CODIFICATION GUIDE

A numerical list of the parts of the Code of Federal Regulations affected by documents published in this issue. Documents carried in the Cumulative Supplement by uncodified tabulation only are not included within the purview of this list.

CODIFICATION GUIDE—Continued

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our Lord nineteen hundred and
[SEAL] forty-six, and of the Independence of the United States of America the one hundred and seventy-first.

HARRY S. TRUMAN

By the President:

W. L. CLAYTON,
Acting Secretary of State.

[F. R. Doc. 46-17531; Filed, Sept. 25, 1946; 5:00 p. m.]

EXECUTIVE ORDER 9784

PROVIDING FOR THE MORE EFFICIENT USE AND FOR THE TRANSFER AND OTHER DISPOSITION OF GOVERNMENT RECORDS

By virtue of the authority conferred on me by the Constitution and statutes, in order to provide that Government records may be utilized to maximum advantage and disposed of expeditiously when no longer needed and in the interest of more efficient internal management of the Government, it is hereby ordered as follows:

1. The head of each agency shall establish and maintain an active continuing program for the effective management and disposition of its records. Agencies shall retain in their custody only those records that are needed in the conduct of their current business, and except as herein otherwise provided, shall promptly cause all other records to be offered for transfer to the National Archives or proposed for other disposition in accordance with law.

2. No records shall be transferred by one agency to the custody of another agency without the approval of the Director of the Bureau of the Budget except for their retirement to the National Archives, as a temporary loan for official use, or as may be otherwise required by statute or Executive order. Any records in the custody of any agency which, in the judgment of the Director of the Bureau of the Budget, are not needed in the conduct of its current business and are needed in the current business of another agency shall be transferred to the latter agency if, in the opinion of the Director, the public interest will be best served by such transfer, provided that any portion of such records deemed to have enduring value may be accessioned by the National Archives and placed on loan to the agency to which the records are physically transferred. In making determinations concerning the transfer of records the Director shall give due regard to the importance of having Government records which are not confidential made generally available to Government agencies and to the public.

3. The Civil Service Commission, with the approval of the Director of the Bureau of the Budget, is authorized to promulgate regulations, not inconsistent with law and regulations of the National Archives Council, requiring and governing the establishment, content, transfer among agencies, and other disposition of personnel records, provided that no agency shall be required to release or transfer confidential material affecting any of its employees.

4. Except as provided in the preceding paragraph 3, the Director of the Bureau of the Budget with the advice and assistance of the National Archives shall conduct such inspections, require such reports, and issue such directives and regulations as he may deem necessary to carry out the provisions of this order.

5. No transfer of records (except in connection with a termination or transfer of functions) shall be made hereunder when the head of the agency having custody of the records shall certify that such records contain confidential information, a disclosure of which would endanger the national interest or the lives of individuals. Whenever any records are transferred which contain information procured under conditions restricting its use, the use of such records shall continue to be limited by such conditions. The provisions of this order shall not be deemed to require the transfer or other disposition of records or authorize access to records in contravention of law or of regulations of the National Archives Council.

6. Definitions

(a) The term "agency" as used herein shall be deemed to mean any executive department or independent establishment, including any government corporation that is operated as an instrumentality of the Federal Government.

(b) The term "records" as used herein shall apply to all books, papers, maps, photographs, or other documentary materials, regardless of physical form or characteristics, made or received by any agency of the United States Government in pursuance of Federal law or in connection with the transaction of public or organizational business and preserved or appropriate for preservation by that agency as evidence of or because of its informational value in relation to its organization, functions, policies, personnel, operations, decisions, procedures, financial transactions, and all other activities of an administrative, management, or program nature.

HARRY S. TRUMAN

THE WHITE HOUSE,
September 25, 1946.

[F. R. Doc. 46-17539; Filed, Sept. 26, 1946; 10:25 a. m.]

Regulations

TITLE 7—AGRICULTURE

Chapter XI—Production and Marketing Administration (War Food Distribution Orders)

[War Food Order 141-1]

PART 1468—GRAIN

DISTILLERS' GRAIN QUOTAS

Pursuant to the authority vested in me by War Food Order No. 141 (11 F. R. 2217, 3997), it is hereby ordered as follows:

§ 1468.15 *Grain quotas for distillers of beverage spirits*—(a) *Definitions.* (1) "Daily mashing capacity" means the quantity of grain mashed in a particular plant during any five consecutive calendar days from January 1, 1945, to the effective date of this order, divided by 5.

(2) Any term not specifically defined herein shall have the meaning set forth for such term in War Food Order No. 141.

(b) *Quotas for September 1946.* Except as hereinafter otherwise provided:

(1) Every distiller may, in each plant operated by him during the month of September 1946, use grain or grain products for the manufacture of distilled spirits for beverage purposes in a quantity not in excess of the following quantity:

(i) Three times the daily mashing capacity of such plant plus

(ii) Three thousand bushels;

Grain already used in September is chargeable against this quota; *Provided, however,* That any distiller whose total allocation of grain and grain products under this order for all plants operated by him is less than 6,000 bushels may use not in excess of 6,000 bushels.

(2) No distiller shall use corn grading No. 1, 2, or 3, when purchased, or wheat or wheat products.

(3) No distiller shall during the month of September 1946, use rye in the manufacture of distilled spirits for beverage purposes in a quantity in excess of 6 percent of the total quantity of grain and grain products authorized to be used by him during such month, or in excess of 2,000 bushels, whichever quantity is the greater; *Provided, however,* That in no case shall the quantity of rye used by any distiller exceed 15 percent of the total quantity of grain and grain products authorized to be used by him during such month under the terms of this order.

(c) *Violations.* Any person who violates any provision of this order may, in accordance with the applicable procedure, be prohibited from receiving, making any deliveries of, or using grain, grain products, alcohol, alcoholic beverages or spirits. Any person who wilfully violates any provision of this order is guilty of a crime and may be prosecuted under any and all applicable laws. Civil action may also be instituted to enforce any liability or duty created by, or to enjoin any violation of, and provision of this order.

(d) *Territorial scope.* This order shall apply within the 48 States and the District of Columbia.

(e) *Effective date.* This order shall become effective at 12:01 a. m., e. s. t., September 26, 1946.

(E. O. 9280, 7 F. R. 10179; E. O. 9577, 10 F. R. 8087; W. F. O. 141, 11 F. R. 2217, 3997)

Issued this 26th day of September, 1946.

[SEAL] C. C. FARRINGTON,
Assistant Administrator.

[F. R. Doc. 46-17541; Filed, Sept. 26, 1946; 11:11 a. m.]

Chapter IX—Production and Marketing Administration (Marketing Agreements and Orders)

PART 934—MILK IN THE LOWELL-LAWRENCE, MASSACHUSETTS, MARKETING AREA

ORDER TERMINATING SUSPENSION ORDER

Correction

In Federal Register Document 46-17086, appearing on page 10696 of the issue for Tuesday, September 24, 1946, the title of Charles F. Brannan should read: *"Acting Secretary of Agriculture."*

TITLE 8—ALIENS AND NATIONALITY

Chapter II—Office of Alien Property Custodian

TABLE OF CHANGES IN MATERIAL HERETOFORE PUBLISHED IN FEDERAL REGISTER

Correction

In the table in Federal Register Document 46-15339, appearing on page 9988 of the issue for Wednesday, September 11, 1946, the tenth section under the column headed "Original sec. No." should read: "503.6-1".

TITLE 10—ARMY: WAR DEPARTMENT

Chapter I—Aid of Civil Authorities and Public Relations

PART 104—RELATIONS WITH AGENCIES OF PUBLIC CONTACT

PUBLIC RELATIONS

In revision of AR 600-700, August 16, 1946, §§ 104.1 through 104.6 inclusive, are superseded by the following:

Sec.

AUTHORITY: §§ 104.1 to 104.6, inclusive, issued under R. S. 161; 5 U. S. C. 22.

§ 104.1 *General.* (a) Because of the importance of the Military Establishment in the defense and welfare of the Nation and its traditional role of a public servant, it is the responsibility of the Army to insure that the American public is fully and accurately informed concerning the purpose and activities of the Army as well as its place in the American community.

(b) The broad mission of public relations is to maintain close and friendly undertstanding between the Army and the public through the dissemination of information, the attainment of public recognition, and the maintenance of public confidence in the Military Establishment, to insure efficient and adequate military security for the United States.

§ 104.2 *Definition.* Public relations is defined as any planned program or procedure which will elicit public understanding and good will. It includes continuous dissemination of information to the public, participation in community life, and a line of conduct by uniformed personnel which will contribute to public understanding and appreciation of the military service.

§ 104.3 *Responsibility for public relations.* (a) The fostering of proper public relations is a responsibility of command, extending through all echelons and ranks. All members of the Army are representatives of the service before the public and share that responsibility in their conduct.

(b) Commanders of all echelons, units, and military installations are charged with the conduct of public relations within their jurisdiction.

(c) The Signal Corps and the Army Air Forces will maintain the official pictorial files of the War Department appropriate to their respective activities.

(d) The War Department Public Relations Division is the agency designated to deal with the public on matters of concern to the War Department and the Army as a whole. The Army Air Forces is authorized to deal with the public in purely air matters in accordance with the broad over-all policies established by the War Department. Subject to established policies and regulations governing the security of military information as promulgated by the Director of Intelligence, War Department General Staff, the Public Relations Division initiates policies which, upon approval, will guide the conduct of public relations with lower echelons and in the field.

§ 104.4 *Public relations operations in the field.* (a) A public relations officer will be appointed to the staff of each post, camp, or station and to the staffs of regiments, air force groups, and equivalent units or higher commands. Public relations officers of posts, camps, stations, and units larger than regiments will have the status of special staff officers. Wherever conditions permit this should be their principal duty. Appointments will be made by unit and installation commanders.

(b) Subject to the supervision of the commanding officer, and in consonance with approved security policy, the duties of a public relations officer include the following:

(1) Advice to the commanding officer on public relations matters, particularly on relations between the command and the nearby communities, but excluding

functions of representatives of the Civil Affairs Division and other military Government agencies.

(2) Liaison with civilian groups, including the dissemination of information pertaining to the command to local information media.

