practice to make such disclosure.

Sale of Control

Haberman v. Murchison, CCH ¶ 93,656, holds that Rule 10b-5 does not encompass the equal opportunity doctrine with respect to sale of control at a premium and that the net asset value of a corporation's common stock is a factor, in addition to market value, in determining if there is in fact a premium for control. The case reiterates the Second

Circuit rejection of the equal opportunity doctrine both as a matter of federal law under 10b-5 and as a matter of state law.

Liability of Directors for Misleading Proxy Statements

Gould v. American Hawaiian Steamship Company, CCH ¶ 93,682, selects negligence rather than absolute liability or proof of scienter as the standard for determining liability of directors for proxy statement disclosure violations. This is a significant opinion with respect to the rationale for the imposition of liability on directors and it contains an important discussion of the underlying philosophy.

Dividend Reinvestment Plans

Long Island Lighting Company, CCH ¶ 79,089, contains a comprehensive discussion of the significant considerations in connection with the registration of a dividend reinvestment plan.

Brokers Financial Reports

Rule 17a-5(n) requiring brokers to mail quarterly financial statements to their customers has been amended so that a broker whose surprise audit date is other than a quarter-end can use the surprise audit financial statements in lieu of one of the required quarter-end financial statements if the surprise audit date is not more than two months prior to a regular quarter-end. This amendment cures the problem under 17a-5(n), as originally adopted, of requiring the mailing of five statements rather than four by brokers whose surprise audit date did not coincide with a regular quarter-end.

Broker-Dealer Capital

Rule 15c3-3 becomes effective January 15, 1973. 15c3-3 restricts the use of customer funds by brokers and requires the establishment of special reserve bank accounts for the protection of customers free credit balances; the determination of fully paid and excess margin securities and their segregation for the benefit of the owning customers; and buy-in no later than the 10th business day if (customer not broker) fails to deliver securities sold long.

The SEC has circulated a proposed comprehensive revision of the net capital rule, Rule 15c3-1, which would replace separate net capital regulation by the exchanges and

make significant changes in the net capital rules. Larger and additional haircuts are proposed. Government bonds and municipal bonds will under the new proposal be subject to haircuts. The proposal should be studied carefully for impact and comment made to the SEC by brokers who would be affected adversely.

Rule 144 - Stock Splits

The SEC has taken the position that the number of shares to be sold under Rule 144 may be adjusted for stock splits or major stock dividends paid after the Form 144 has been filed.

Definition of Security

In two recent no-action letters, The Rouse Co., CCH ¶ 79,073, and Warner & Swasey Company, CCH ¶ 79,097, the SEC has taken the position that a guaranty of subsidiary indebtedness by a parent constitutes the issuance of a security by the parent required to be reported pursuant to Item 7 of Form 8-K. The Warner & Swasey situation involved the parent's guaranty of a subsidiary's lease underlying an industrial review bond issue.

Investment Company Codes of Ethics

Release IC-7581, December 26, 1972, proposes a rule requiring investment companies to adopt codes of ethics restricting affiliates trading in securities which they know the investment company is going to trade in. The comment period expires February 28, 1973.

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