August 6, 1973

To Our Clients

Recent Developments

Institutional Investor Full Disclosure Act. S. 2234 introduced by Senator Williams would require any bank, institution or investment manager managing portfolios aggregating more than $10,000,000 and any broker managing $5,000,000 to report at least quarterly (sooner if determined by the SEC) their portfolios and all transactions involving 2,000 shares or 1% of a company's stock.

Nonmember Discount. The NYSE has proposed an amendment to Rule 385 so as to foreclose banks and insurance companies from availing themselves of the 40% nonmember discount with respect to their pension fund accounts. The amendment reinstates the 50% primary purpose test and defines pension funds as affiliated persons in the same manner as S. 470.

Accountants Liability. Gold v. DCL Inc., CCH ¶94,036 (S.D.N.Y. 1973) holds that an accountant who has notified a company that he will not certify year end results without qualification and is thereafter dismissed has no duty of disclosure with respect to the company's release of its year end unaudited results. Note this may be a doubtful precedent in that apparently it was not argued and the court did not consider any duty of disclosure predicated on the accountants certification of the previous year and failure to relate the qualification problem thereto.

Tender Offers. Sonesta International Hotels Corp. v. Wellington Associates, CCH ¶94,041 (2d Cir. 1973) is another example of strict court interpretaion of the Williams Act disclsoure provisions. This has become so much the practice that we now advise that it is most unlikely that a contested tender offer will be successful if the target is determined and well represented.

Prompt Reporting. The SEC has expressed concern about delinquency in filing periodic reports. The release warns that the SEC will consider trading suspensions and in egregious cases criminal reference.

Disclosure of Salesman's Extra Compensation. In re Cohen Goren Equities, Inc., SEA Rel. 10252, June 28, 1973 is another illustration that failure to disclose extra compensation to salesmen in

connection with a particular transaction may be a 10b-5 violation. Like the market maker disclosure problem this can be avoided by making appropriate disclosure in recommendations and confirmations.

Margin Regulations. Section 220.120 of Regulation T issued on June 22, 1973 sets forth a number of Federal Reserve Board answers to same day margin substitution problems. The Federal Reserve Board is proposing to extend its interpretation that Regulation T precludes brokers from selling tax shelters on an installment basis to the previously excepted separate property and management contract situations where it had been the Federal Reserve Board's position that credit confined to the property part was permitted.

Net Capital Treatment of Securities Positions in Suspended Securities. SEA Rel. 10209, June 8, 1973 sets forth the SEC interpretation that suspended securities have no value for asset, capital or loan purposes, should be valued at the last sale for liability and indebtedness purposes and that accounts failing to pay for suspended securities should be considered unsecured.

The SEC continues to follow SEA Rel. 7920, July 19, 1966 as to consummation of transactions in suspended securities. Consummation is permitted provided the broker is acting in good faith, is not connected with the activity which caused the suspension, has no reason to believe his customer is so connected and informs the customer of the suspension and reasons therefor.

Spinoffs. In SEC v. Datatronics Engineers, Inc., the Fourth Circuit has held that spinoffs are sales and require registration under the 1933 Act.

Open Items with SIPC Brokers. Rule S6d-1, SIPC Rel. 5, July 25, 1973 governs the treatment of open items with brokers in SIPC liquidation. Unless fails are promptly bought-in or sold-out and the trustee notified by the claiming broker the open item will not be recognized by the trustee. Only customer transactions are covered by SIPC and then only to the extent of $20,000 net money difference for each customer account in the case of close out of open items.

Disclosure of Litigation against Accountants and Lawyers. SA Rel. 5411, July 25, 1973 announces an SEC inquiry about 1933 and 1934 Act disclosure of litigation against a registrant's accountants, lawyers and other professionals. Until the SEC adopts a position on this matter, disclosure will not be required except under

unusual circumstances and registrants are left to determine themselves whether such disclosure is necessary. In view of the recent litigation attacking shareholder ratification of accountants on the ground of nondisclosure of litigation against the accountants, and the possibility of this becoming a basis for strike suits, we recommend that summary disclosure be made: "In recent years Messrs. _____, as is the case of many accounting firms, have been sued for violations of the federal securities laws and other matters in connection with financial statements of other companies certified by them. Messrs. _____ have settled some of such suits for substantial sums [and in several such suits judgments have been rendered against Messrs. _____.] The Board of Directors has considered such matters in connection with the selection of Messrs. _____ and determined that in view of the excellent general reputation of Messrs. _____ and their satisfactory services to the Corporation, they should continue to act as the Corporation's accountants and recommends that the shareholders vote in favor of the ratification of the selection of Messrs. _____."

Accounting for Brokers. SEA Rel. 10297, July 25, 1973 proposes to amend Rule 17a-5 to permit independent public accountants to perform audit procedures prior to the balance sheet date. The securities count, confirmation of accounts and similar procedures will have to be on the same date and not more than 100 days prior to the balance sheet date. Notice of preliminary work involving these procedures must be given to the Regional Office of the SEC. The release discusses the SEC interpretation of the "material inadequacies" which must be reported by accountants on Form X-17A-5:

> "A material inadequacy which should be reported includes any material weakness which has substantially contributed to or, if appropriate corrective action is not taken, could reasonably be expected to substantially contribute to (1) severe operational problems, (2) material losses or misstatement of the broker's or dealer's financial statements, or (3) violations of the Commission's recordkeeping and financial responsibility rules.
>
> In this regard, it is the Commission's view that both the public interest and the broker-dealer community are not properly served if weaknesses are considered material only after such inadequacies have resulted in substantial financial loss. Accordingly, it is incumbent

upon the independent public accountant to report those weaknesses which the exercise of prudent judgment indicates could reasonably be expected to result in a substantially adverse impact if appropriate corrective action is not promptly taken. Further, it is the independent public accountant's responsibility to satisfy himself that the action taken or proposed is appropriate under the circumstances and if not, to reflect that opinion in his report.

At a minumum, a severe operational problem is one that inhibits a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other brokers or dealers or creditors. The Commission believes that it will normally be a rare occurrence when a severe operational problem does not have the very real potential to ultimately manifest itself in the form of either material losses, misstatements of the broker's or dealer's financial statements or violations of the Commission's recordkeeping or financial responsibility rules.

The Commission's view that material inadequacies reportable under Form X-17A-5 include those weaknesses related to operational problems and violations of the Commission's recordkeeping and financial responsibility rules takes cognizance of the independent public accountant's technical expertise and his integral functions within the regulatory framework of the securities industry. Accordingly, the Commission is of the belief that weaknesses in the practices or procedures used by a broker or dealer in complying with the recordkeeping and financial responsibility rules, shall be reported by the independent public accountant, irrespective of the financial position of the broker or dealer."

Class Actions. Four Seasons Securities Laws Litigation, CCH ¶94,052 (W.D. Okla. 1973) has an interesting reference to some of the attorneys who are active in class actions and the basis for awarding fees.

M. Lipton