(3) Review, under established policies, of material for dissemination to the public and of material for publication in unit and post newspapers.

(4) Reception of all representatives of local and national information media and assistance to them in obtaining desired material relating to the command.

(c) On posts where two or more military units or activities are situated, public relations responsibility will rest with the senior permanent commander stationed there. All public relations activities under his jurisdiction will be coordinated as he may direct.

(d) Direct communication between public relations offices regardless of command channels is authorized to expedite the exchange of information. Such communication, for the purpose of coordination and mutual assistance, in no way infringes upon the responsibility and authority of commanders.

§ 104.5 *War Department Public Relations Division.* (a) The War Department Public Relations Division will initiate policies to govern the conduct of public relations within lower echelons and in the field. All agencies dealing with public relations and related activities will operate under the policies laid down by the War Department.

(b) The Public Relations Division, consisting of the Chief, Public Relations Division, and assigned personnel, will function under the supervision of the Chief of Public Information, War Department. Policies initiated by the division will be approved by the Chief of Public Information prior to publication as War Department policies.

(c) Material of general interest to the public emanating from the War Department will be released through the Public Relations Division unless other provision is made by the division.

(d) To accomplish its mission the Public Relations Division must have timely knowledge of War Department plans and actions. To this end each staff division, service, and major command will, as a general rule, make available all information desired by the Chief, Public Relations Division. When, in the opinion of the head of the division, chief of service, or major commander, information should be withheld in the national interest, decision by higher authority will be obtained. Release of information obtained from any War Department agency upon request will be released only after coordination with originating agency.

(e) Direct communication is authorized between the Public Relations Division and commanders of posts, camps, stations, installations, field and oversea commands on matters pertaining to public relations.

§ 104.6 *Public activities by military personnel.* (a) Members of the Army of the United States usually appear before the public in an official or semiofficial capacity and so contribute to the impression formed by the public. Consequently, care will be taken to differentiate between personal ideas and opinions, and official plans and purposes. Furthermore, their military status limits the extent to which members of the Army may, with propriety, make public pronouncements on political, diplomatic, legislative, administrative measures, and on matters the treatment of which tends to prejudice discipline, to involve superior officers in controversy, to interpret official publications, or to define military procedure.

(b) Within the bounds of security and propriety the writing of articles, books, and other related material intended for publication, and the engaging in public and private discussions on appropriate occasions, by officers and enlisted men, on topics of military, professional, or general interest concerning the Army, or in the interest of the national defense, are authorized and desirable.

(c) Literary activities of military personnel not covered by (a) and (b) of this section are limited only by the dictates of propriety and good taste. For additional references dealing with public activities of military personnel see AR 600–10. [AR 600–700, 10 Jan. 46]

[SEAL] H. B. LEWIS,
Brigadier General,
Acting The Adjutant General.

[F. R. Doc. 46–17419; Filed, Sept. 26, 1946; 8:50 a. m.]

Chapter VII—Personnel

PART 701—RECRUITING AND INDUCTION FOR THE ARMY OF THE UNITED STATES

ENLISTMENTS AND REENLISTMENTS IN THE REGULAR ARMY

Pending the revision of Part 701, pertaining to enlistments and reenlistments in the Regular Army, paragraph 10b (11 FR 4649) is rescinded and the following substituted therefor:

10. *Periods of enlistment.* * * *

b. In addition, any qualified and acceptable member of the Army of the United States (including members of the Regular Army, members of the Enlisted Reserve Corps on active duty, and members of the National Guard of the United States), currently serving on active duty, is authorized, upon completion of at least 6 months in his current term of such active service, to enlist for a period of 1 year plus the period of any reenlistment furlough granted at the beginning of such enlistment, except that, a member of the Regular Army, serving in an enlistment contracted on or after 1 June 1945, will not be discharged prior to the expiration of such current enlistment period for the purpose of reenlisting in the Regular Army. Enlistments or reenlistments contracted in accordance with the provisions of this subparagraph must be accomplished on the day following the date of discharge.

(41 Stat. 765; 10 U. S. C. 42) [WD Cir 110, 17 Apr 1946 as amended by Cir 267, 5 Sep 1946]

[SEAL] H. B. LEWIS,
Brigadier General,
Acting The Adjutant General.

[F. R. Doc. 46–17420; Filed, Sept. 26, 1946; 8:50 a. m.]

TITLE 24—HOUSING CREDIT

Chapter VIII—Office of Housing Expediter

[Premium Payments Reg. 8, Amdt. 2]

PART 805—PREMIUM PAYMENTS REGULATIONS UNDER VETERANS' EMERGENCY HOUSING ACT OF 1946

CAST IRON SOIL PIPE

Section 805.8 (Premium Payments Regulation 8) (11 F. R. 8523, 9674) is amended as follows:

1. By inserting a paragraph numbered (c) (5), following paragraph (c) (4), which new paragraph shall read as follows:

§ 805.8 *Cast iron soil pipe.* * * *

(c) *Establishment of quota.* * * *

(5) (i) The quota for each operating plant, as established under paragraph (c) (1) of this section, shall be reduced by the excess, if any, of the total amount of 5" and larger pipe sizes produced by such plant during the month of August, 1946 over 7% of its total production during that month. Such reduction in quota shall apply only with respect to claims filed for the months determined as follows:

(a) For an operating plant whose August 1946 production of 5" and larger pipe sizes represented more than 7%, but less than 10%, of its total production for that month, the reduced quota for such plant shall be applied only with respect to claims filed for the month of September 1946 and for no other month.

(b) For an operating plant whose August 1946 production of 5" and larger pipe sizes represented 10% or more, but less than 20%, of its total production for that month, the reduced quota for such plant shall be applied only with respect to claims filed for each of the months of September and October 1946 and for no other month.

(c) For an operating plant whose August 1946 production of 5" and larger pipe sizes represented 20% or more of its total production for that month, the reduced quota for such plant shall be applied only with respect to claims filed for each of the months of September, October and November 1946 and for no other month.

(ii) In the case of any producer with two or more plants, none of the plants of such producer will be eligible for the reduction in quota provided for in this subparagraph (c) (5) unless the total combined production in all the plants of such producer of 5" and larger pipe sizes during the month of August, 1946 exceeded 7% of the total combined production in all such plants during that month.

2. This amendment is effective as of September 1, 1946.

3. Issued this 27th day of September 1946.

WILSON W. WYATT,
Housing Expediter.

[F. R. Doc. 46–17459; Filed, Sept. 26, 1946; 8:45 a. m.]

TITLE 17—COMMODITY AND SECURITIES EXCHANGES

Chapter II—Securities and Exchange Commission

PART 211—INTERPRETATIVE RELEASES RELATING TO ACCOUNTING MATTERS (ACCOUNTING SERIES RELEASES)[1]

[1] The interpretative opinions included herein are opinions issued in the past for the guidance of the public by members of the Commission's staff (or in a few instances by the Commission) and heretofore made public pursuant to Commission authorization. The opinions are to be read as of the date of original publication and in the context of the rules, statutes and circumstances then existing. However, opinions or portions of opinions which are clearly obsolete have been omitted. While it is not clear that publication of interpretative opinions of this kind in the FEDERAL REGISTER is required, it is believed that such publication may be helpful to the public and that it falls within the spirit of the Administrative Procedure Act. Where rules referring to an opinion have been renumbered since the issuance of the opinion, the new designations are indicated in brackets.

§ 211.0 *Treatment of Federal income and excess profits taxes and surtax on undistributed profits.* Recently you requested my[1] opinion with respect to the treatment of Federal income and excess profits taxes and surtax on undistributed profits in financial data included in registration statements filed with this Commission.

In my opinion, provision should be made in the profit and loss or income statement for each of these taxes, whether the period covered by such statements is a full year or only a part thereof. If such provision is based, of necessity, substantially on factors the certainty of which is in doubt, this fact should be indicated and footnotes should be appended to the financial statements explaining such qualification.

It may, however, be impracticable, if not impossible, because of uncertainty with respect to the registrant's dividend policy or the status of contract provisions restricting dividend payments, to determine or accurately estimate the liability for surtax on undistributed profits. In this event, no provision for this tax need be made but the omission thereof should be explained by footnote to the financial statements indicating therein the approximate maximum amount involved.

The surtax on undistributed profits should be shown in the profit and loss or income statement separately from other Federal income taxes and if no such tax is incurred by the company, that fact should be indicated. [Securities Act Release No. 1210, January 6, 1937]

§ 211.1 *Treatment of losses resulting from revaluation of assets.* The question under discussion concerns the propriety of a charge (representing a reduction from net cost values of plant and equipment to a valuation established by the executive officers of your company) to capital surplus instead of to earned surplus. The capital surplus to which this charge was made was created pursuant to resolutions of the stockholders and directors providing for the reduction of the par value of the issued and outstanding common stock for the specific purpose of taking care of this revaluation of plant and equipment.

It is my[1] understanding that the plant and equipment were originally built for, and have until a few years ago been operated in, the manufacture of a class of goods the production of which has been discontinued. Under these conditions, some of the buildings and equipment became useless or obsolete, several of the buildings having been razed prior to the write-off and others subsequently. Other portions of the plant were of unduly large capacity for planned future requirements. The write-downs in question were made in accordance with the instructions of the directors and stockholders as stated in their respective resolutions; namely, "to the degree considered proportionate to the condition of each such asset with respect to the state

[1] Chief Accountant.

of being partially or wholly obsolete, of over-capacity, of lessened utility value, of too high book value in comparison with replacement cost, or unduly costly in operation."

To my mind, the revaluation of the assets involved was simply a recognition by the company, as of the date of the write-down, of an accumulation of depreciation in values incidental to the risks involved in the ordinary operation of its business. This depreciation did not occur as of a given date; it took place gradually over a period of years coincident with the evolution of the industry. Thus it was an element of production costs applicable to an indefinite period prior to the write-down and as such would have been charged against income had it been discerned and provided for currently.

It is my conviction that capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been chargeable against income. In case a deficit is thereby created, I see no objection to writing off such a deficit against capital surplus, provided appropriate stockholder approval has been obtained. In this event, subsequent statements of earned surplus should designate the point of time from which the new surplus dates.

Accordingly, in my opinion, the charge here in question should have been made against earned surplus. In view of the stockholder action that has been taken, I see no objection to the deficit in earned surplus resulting from this write-off being eliminated by a charge to the capital surplus created by the restatement of capital stock. [Accounting Series Release No. 1, April 1, 1937]

§ 211.2 *Independence of accountants; relationship to registrant.* The Securities and Exchange Commission from time to time has been called upon to determine whether, in a particular case, the relationship existing between a registrant and an accountant was of such a nature as to prevent him from being considered independent for the purpose of certifying financial statements to be filed in connection with the registration of securities under the Securities Act of 1933 and the Securities Exchange Act of 1934.

In response to such requests, the Commission has taken the position that an accountant cannot be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune.

In a recent case involving a firm of public accountants, one member of which owned stock in a corporation contemplating registration, the Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of such corporation and based its refusal upon the fact that the value of such holdings was substantial and constituted more than 1 percent of the partner's personal fortune. [Accounting Series Release No. 2, May 6, 1937]

§ 211.3 *Treatment of investments in subsidiaries in consolidated statements.* You have requested my[1] opinion concerning the propriety of the practice whereby the subject company, in consolidating its accounts with those of its subsidiaries, eliminated from its investment account, only the par or stated value of the stocks of subsidiaries.

It is my understanding that:

(a) The aggregate cost of these investments to the parent company was in excess of its proportionate interest in the equities in the net assets of the subsidiaries as shown on the books of the latter.

(b) The parent's equities in the surpluses of the subsidiaries at the dates their stocks were acquired by the parent were included as part of consolidated surplus.

(c) The amount of the parent's investment account not eliminated was shown as an asset on the consolidated balance sheet, designated "excess of cost over par or stated value of the securities of subsidiaries eliminated in consolidation."

The acquisition by one company of the controlling stock interest in another constitutes, in effect, the acquisition of the assets of the acquired company subject to its liabilities and the interests of minority stockholders. The values of such assets, after deducting the liabilities and minority interests, constitute the equity of the parent in the subsidiary and the book value of such equity is equal to the par or stated value of the stock(s) owned by the acquiring company plus the portion of the surplus(es) of the subsidiary applicable thereto.

The purpose of a consolidated balance sheet is to reflect the financial condition of a parent company and its subsidiaries as if they were a single organization. Thus, in such a balance sheet, the parent company's equities in net assets of subsidiaries are substitued for its investments therein. This substitution is effected by eliminating from the parent company's investment account an amount equal to the par or stated value of the subsidiaries' stocks owned by the parent and its proportionate share of their surpluses at acquisition. Any part of the parent's investment account remaining (representing the excess cost thereof over the equities in the net assets represented thereby) may properly be retained among the consolidated assets.

The foregoing consolidation procedure, which, in my[1] opinion, conforms to sound and generally accepted accounting practice, has not been followed by the subject company. Instead, by eliminating only an amount equal to the par or stated value of the subsidiaries' stocks from the parent company's investment account, consolidated assets and surplus are overstated in an amount equal to the parent's proportionate share of the surpluses of the subsidiaries as at the respective dates of the acquisition of their stocks. [Accounting Series Release No. 3, September 13, 1937]

§ 211.4 *Administrative policy on financial statements.* In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant. [Account Series Release No. 4, April 25, 1938]

§ 211.5 *Treatment of dividends on corporation's own capital stock held in sinking-fund.* You have asked whether it is proper for a corporation to treat as income dividends applicable to shares of its own stock held in a sinking-fund.

In my[1] opinion dividends on a corporation's own stock held in its treasury or in sinking or other special funds should not be included in income. The treatment of such dividends as income results in an inflated showing of earnings inasmuch as the earnings from which dividends are paid have already been included in income or surplus either during the current or prior accounting periods.

When a corporation's own stock is held in a sinking or other special fund, the requirements in respect of which are such that earnings accruing to the securities held therein must be added to the fund, dividends applicable to the corporation's own stock so held should, nevertheless, not be treated as income. [Accounting Series Release No. 5, May 10, 1938]

§ 211.6 *Treatment of excess of proceeds from sale of treasury stock over cost thereof.* Question has been raised with respect to the proper treatment of an item of $488,211.83 representing "excess of proceeds from sale of 12,200 reacquired shares of the company's capital stock over the cost thereof." These shares represent part of 41,400 shares of the capital stock of the registrant, a manufacturing company, reacquired by it prior to the year 1934 "for the purpose of resale when market conditions improved."

Under the laws of most states there are certain legal restraints upon the issuance of new shares that do not apply to the sale of treasury shares. However, from an accounting standpoint, there appears to be no significant difference in the final effect upon the company between (1) the reacquisition and resale of a company's own common stock and (2) the reacquisition and retirement of such stock together with the subsequent issuance of stock of the same class.

[1] Chief Accountant.

It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or in earned surplus. There would seem to be no logical reason why surplus arising from the reacquisition of the company's capital stock and its subsequent resale should not also be treated as capital.

In my [1] opinion the $488,211.83 excess of proceeds from the sale of 12,200 reacquired shares of this registrant's capital stock over the cost thereof should be treated as capital stock or capital surplus as the circumstances require. [Accounting Series Release No. 6, May 10, 1938]

§ 211.7 *Commonly cited deficiencies in financial statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934.* As an aid to registrants and their accountants in the preparation of financial statements to be filed with this Commission pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934 there is submitted herewith a list of the more common deficiencies which it has been found necessary to cite in connection with financial data included in registration statements filed with this Commission.

It will be noted that many of the deficiencies cited do not involve any important problem in accounting and that some involve simply the failure to follow the express regulations and instructions of the Commission.

It is thought that if particular attention is given to the items comprising this list and to the instructions pertaining thereto, contained in the Commission's forms and regulations, considerable inconvenience and expense to registrants will be avoided and the work of the Commission's staff in reviewing the statements filed will be greatly facilitated.[2]

(a) *Accountants' certificates.* (1) Accountant's opinion in respect of (1) the financial statements of, and (2) the accounting principles and procedures followed by the registrant, not clearly stated.

(2) Use of equivocal phrases such as "subject to the foregoing," "subject to the above comments," "subject to comments and explanations in exhibits," "subject to the accompanying comments," etc.

(3) A reasonably comprehensive statement as to scope of the audit made not included in the certificate.

(4) Adequate audit not made by certifying accountant. In this connection attention is directed to the regulation that accountants shall not omit "any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit."

(5) Failure to certify all financial statements required to be submitted, e. g., failure to certify profit and loss statement as well as balance sheet, and failure to certify statements of registrant as well as statements of registrant and subsidiaries consolidated.

(6) Financial statements and supporting schedules covered by the certificate not clearly identified.

(7) Certifying that the accounting principles followed by the registrant are in accordance with the system of accounts prescribed by a State regulatory body, or in a particular industry, but without indicating whether the practice of the registrant is in accordance with generally accepted accounting principles and procedures.

(8) Effect upon the financial statements of substantial changes in accounting policies of the registrant not commented upon and explained by the certifying accountants.

(9) Effect upon the financial statements of the registrant's failure to follow generally accepted accounting principles and procedures not commented upon and explained by the certifying accountants.

(10) Disclaimer of responsibility on the part of the certifying accountants with respect to matters clearly within their province.

(11) Reservations on the part of the certifying accountants with respect to matters not within their province which might indicate that apparently the accountants were not satisfied that such matters as legal titles, outstanding liabilities, etc., were properly reflected in the financial statements.

(12) Certificate undated, or not manually signed.

(b) *Consolidated financial statements*—(1) *Balance sheets.* (i) Failure to include footnote indicating the method followed in dealing with the difference between the investment in subsidiaries, as shown in the parent's books, and the parent's equity in net assets of the subsidiaries, as shown in the books of the latter and to state the amount of such difference.

(ii) Amount of the minority interest in the capital and in the surplus of the subsidiaries consolidated not stated separately in the consolidated balance sheet.

(iii) Failure to state, as required, the principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance sheet.

(iv) Improper treatment, in consolidation, of surpluses of subsidiary companies existing at date of acquisition by parent company. (See Accounting Series Release No. 3) (17 CFR, 211.3)

(2) *Profit and loss statements.* (i) Preparation of consolidated profit and loss statement on a different basis than the consolidated balance sheet, e. g., inclusion in the consolidated profit and loss statement income and expenses of subsidiaries whose assets and liabilities are not reflected in the consolidated balance sheet but for which separate balance sheets are submitted.

(ii) Failure to eliminate intercompany items, or to explain satisfactorily the reasons for not eliminating such items.

(c) *Balance sheet*—(1) *Assets.* (i) Failure to state total of current assets and to designate the total.

(ii) Inclusion among current assets of assets not realizable within 1 year, excepting where recognized trade practices, which are stated, permit otherwise.

(iii) Classification, in the parent company's balance sheet, of receivables from subsidiaries as current assets, in cases where the subsidiaries classify their obligations to the parent company as noncurrent.

(iv) Failure to indicate, where required, assets hypothecated or pledged.

(v) Failure to disclose, with adequate explanation, assets held conditionally.

(vi) Classification as marketable securities, securities not having a ready market.

(vii) Failure to state, where required, the basis of determining the balance sheet amounts of investment or marketable securities. In this connection the term "book value" is unacceptable.

(viii) Failure to state parenthetically the aggregate quoted value of investment and marketable securities when not shown on basis of current market.

(ix) Failure to reduce the carrying value of investments in subsidiaries to the extent of any dividends received thereon out of surplus of such sibsidiaries existing at date of acquisition.

(x) Inclusion in trade accounts receivable of accounts not properly within such category.

(xi) Failure to state separately in the balance sheet, or in a schedule therein referred to, major classes of inventory such as (a) raw materials; (b) work in process; (c) finished goods; and (d) supplies, or to use any other classification reasonably informative.

(xii) Basis of determining the amounts of the inventories as shown in the balance sheet not stated.

(xiii) Reserve for depreciation on appreciated value of fixed assets not provided.

(xiv) Inclusion in carrying values of fixed assets, expenditures not properly includible therein, such as discount or commissions or capital stock and promotion expenses.

(xv) Method used in amortizing debt discount and expense not stated.

(xvi) Failure to explain what provisions have been made for writing off discounts and commissions on capital stock.

(xvii) Where treasury stock is carried as an asset, failure to state reasons for such practice.

(xviii) Failure to state separately the amount of reacquired long-term debt of the registrant.

(xix) Absence of a reserve for doubtful accounts not explained.

(d) *Liabilities.* (1) Failure to state total of current liabilities and to designate the total.

(2) Inclusion, with general reserves, of accruals for taxes which are actual liabilities.

(3) Failure to state separately by years, where required, the total amounts of the respective maturities of long-term debt.

(4) Accounts and notes payable, and accruals, not segregated as required.

(5) Deferred income not set out separately.

(6) Failure to disclose, with full particulars, all contingent liabilities.

[1] Chief Accountant.

[2] Letter from Chief Accountant, to accountants practicing before the Securities and Exchange Commission.

(e) *Capital stock.* (1) Aggregate capital stock liability of each class of stock not stated separately.

(2) Failure to show the number of shares authorized, in treasury, and outstanding.

(3) Assigned or stated value of no par value stock not indicated.

(f) *Surplus.* (1) Failure to show in balance sheet the division of surplus into various classes, in cases where registrant has differentiated in its accounting for surplus.

(2) Use of capital surplus to absorb write-down in plant and equipment which should have been charged to earned surplus. (See Accounting Series Release No. 1 (17 CFR. 211.1))

(3) Failure to date earned surplus account after deficit has been eliminated (with stockholders' approval) by a charge to capital surplus.

(4) Failure to state amount of surplus restricted (a) because of acquisition of company's own stock and (b) to the extent of the difference between par, assigned or stated value of preferred stock and the liquidating value of such stock.

(5) Deficit not clearly designated in the balance sheet.

(6) Treatment of surplus of subsidiary at date of acquisition as earned surplus.

(g) *Profit and loss statement.* (1) Charges made to surplus rather than profit and loss for expenses or losses properly attributable to current operations.

(2) Crediting profit and loss rather than surplus for sale of assets previously written off by a charge to surplus.

(3) When opening and closing inventories are used in determining cost of goods sold, failure to state basis of determining the amount of such inventories.

(4) Where no depletion or depreciation has been provided, failure to indicate that fact and the effect upon current operations in the profit and loss statement.

(5) Failure to state basis of conversion of all items in foreign currencies, and the amount and disposition of resulting unrealized profit and loss when significant.

(6) Gross sales net of discounts, returns, and allowances not shown in profit and loss statement.

(7) Failure to state separately, as required by instructions, gross sales and operating revenues when the lesser amount is more than 10 percent of the sum of the two items.

(8) Selling, general, and administrative expenses not segregated in profit and loss statement.

(9) Failure to explain in footnote to profit and loss statement, effect of change in significant accounting principle or practice.

(10) Failure to show separately from other taxes surtax on undistributed profits or failure to state expressly that no liability existed for such tax. (See Securities Act of 1935 Release No. 1210.)

(11) Principle followed in determining the cost of securities sold not stated, *e. g.*, "average costs," "first-in, first-out," "specific certificate or bond."

(12) Failure to state basis of taking profits into income when sales are made on an installment or other deferred basis.

(13) Failure to refer in profit and loss statement to supporting schedule when analysis of certain expenses is presented in such schedule.

(h) *Schedule of property, plant, and equipment.* (1) Failure to show property by major classifications such as land, buildings, equipment, leaseholds, etc., where required.

(2) Nature of changes in property, plant, and equipment during the year not explained clearly, and accounts affected not indicated.

(3) Failure to explain fully policy of amortization and/or depreciation of property, plant, and equipment credited directly to asset accounts.

(i) *Schedule of reserves for depreciation, depletion, and amortization of fixed assets.* (1) Failure to follow instructions: "State the company's policy with respect to the provisions for depreciation, depletion, and amortization or reserves created in lieu thereof during the fiscal year."

(2) Failure to comply with the instructions: "Where practicable, reserves shall be shown to correspond with the classifications of property in [property schedule] separating especially depreciation, depletion, and amortization."

(3) Charges to reserves other than retirements, renewals, and replacements, not adequately described as required by instructions.

(j) *Schedule of intangible assets.* (1) Intangible assets not listed by major classes as required by instructions.

(2) Failure to state policy with respect to provisions for depreciation and amortization of intangible assets in cases where a separate schedule for such reserves is not provided.

(k) *Schedule of reserve for depreciation and/or amortization of intangible assets.* (1) Failure to comply with instructions: "State the company's policy with respect to the provisions for depreciation and amortization of intangible assets, or reserves created in lieu thereof."

(l) *Schedule of funded debt.* (1) Each issue of funded debt not designated fully as required by instructions.

(m) *Schedule of reserves.* (1) Failure to reflect all changes in reserves during the year and to properly describe major charges thereto.

(n) *Schedule of capital stock.* (1) Failure to list each issue of capital stock of all corporations in a consolidated group, whether eliminated in consolidation or not.

(2) Treatment of unissued stock as treasury stock.

(o) *Schedule of surplus.* (1) Failure to show division of surplus into classes when required by instructions.

(2) Analysis of surplus account not included either in balance sheet or as a continuation of the profit and loss statement, or in a schedule referred to in the balance sheet.

(3) Failure to describe in detail miscellaneous additions to and deductions from surplus.

(p) *Schedule of analysis of certain expenses in profit and loss statement.* (1) Amounts charged to costs and those charged to other profit and loss items not segregated.

(2) Failure to report in this schedule all expenses pertaining to maintenance and repairs.

(3) Items in this schedule at variance with other statements or schedules.

(q) *Schedule of income from dividends.* (1) Failure to show as required in column C of this schedule the "amount of equity in net profit and loss for the fiscal year" of affiliates, notwithstanding the fact that no dividends were received during the year from affiliates.

(2) Failure to show separately for each affiliate the "amount of dividends" and the "amount of equity in net profit and loss for the fiscal year" when registrant does not meet requirements that these items may be reported in total only when substantially all the stock and funded debt of the subsidiaries are held within the affiliated group. [Accounting Series Release No. 7, May 16, 1938]

§ 211.8 *Creation by promotional companies of surplus by appraisal.* In connection with a registration statement, an industrial company in its promotional stages with no record of business or earning capacity, filed a balance sheet in which property, plant, and equipment, acquired in an arm's length transaction at a cost of $200,000, was carried at $720,042.81 which represented its "sound value" derived from an independent appraisal of the estimated "replacement value new less (observed) depreciation." Thus the balance sheet figure exceeded cost by $520,042.81, which excess was carried as "surplus arising from revaluation of property."

In the appraisal report filed, the term "sound value" was qualified by the appraiser as being "The value for use by a going concern having prospects for the profitable use, at normal plant capacity, of the properties appraised."

The registrant was required to amend its balance sheet to eliminate the surplus and to show the fixed assets at cost. [Accounting Series, Release No. 8, May 20, 1938]

§ 211.9 *Presentation of stock having preferences on involuntary liquidation in excess of par or stated value.* Inquiry has been made with respect to the proper presentation in statements filed with the Commission of preferred or other senior classes of capital stock having preferences on involuntary liquidation in excess of the par or stated value. In such cases the method of presentation is of importance in order to reflect fully and adequately the equities of the various classes of stockholders, and to indicate the status of surplus particularly from a dividend standpoint.

As required by the regulations of the Commission there should be set forth in the balance sheet for each class of stock (1) the number of shares (a) authorized and (b) outstanding; (2) the par value per share or, if no par value, the stated or assigned value per share, if any; and (3) the aggregate capital stock liability thereof. In addition, it is my[1] opinion that in the case of preferred stock the preferences on involuntary liquidation

[1] Chief Accountant.

if other than the par or stated value, and the dividends in arrears, if any, should be shown (preferably in the balance sheet) both per share and in the aggregate for each class of such stock.

As a means of further disclosure when the excess involved is significant there should be shown in the balance sheet or in footnotes thereto (1) the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value; (2) a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital and the surplus, if such is the case; and (3) a statement as to the existence of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred stock exceeds its par or stated value.

The Securities and Exchange Commission also issued today the following statement of administrative policy in connection with the problem discussed in the above opinion.

In addition to requiring disclosure of the pertinent facts outlined in the above opinion, it is the administrative policy of the Commission when the excess involved is significant to require as a means of further disclosure that there be filed as an exhibit an opinion of counsel as to whether there are any restrictions upon surplus by reason of the difference between the preference of the preferred stock on involuntary liquidation and its par or stated value and also as to any remedies available to security holders before or after the payment of any dividend that would reduce surplus to an amount less than the amount by which the aggregate preference of such stock on involuntary liquidation exceeds its aggregate par or stated value. Such opinion of counsel should set forth any applicable constitutional and statutory provisions and should refer to any decisions which, in the opinion of counsel, are controlling. [Accounting Series Release No. 9, December 23, 1938]

§ 211.10 *Treatment of unamortized bond discount and expense applicable to bonds retired prior to maturity with proceeds from sale of capital stock.* Question has frequently been raised as to the proper treatment to be accorded unamortized debt discount and expense applicable to bonds which, prior to maturity, have been retired by the use of funds derived from the sale of capital stock. As generally presented, the inquiry relates to the propriety of carrying such unamortized debt discount and expense as a deferred charge and amortizing it over the remaining portion of the original life of the retired bonds.

While it may be permissible to retain on the books and amortize any balance of discount and expense applicable to bonds refunded by other evidences of indebtedness, similar treatment is not ordinarily acceptable, in my[1] opinion, when funds used to retire the existing bonds are derived from the sale of capital stock. In such cases it is my opinion that, as a general rule, sound and generally accepted accounting principles and practice require that the unamortized balance of the debt discount and expense applicable to the retired bonds should be written off by a charge to earnings or earned surplus, as appropriate, in the accounting period within which the bonds were retired. [Accounting Series, Release No. 10, December 23, 1938].

§ 211.11 *Consolidation of foreign subsidiaries of domestic corporations.* Inquiry has been made as to the propriety of including in consolidation with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies, or whose assets and operations are endangered by the war conditions prevailing abroad.

Foreign currency restrictions and war conditions are of such significance with respect to subsidiaries operating in affected territories as to require, in my[1] opinion, that registrants consider carefully their policy with respect to the inclusion of such subsidiaries in consolidated financial statements. It is my opinion in general that the consolidation of such foreign subsidiaries with the domestic parent and other domestic or foreign subsidiaries may be misleading. However, if, notwithstanding the existence of exchange restrictions and war conditions affecting certain foreign subsidiaries at the time the financial statements are prepared, the inclusion of such foreign subsidiaries in the consolidated statements is considered desirable and in the particular case will not prevent a clear and fair presentation of the financial condition and the results of operations of the registrant and its subsidiaries, their inclusion is ordinarily permissible. If included, however, disclosure should be made as to the effect, insofar as this can be reasonably determined, of foreign exchange restrictions and war conditions upon the consolidated financial position and operating results of the registrant and its subsidiaries.

In any case, the existence of currency restrictions and war conditions requires that careful consideration should also be given to the question of providing, and, if provision appears necessary, the extent of such provision, for impairment of the registrant's investment in such foreign subsidiaries by reason of the prevailing conditions and losses suffered by such subsidiaries. [Accounting Series Release No. 11, January 10, 1940]

§ 211.12 *Adoption of Regulation S–X (17 CFR, Part 210)—Amendments to Form 15*[2] *and Form 17 (17 CFR, 249.15, 217).* In connection with the adoption of Regulation S–X (17 CFR, Part 210), the following statement was made.

> The new single accounting regulation will be substituted for the several existing sets of accounting instructions which have heretofore applied to the various forms. Moreover, the new regulation will have the effect of simplifying amendments and interpretations of accounting rules, inasmuch as such amendments and interpretations will apply to a single regulation instead of to a variety of requirements.

In general, the new regulation constitutes a codification of existing instructions as to the form and contents of financial statements as now contained in each of the several forms listed. Instructions as to the dates and periods for which financial statements are required to be filed, however, will be found in the respective forms.

As now organized, the regulation is subdivided into 12 articles. The first 4 articles contain rules of general application. The next 6 articles prescribe, respectively, the form and content of financial statements for commercial and industrial companies, investment companies, insurance companies, committees issuing certificates of deposit, bank holding companies, and natural persons. The remaining articles deal with the form and content of surplus statements and supplementary schedules. A comprehensive table of contents is included.

Some new requirements have been added in the new regulation, principally with a view to obtaining more informative disclosure as to such accounting policies as depreciation, depletion, and maintenance and as to such matters as advances to and from affiliates, directors, and officers. Additional flexibility to the requirements has been given through extension of the rules permitting the elimination of schedules and special information when the amounts involved are not material.

The new regulation incorporates a considerable number of the many well-considered and helpful suggestions received from the large group of accountants, registrants, and others, including representatives of the professional societies, to whom a tentative revision of the instructions was made available.

In view of the pending proceedings in the matter of *McKesson and Robbins, Incorporated,* and several other cases, the rules governing certification by accountants, although altered and clarified in some respects, have been retained in substantially the form now found in the General Rules and Regulations under the Securities Act of 1933 (17 CFR, Part 239) and the several major forms under the 1933 and 1934 Acts. Upon completion of these proceedings, however, such rules are to be reconsidered with a view to revisions deemed necessary as a result of these cases.

The amendment to Form 15 and Form 17 and to the related instruction books is not reproduced here. [Accounting Series Release No. 12, February 21, 1940]

§ 211.13 *Form of accountants' certificate.* In a recent case a registrant had not maintained cash books, journals, other books of original entry or ledgers during the period covered by the financial statements filed by it with the Commission. Its files, however, contained original underlying data such as canceled checks, check stubs, bank statements, purchase orders, vendors' invoices, sales orders, and duplicate sales invoices.

In order to prepare financial statements it was deemed necessary by the independent accountants who certified the statements that the cash transactions and sales be recorded in books of original entry and in turn posted to a general

[1] Chief Accountant.

[2] Rescinded August 28, 1942.

ledger and that the books then be adjusted to an accrual basis. The entry and analysis of the transactions in formal books of account were carried out by one of the firm's junior accountants, loaned on a per diem basis, and by an officer of the company. The accountants maintained that this preliminary work consisted merely of classifying and summarizing records of transactions prepared by employees of the company at the time of the transaction. However, in many cases notations as to the purpose of disbursements had not been made on the check stubs contemporaneously with the transaction and accordingly it was necessary to rely in such cases upon the memory of an officer of the registrant in classifying and recording disbursements.

Upon the completion of this preliminary work the certifying accountants found that satisfactory determination had not been made of the balances in certain of the registrant's asset, liability and income and expense accounts. In the second or audit phase of the engagement the accountants therefore deemed it necessary to undertake work of a special nature and in some instances to make original determinations as to the amounts of such accounts.

As an illustration of the condition of the accounts, it may be pointed out that in making their examination the accountants determined that certain payments by customers had not been reflected in the accounts. Upon inquiry the accountants learned that the amounts unaccounted for had been received for the account of the registrant by a company affiliated with the registrant, or by an officer of the registrant, or by the registrant's principal vendor. These amounts were thereafter taken into consideration by the accountants in determining the balances due to the affiliate, the officer, and the supplier, as well as in accounting for the proceeds of sales and the balances due from customers. It thus appears that the accountants rather than employees of the registrant made the only realistic determination of these particular balances and that such determination was not based solely on underlying records of the registrant made by its employees, contemporaneously with the transaction.

After thus ascertaining that a balance of $54,000 was owing by the registrant to its affiliate as of December 31, 1938, the accountants requested a written confirmation of this amount from the affiliate. After a confirmation of the amount had been received, the accountants in the course of other necessary work learned of transactions which appeared to reduce the amount owing by the registrant to its affiliate to $39,000. Confirmation of this new amount, $15,000 less than the original balance, was also requested and obtained from the affiliate in due course. This difference was in large part accounted for by a deposit by the registrant with a vendor in connection with a purchase order. Subsequently, the vendor paid over to the registrant's affiliate the amount of the deposit as a refund. However, the officer responsible for the accounts of both the registrant and its affiliate apparently had no knowledge of this transaction until discovered by the accountants and called to his attention. Thus it appears that at no time had either of these companies independently determined, the status of the account between them. Similar confusion existed in the registrant's accounts with its officers and with its principal vendor.

Such circumstances as these led the accountants to extend their investigations to such an extent as to approach the character of a detailed audit. Upon the completion of the audit entries were prepared by the accountants for the purpose of adjusting the registrant's accounts to reflect the proper assets and liabilities and to place the accounts on an accrual basis. In my[1] opinion, these entries were of a character and extent that would not ordinarily be effected in the course of an audit such as is contemplated by the form of certificate furnished by these accountants.

Notwithstanding these unusual circumstances the certificate furnished by the accountants to accompany the financial statements filed with the Commission stated that:

> In connection therewith we examined or tested accounting records of the corporation and other supporting evidence and obtained information and explanations from its officers and employees and made substantial tests of the income and expense accounts for the period under review.

The certificate also stated that the financial statements:

> * * * fairly present, in accordance with accepted principles of accounting consistently maintained by the corporation during the period under review its position * * * and the results of its operations * * *.

Disclosure of certain of the procedures followed by the accountants was made in notes to the registrant's statement of profit and loss. In addition various notes to the registrant's balance sheet contained partial disclosure as to the scope of the accountants' audit with respect to particular balance sheet accounts.

In my opinion when a registrant during the period under review has not maintained records adequate for the purpose of preparing comprehensive and dependable financial statements, that fact should be disclosed. If, because of the absence or gross inadequacy of accounting records maintained by a registrant, it is necessary to have essential books of account prepared retroactively and for the accountant to enlarge the scope of the audit to the extent indicated in order to be able to express his opinion, these facts also should be disclosed, and I[1] believe it is misleading, notwithstanding partial disclosure by footnotes as in the instant case, to furnish a certificate which implies that the accountant was satisfied to express an opinion based on a test-check audit.[2] Moreover, it is misleading, in my opinion, to state or imply that accepted principles of accounting have been consistently followed by a registrant during the period under review if in fact during such period books of account were not maintained by a registrant or were grossly inadequate, or if it has been necessary for the accountant to make pervasive and extraordinary adjustments of the character under consideration. [Accounting Series Release No. 13, February 20, 1940]

§ 211.15 *Description of surplus accruing subsequent to effective date of quasi-reorganization.* Question has frequently been raised as to the proper description of the earned surplus account subsequent to the effective date of a quasi-reorganization" I[1] refer to the corporate procedure in the course of which a deficit is charged to capital surplus previously existing or arising in the course of the quasi-reorganization.

It is my opinion that sound accounting practice ordinarily requires that a clear report be made to stockholders of the proposed restatements and that their formal consent thereto be obtained. In such a situation it is also essential, in my opinion, that full disclosure of the procedure be made in the financial statements for the fiscal year involved and that any subsequent statements of surplus should designate the point of time from which the new earned surplus dates.

Furthermore, in view of the importance of such proceedings, I am of the opinion that until such time as the results of operations of the company on the new basis are available for an appropriate period of years (at least 3) any statement or showing of earned surplus should, in order to provide additional disclosure of the occurrence and the significance of the quasi-reorganization, indicate the total amount of the deficit and any charges that were made to capital surplus in the course of the quasi-reorganization which would otherwise have been required to be made against income or earned surplus.

Reference is also made to the provisions of Accounting Series Release No. 16 (17 CFR, 211.16) which indicates the further disclosures that in my opinion are necessary when the transfer of a deficit to capital surplus has been effected by resolution of the board of directors but without approval of the stockholders, such action being permissible under the applicable state law. [Accounting Series Release No. 15, March 16, 1940]

§ 211.16 *Disclosure of charge of deficit to capital surplus without approval of stockholders.* Inquiry has frequently been made as to the disclosure necessary in financial statements filed with the Commission under the Securities Act of

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[1] Chief Accountant.

[2] In this connection it should be noted that under somewhat similar circumstances the Commission in stop-order opinions has previously held that an accountant certifying financial data is under a duty to disclose the existence of areas of information about which there is considerable doubt. See *Livingston Mining Company*, 2 S. E. C. 141, 148; *Platoro Gold Mines, Inc.*, 3 S. E. C. 872 (1938).

[3] Although not in question here, the status of accountants as independent experts may be jeopardized when employees of the certifying accountants prepare the registrant's ledgers and books of original entry or when the accountants' work becomes a substitute for management's accounting of its stewardship rather than a check upon that accounting. Cf. *Interstate Hosiery Mills, Inc.*, 4 S. E. C. 706 (1939).

1933 or the Securities Exchange Act of 1934 when a company has charged a deficit to capital surplus without approval of the stockholders. In a typical case it was indicated that a company on January 1, 1939, had a deficit of $800,000 and a capital surplus of $1,500,000 arising out of the excess of the amount paid in for its stock over the par value thereof and that earned surplus since January 1, 1939, amounted to $100,000. By resolution of the board of directors, dated January 16, 1939, but without approval of the stockholders, the deficit had been charged off to capital surplus. I[1] am informed that under the applicable state law it was permissible to effect this restatement without approval of the stockholders.

From the facts of this case it appeared that the company sought to effect a quasi-reorganization such as is referred to in Accounting Series Release No. 15 (17 CFR, 211.15). However, as there stated, it is my opinion that in such cases sound accounting practice ordinarily requires that a clear report be made to stockholders of the proposed restatement and that their formal consent thereto be obtained. If, however, under the applicable State law it is permissible to eliminate a deficit without obtaining the formal consent of stockholders and if such consent of stockholders is not obtained, it is necessary in my opinion to make a complete disclosure of all the attendant facts and circumstances and their effect on the company's financial position in each balance sheet and surplus statement filed with the Commission thereafter.

Under the circumstances of the case cited, it is my opinion that, to effect the minimum appropriate disclosure in the surplus accounts, information should be given in respect of subsequent earned surplus in approximately the following fashion:

Total deficit to Dec. 31, 1939	$700,000
Less deficit at Jan. 1, 1939, charged to capital surplus by resolution of the board of directors and without approval of stockholders, such action being permissible under the applicable State law	800,000
Earned surplus since Jan. 1 1939	100,000

As an additional disclosure in situations to which the provisions of this release are applicable it has been the administrative policy of the Commission to require that in the registration statement or other filing containing financial statements first reflecting such action by the directors there be included an explanation of the action taken and an indication of its possible effect on the character of future dividends. As an example of an appropriate disclosure, there may be cited the following paragraph:

It should be noted that on ------ by action of the board of directors, without action by the stockholders, the company charged off a $------ deficit in earned surplus against its capital surplus. This proceedure will permit the company in the future to reflect undistributed earnings subsequent to ------ as earned surplus, instead of as a reduction of the deficit charged off to capital surplus. One result of this procedure is to permit the distribution, as ordinary dividends, of earned surplus accruing subsequent to ------, without regard to the deficit charged off to capital surplus. Furthermore, if earnings subsequent to ------ are less than the deficit written off, distributions thereof may in effect represent distributions of capital or capital surplus.

In view of the fact that no statement of policy in such cases has previously been announced, the policy has been adopted of not insisting upon the additional disclosures outlined in the preceding paragraphs if the restatement involved occurred prior to December 31, 1938, or the beginning of the period for which financial statements are required in the particular filing, whichever is earlier. [Accounting Series Release No. 16, March 16, 1940]

§ 211.17 *Use of natural business year as basis for corporate reporting.* You have inquired as to the possibility, under the rules administered by the Commission, of changing from the calendar-year basis currently employed to a fiscal-year basis for your financial statements. You have also inquired as to the method of reflecting the changed fiscal year in the financial reports to be filed with this Commission. In this connection I[1] may point out that the rules of the Commission do not prescribe the use of any particular fiscal year for the financial statements required. However, the advantages to be obtained from the adoption of a fiscal-year-end date which coincides with the lowest point in the annual cycle of operations are clear and to my mind have never been shown to be outweighed by related disadvantages. Among the more important advantages there may be mentioned the probability of obtaining more complete and reliable financial statements since at the close of the natural business year incomplete transactions, and such items as inventories, would ordinarily be at a minimum. Mention may also be made of the fact that the general adoption of the natural business year would facilitate the work of public accountants by permitting them to spread much of their work throughout the calendar year, and thus aid them in rendering the most effective service to their clients.

In this connection, I call your attention to Rule X–13A–4 (17 CFR, 240.13a–4) of the General Rules and Regulations under the Securities Exchange Act of 1934 which includes, among other things, the following specific provisions as to the character of reports to be filed with the Commission after a change in the fiscal year. In the case of an interim period of less than 3 months no separate report is required. However, in such case, the next annual report is to cover the period up to the close of the following full fiscal year and is to show separate schedules and profits and loss statements for the interim period, as well as for such fiscal year. If the interim period is more than 3 months, a separate report comparable to the annual report is required to be filed. If the interim period is less than 6 months, the financial statements in such report need not be certified. However, if the statements are not certified, the next annual report shall include separate certified financial statements covering the interim period. You will also note that if the fiscal date is changed it is necessary, under the rule, to notify the Commission within 10 days thereafter. [Accounting Series, Release No. 17, March 18, 1940]

§ 211.19 *In the Matter of McKesson & Robbins, Inc.; Summary of findings and conclusions.* File No. 1–1435—Securities Exchange Act of 1934, section 21 (a).

This is a summary of our report on the McKesson & Robbins hearings held pursuant to our order of December 29, 1938, under Section 21 (a) of the Securities Exchange Act of 1934.

The order for the hearings was based upon evidence that the information set forth in the registration statement and annual reports of McKesson & Robbins, Incorporated, especially the financial statements and schedules included therein which were prepared and certified by Price, Waterhouse & Co., was materially false and misleading. We stated our purpose to be to determine:

(1) The character, detail and scope of the audit procedure followed by Price, Waterhouse & Co. in the preparation of the financial statements included in the said registration statement and reports;

(2) The extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied by Price, Waterhouse & Co. in the preparation of the said financial statements; and

(3) The adequacy of the safeguards inhering in the said generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements.

As directed, hearings commenced on January 5, 1939, and continued, with some necessary adjournments, through April 25, 1939. Throughout the hearings Price, Waterhouse & Co. were represented by counsel, as were all witnesses who desired counsel. Opportunity was accorded such counsel to examine witnesses called by the Commission and to call their own witnesses. In all, 46 witnesses were examined. Of these, 9 were partners and employees of Price, Waterhouse & Co.; 12 were accountants of other firms called to testify as experts; 1 represented the Controllers Institute of America and 1 the American Institute of Consulting Engineers; 2 were from S. D. Leidesdorf & Co., accountants for the Trustee of McKesson & Robbins; 1 was a person who prepared many of the fictitious documents; 8 were employees of McKesson & Robbins; 11 were McKesson directors; and the last was a Commission investigator, who was called to identify certain documents. Throughout, Price, Waterhouse & Co., the witnesses, and their counsel extended the fullest cooperation in facilitating the conduct of the proceedings. The record of the public hearings is contained in 4,587 pages of testimony and 285 exhibits comprising in excess of 3,000 pages. Copies of the draft of the full report were submitted to Price, Waterhouse & Co. and their counsel, and their criticism and brief thereon were considered by the Commission before issuing this report.

[1] Chief Accountant.

The full report based upon the testimony and the exhibits and our study of recognized authoritative works on auditing consists of five sections in the text and five appendices as follows:

Section I. A summary of our findings and conclusions;

Section II. A brief statement reciting the manner in which the fraud came to the attention of the public and this Commission;

Section III. A description of the manner in which the manipulation of the accounts of McKesson & Robbins was carried out by Coster-Musica and his associates;

Section IV. A description of the audit conducted by Price, Waterhouse & Co.;

Section V. Our conclusions as to the Price, Waterhouse & Co. audit of McKesson & Robbins, Incorporated, and as to the adequacy of the safeguards inhering in generally accepted auditing practices;

Appendix A. A brief summary of action taken subsequent to the discovery of the fraud by accounting organizations and others interested in the work of independent public accountants;

Appendix B. A comparison of those sections of the English Companies Act of 1929 dealing with appointment of auditors and Horace B. Samuel's suggested amendments to those sections of that Act;

Appendix C. Our order for public hearings in this matter;

Appendix D. A list of all witnesses who testified, with the page numbers of their testimony;

Appendix E. A description of all exhibits introduced in the hearings.

(a) *Summary of prinicipal facts.* The securities of McKesson & Robbins, Incorporated (Maryland) were listed and traded on the New York Stock Exchange and registered under the Securities Exchange Act of 1934. Financial statements of the Corporation and its subsidiaries for the year ended December 31, 1937 (the last before the disclosure of the fraud hereinafter described), certified by Price, Waterhouse & Co., filed with this Commission and the New York Stock Exchange, and issued to stockholders reported total consolidated assets in excess of $87,000,000. Approximately $19,000,000 of these assets are now known to have been entirely fictitious. The fictitious items consisted of inventories, $10,000,000; accounts receivable, $9,000,000; and cash in bank, $75,000; and arose out of the operation at the Bridgeport offices of a wholly fictitious foreign crude drug business shown on the books of the Connecticut Division of McKesson & Robbins, Incorporated (Maryland) and McKesson & Robbins, Limited (Canada), one of its subsidiaries. For the year 1937, fictitious sales in these units amounted to $18,247,020.60 on which fictitious gross profit of $1,801,390.60 was recorded. At the time of the exposure of the fraud on or about December 5, 1938, the fictitious assets had increased to approximately $21,000,000.

The fraud was engineered by Frank Donald Coster, president of McKesson & Robbins since its merger with Girard & Co., Inc., in November 1926. In reality Coster was Philip M. Musica who, under the latter name, had been convicted of commercial frauds. In carrying out the fraud Coster, in the later years, was assisted principally by his three brothers: George E. Dietrich, assistant treasurer of the Corporation, who was in reality George Musica; Robert J. Dietrich, head of the shipping, receiving, and warehousing department of McKesson & Robbins at Bridgeport, Conn., who was in reality Robert Musica; and George Vernard, who was in reality Arthur Musica and who managed the offices, mailing addresses, bank accounts and other activities of the dummy concerns with whom the McKesson companies supposedly conducted the fictitious business.

To accomplish the deception, purchases were pretended to have been made by the McKesson companies from five Canadian vendors, who thereafter purportedly retained the merchandise at their warehouses for the account of McKesson. Sales were pretended to have been made for McKesson's account by W. W. Smith & Company, Inc., and the goods shipped directly by the latter from the Canadian vendors to the customers. Payments for goods purchased and collections from customers for goods sold were pretended to have been made by the Montreal banking firm of Manning & Company also for the account of McKesson. W. W. Smith & Company, Inc., Manning & Company, and the five Canadian vendors are now known to have been either entirely fictitious or merely blinds used by Coster for the purpose of supporting the fictitious transactions.

Invoices, advices, and other documents prepared on printed forms in the names of these firms were used to give an appearance of reality to the factitious transactions. In addition to this manufacture of documents, a series of contracts and guaranties with Smith and Manning and forged credit reports on Smith were also utilized. The foreign firms to whom the goods were supposed to have been sold were real but had done no business of the type indicated with McKesson.

The fictitious transactions originated early in the life of Girard & Co., Inc., Coster's predecessor concern, incorporated on January 31, 1923, and increased until they reached the proportions mentioned above. The manner of handling the transactions described above was the one in vogue since the middle of 1935. Prior to that time the fictitious goods were supposed to have been physically received at and reshipped from the Bridgeport plants of McKesson. And prior to 1931 McKesson made actual cash payments directly for the fictitious purchases, which at that time were supposed to have been made from a group of domestic vendors, but recovered a large part of this cash purportedly as collections on the fictitious sales. The change from using actual cash to the supposed clearance through Manning & Company was not effected abruptly but for some time after 1931 both systems were used. The Canadian vendors, however, were used only in connection with the Manning clearance system. From the report of the accountant for the trustee in reorganization of McKesson & Robbins, Incorporated, it appears that out of an actual cash outgo from the McKesson companies in connection with these fictitious transactions of $24,777,851.90 all but $2,869,482.95 came back to the McKesson companies in collection of fictitious receivables or as cash transfers from the pretended bank of Manning & Company.

(b) *Summary of conclusions as to individual auditing procedures.* Our conclusions as to the individual auditing procedures are developed in detail in Section V of our report. The full discussion of each topic should be consulted for the basis and complete statement of the conclusions which we here summarize.

(1) *Appointment and responsibility of auditors; determination of the scope of the engagement.* All appointments of Price, Waterhouse & Co. as auditors for Girard & Co., Inc., and the successor McKesson companies were made by letter from Coster or the comptroller, McGloon, near the close of the year to be audited. The testimony of the directors is that with rare exceptions members of the board had no part in arranging for the audit and did not know the content either of the letters of engagement or of the long form report addressed to Coster, in which the character of the work was set forth.

While the appointment of Price, Waterhouse & Co. and the method of determining the scope of the engagement in this case was in accord with generally accepted practice, we do not feel that it insures to the auditor, in all cases, that degree of independence which we deem necessary for the protection of investors. Adoption of the following program, we feel, would aid materially in correcting present conditions:

(i) Election of the auditors for the current year by a vote of the stockholders at the annual meeting followed immediately by notice to the auditors of their appointment.

(ii) Establishment of a committee to be selected from nonofficer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement.

(iii) The certificate (sometimes called short-form report or opinion) should be addressed to the stockholders. All other reports should be addressed to the board of directors, and copies delivered by the auditors to each member of the board.

(iv) The auditors should be required to attend meetings of the stockholders at which their report is presented to answer questions thereon, to state whether or not they have been given all the information and access to all the books and records which they have required, and to have the right to make any statement or explanation they desire with respect to the accounts.

(v) If for any reason the auditors do not complete the engagement and render a report thereon, they shall, nevertheless, render a report on the amount of work they have done and the reasons for noncompletion, which report should be sent by the company to all stockholders.

In approaching his work with respect to companies which file with us or in which there is a large public interest, the auditor must realize that, regardless of what his position and obligations might have been when reporting to

managers or to owner-managers, he must now recognize fully his responsibility to public investors by including the activities of the management itself within the scope of his work and by reporting thereon to investors. The adoption of a program such as that outlined above should serve to secure recognition of these newly emphasized obligations of the auditor to public investors.

(2) *Organization and training of staff.* We have found that there is great similarity among accounting firms in the organization of the staff and assignments to engagements. We deplore, as do accounting firms, the necessity for recruiting large numbers of temporary employees during a very short busy season. This condition and the lack of training in the firm's methods which it ordinarily entails are inimical to attaining the best results from the auditors' services. A major improvement in this condition could be made by the general adoption by corporations of the natural business year for accounting purposes. The recruiting of temporary employees was more aggravated in Price, Waterhouse & Co. than in other comparable firms whose representatives testified as experts. This situation, coupled with the fact that Price, Waterhouse & Co. had a higher ratio of both permanent and peak staff per partner than other firms, leads us to the conclusion that Price, Waterhouse & Co. partners could not have given adequate attention to the training, development, and supervision of their staff.

(3) *Investigation of new clients.* The facts of this case suggest that for new and unknown clients some independent investigation should be made of the company and of its principal officers prior to undertaking the work. Such an inquiry should provide a valuable background for interpreting conditions revealed during the audit or, in extreme cases, might lead to a refusal of the engagement.

(4) *Review of the client's system of internal check and control.* We are convinced by the record that the review of the system of internal check and control at the Bridgeport offices of McKesson & Robbins was carried out in an unsatisfactory manner. The testimony of the experts leads us to the further conclusion that this vital and basic problem of all audits for the purpose of certifying financial statements has been treated in entirely too casual a manner by many accountants. Since in examinations of financial statements of corporations whose securities are publicly owned the procedures of testing and sampling are employed in most cases, it appears to us that the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized.

(5) *Cash.* The record is clear that the cash work performed on this engagement by Price, Waterhouse & Co. conformed in scope to the then generally accepted standards of the profession. It is equally clear to us that prior to this case many independent public accountants depended entirely too much upon the verification of cash as the basis for the whole auditing program and hence as underlying proof of the authenticity of all transactions. Where, as here, during the final three years of the audit, physical contact with the operations of a major portion of the business was limited to examination of supposed documentary evidence of transactions carried on completely offstage through agents unknown to the auditors save in connection with the one engagement, it appears to us that the reliability of these agents must be established by completely independent methods. Confirmation of the bank balance under these circumstances was proven in this case to be an inadequate basis for concluding that all the transactions were authentic.

(6) *Accounts receivable.* Viewed as a whole the audit program for accounts receivable as used by Price, Waterhouse & Co. conformed to then generally accepted procedures for an examination of financial statements although confirmation of the accounts was not included in the program. The facts of this case, however, demonstrate the utility of circularization and the wisdom of the profession in subsequently adopting confirmation of accounts and notes receivable as a required procedure "* * * wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern * * *."

(7) *Intercompany accounts.* The record indicates that it is not enough for auditors to reconcile intercompany balances and that valuable insight into the company's manner of doing business may be gained by a review of the transactions passed through such accounts during the year. Best practice we believe requires the latter procedure. In this case the recommended procedure, although employed to some extent, was not applied in a thoroughgoing and penetrating manner.

(8) *Inventories.* Price, Waterhouse & Co.'s audit program for the verification of inventories was essentially that which was prescribed by generally accepted auditing practice for the period. However, we find that a substantial difference of opinion existed among accountants during this time as to the extent of the auditors' duties and responsibilities in connection with physical verification of quantities, quality, and condition. Price, Waterhouse & Co., in common with a substantial portion of the profession, took the position that the verification of quantities, quality, and condition of inventories should be confined to the records. There was, however, a substantial body of equally authoritative opinion which supported the view, which we endorse, that auditors should gain physical contact with the inventory either by test counts, by observation of the inventory taking, or by a combination of these methods. Meticulous verification of the inventory was not needed in this case to discover the fraud. We are not satisfied, therefore, that even under Price, Waterhouse & Co.'s views other accountants would condone their failure to make inquiries of the employees who actually took the inventory and to determine by inspection whether there was an inventory as represented by the client. We commend the action of the profession in subsequently adopting, as normal, procedures requiring physical contact with clients' inventories.

(9) *Other balance sheet accounts.* (i) The testimony in respect to the auditing of plant accounts suggests that some accountants, including Price, Waterhouse & Co., could, with advantage, devote more attention to physical inspection than has been general practice with them in the past.

(ii) The work in respect to liabilities was in accord with generally accepted practice but suggests the desirability of independent inquiry when large purchases are made from a very few otherwise unknown suppliers.

(iii) The record demonstrates the necessity of a thorough understanding of the client's tax situation which apparently was not obtained by Price, Waterhouse & Co. in regard to the application of the Canadian law.

(10) *Profit and loss accounts.* We are of the opinion that such analyses of profit and loss accounts as were made were applied to improper combinations of departments with the result that significant relationships were concealed. It is our conclusion that the independent accountant is derelict in his duty if he does not insist upon having proper analyses available for his review. It is our opinion that best practice supports this view.

(11) *The wholesale houses.* It must be emphasized again that although the bulk of this report deals with the two units in which the fraud occurred, which were under the direct charge of the Company's principal officer, some material bearing on the work in the other units, mostly wholesale houses, was introduced at the hearings. As to this portion of the audit, which constituted the larger part of the Price, Waterhouse & Co. engagement, covering for 1937 approximately 70 percent of the reported assets and 85 percent of the net sales, and which occupied approximately 97 percent of the auditors' time, it appears that the work in these other units was carried out in a thorough fashion in accordance with generally accepted auditing practice prevailing during the periods involved, including limited inspections of inventories but no confirmation of accounts and notes receivable.

(12) *Review procedure.* The mechanics of the review procedure as carried out by Price, Waterhouse & Co. on this engagement were substantially the same as those of the majority of accounting firms. However, it is our opinion that the partner in charge in this case was not sufficiently familiar with the business practices of the industry in question and was not sufficiently concerned with the basic problems of internal check and control to make the searching review which an engagement requires.

(13) *The certificate.* The form of certificate used by Price, Waterhouse & Co. conformed to generally accepted practice during the period of the Girard-McKesson engagement. We are of the opinion that the form of the accountant's certificate should be amended to include in addition to the description of the scope of the audit a clear certification that the audit performed was, or

was not, adequate for the purpose of expressing an independent opinion in respect to the financial statements. If any generally accepted procedures are omitted these should be named together with the reasons for their omission. Exceptions to the scope of the audit or to the accounts must be clearly designated as "exceptions."

(14) *Circumstances available for the auditors' observation in the procedures and records of the Girard-McKesson companies which might have led to the discovery of the fraud.* The firm of Price, Waterhouse & Co. for 14 years served as independent public accountants for F. Donald Coster's enterprises. Within range of the procedures which they followed there were numerous circumstances which, if they had been recognized and carefully investigated by resourceful auditors, should have revealed the gross inflation in the accounts.

We can not and do not say that every one of the items should have been recognized by the auditors as significant and, if investigated, would have led to the exposure of the gross falsification of the financial statements. It is also quite conceivable that for a time many could have been and perhaps were explained away. We do believe, however, that the number of items and the period of time over which some of them repeated themselves gave ample opportunity for detection by alert and inquisitive auditors.

(c) *Conclusion.* In conclusion we reproduce the summary from the last section of our report:

Our conclusion based upon the facts revealed by the record, the testimony of the expert witnesses, and the writings of recognized authorities is that the audits performed by Price, Waterhouse & Co. substantially conformed, in form, as to the scope and procedures employed, to what was generally considered mandatory during the period of the Girard-McKesson engagements. Their failure to discover the gross overstatement of assets and of earnings is attributable to the manner in which the audit work was done. In carrying out the work they failed to employ th. degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well-known and authoritative works on auditing. In addition, the overstatement should have been disclosed if the auditors had corroborated the Company's records by actual observation and independent confirmation through procedures involving regular inspection of inventories and confirmation of accounts receivable, audit steps which, although considered better practice and used by many accountants, were not considered mandatory by the profession prior to our hearings.

Price, Waterhouse & Co. maintain that a balance sheet examination is not intended and cannot be expected to detect a falsification of records concealing an inflation of assets and of earnings if accomplished by a widespread conspiracy carried on by the president of a corporation, aided by others within and without the recognized ranks of a corporation's operating personnel, and that no practical system of internal check can be devised the effectiveness of which cannot be nullified by criminal collusion on the part of a chief executive and key employees. Such cases are so rare, in their opinion, that there is no economic justification for the amount of auditing work which would be required to increase materially the protection against it.

The inference to be drawn from this position and from statements made by others in connection with this case is that a detailed audit of all transactions as distinguished from an examination based on tests and samples would have been necessary to reveal the falsification. However, as we view the situation in this case, a detailed audit of all transactions carried out by the same staff would merely have covered a larger volume of the same kinds of fictitious documents and transactions. While this might have brought under review more instances of what we have listed as circumstances suggesting further investigation, there is little ground for believing that this alone would have raised any greater question as to the authenticity of the transactions.

Moreover, we believe that, even in balance sheet examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits whether resulting from collusive fraud or otherwise. We believe that alertness on the part of the entire staff, coupled with intelligent analysis by experienced accountants of the manner of doing business, should detect overstatements in the accounts, regardless of their cause, long before they assume the magnitude reached in this case. Furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted. Without underestimating the important service rendered by independent public accountants in their review of the accounting principles employed in the preparation of financial statements filed with us and issued to stockholders, we feel that the discovery of gross overstatements in the accounts is a major purpose of such an audit even though it b conceded that it might not disclose every minor defalcation. In short, Price, Waterhouse & Co.'s failure to uncover the gross overstatement of assets and of earnings in this case should not, in our opinion, lead to general condemnation of recognized procedures for the examination of financial statements by means of tests and samples.

We do feel, however, that there should be a material advance in the development of auditing procedures whereby the facts disclosed by the records and documents of the firm being examined are to a greater extent checked by the auditors through physical inspection or independent confirmation. The time has long passed, if it ever existed, when the basis of an audit was restricted to the material appearing in the books and records. For many years accountants have in regularly applied procedures gone outside the records to establish the actual existence of assets and liabilities by physical inspection or independent confirmation. As pointed out repeatedly in this report, there are many ways in which this can be extended. Particularly, it is our opinion that auditing procedures relating to the inspection of inventories and confirmation of receivables, which, prior to our hearings, had been considered optional steps, should, in accordance with the resolutions already adopted by the various accounting societies, be accepted as normal auditing procedures in connection with the presentation of comprehensive and dependable financial statements to investors.

We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession adopting certain of the auditing procedures considered in this case. We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested in this report will not be made. Further, the adoption of the specific recommendations made in this report as to the type of disclosure to be made in the accountant's certificate and as to the election of accountants by stockholders should insure that acceptable standards of auditing procedure will be observed, that specific deviations therefrom may be considered in the particular instances in which they arise, and that accountants will be more independent of management. Until experience should prove the contrary, we feel that this program is preferable to its alternative—the detailed prescription of the scope of and procedures to be followed in the audit for the various types of issuers of securities who file statements with us—and will allow for further consideration of varying audit procedures and for the development of different treatment for specific types of issuers.

[Accounting Series Release No. 19, December 5, 1940]

§ 211.21 *Amendment of Rules 2–02 and 3–07 of Regulation S–X (17 CFR, 210.2–02, 210.3–07).* The text of this amendment is reflected in Regulation S–X (17 CFR, Part 210) as amended to and including October 18, 1944.

The following statement was made at the time these rules were amended:

At the time of the adoption of Regulation S–X it was stated that "In view of the pending proceedings in the matter of McKesson and Robbins, Incorporated, and several other cases, the rules governing certification by accountants, although altered and clarified in some respects, have been retained in substantially the form now found in the General Rules and Regulations under the Securities Act of 1933 and the several major forms under the 1933 and 1934 Acts. Upon completion of these proceedings, however, such rules are to be considered with a view to revisions deemed necessary as a result of these cases."

The form of the accountant's certificate was considered at some length in the Report of Investigation, In the matter of McKesson & Robbins, Inc. The following conclusions reached on this subject are quoted from pages 434–435 of the report.

"* * * it appears to us* that the following principles should be adopted respecting the form and content of accountants' certificates in order to avoid possibility of confusion in the future."

The work done should be described as the auditor sees fit and any desired information concerning the accounts may be stated. While we do not think that each audit step should necessarily be set forth, it is to be hoped that really descriptive language will be used as distinguished from a standard form based upon procedures set forth in a bulletin neither of which is referred to in the certificate. While the road is left clear to the auditor to describe in his own language what he has done and what he has found, we suggest one positive requirement in this connection. The certificate should state as part of the description of the scope of examination every generally recognized normal auditing procedure which has been omitted and the reasons for the omission.

We believe that, in addition to the present expression of opinion that the company's position and results of operations are fairly presented by the accounts, the accountant should certify that the examination conducted was not less than that necessary in order to form the foregoing opinion. This statement may well replace the one gen-

* The Commission.

erally in use in certificates prior to the present bearings in which the only reference to the examination in the opinion paragraph was in the words "based upon such examination" or "subject to the foregoing" following "In our opinion." Besides not definitely stating whether the examination was sufficient in scope, these words would seem to incorporate all prior references to the examination in the preceding paragraphs of the certificate and base the auditor's opinion thereupon without specifically stating whether those references were purely descriptive or in the nature of exceptions. Exceptions to the scope of the audit or to the accounts should be expressly so stated in the same sentence as the certification as to the scope of the audit and the opinion as to the accounts, respectively. Exceptions may be incorporated by reference in such sentences but must be specifically designated as "exceptions." If any required information has been withheld by the client or access to records denied these facts should, of course, be treated as exceptions.

We said above that the auditor should certify that the examination was not less than the required minimum of accepted practice both as to procedures and the manner of their application. While accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them, we do think they can and should certify that the examination, on which their opinion as to the financial statements was based, was at least equal to professional requirements.

Amendments of the rules as to accountants' certificates have for some time been the subject of correspondence and discussion between committees representing the American Institute of Accountants, the Controllers Institute of America, and the American Accounting Association, and numerous individual accountants and members of the Commission's staff. During this time the suggestions made by individuals as well as by the committees have been given careful consideration and a number of them embodied in drafts of the rules which have been made available to the cooperating committees and individuals for further criticism. Successive revisions and criticism have resulted in the revised rules now adopted by the Commission.

The revised Rule 2-02 (17 CFR, 210.2-02) sets forth requirements as to the contents of the accountant's certificate and is divided into four sections.

Section (a) states certain technical requirements and involves no change from previously existing rules.

Section (b) contains the requirements for the accountant's representations as to the nature of the audit which he has made. Under subsection (i) the accountant must give a reasonably comprehensive description of the scope of the audit which he has performed. In accordance with the opinion of the Commission in the McKesson report, the subdivision also requires that, if any generally recognized normal auditing procedures have been omitted with respect to significant items in the financial statements, such omissions shall be stated with a clear explanation of the reasons for such omission. It is contemplated that designation of procedures omitted would be confined to the primary auditing requirements which have been recognized as normal auditing procedure, as for example, the circularization of receivables, and would not extend to detailed or mechanical steps. Since in particular circumstances such omissions may be proper, the specification of such omissions and the reasons therefor in connection with the description of the audit would not be considered as exceptions or qualifications unless specifically so noted in connection with subsection (ii) which requires that the accountant shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. In referring to generally recognized normal auditing procedures the Commission has in mind those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as for example, the various accounting societies and governmental bodies having jurisdiction. In referring to generally accepted auditing standards the Commission has in mind, in addition to the employment of generally recognized normal auditing procedures, their application with professional competence by properly trained persons. The Commission further recognizes that the individual character of each auditing engagement and the facts disclosed through a vigilant, inquisitive, and analytical approach by the auditor may call for the extension of normal procedures or the employment of additional procedures. Therefore, subsection (iii) requires that the accountant also state whether he omitted any procedure deemed necessary by him under the circumstances of the particular case.

Paragraphs 2 and 3 of section (b) incorporate provisions of previous rules and add the requirement that "appropriate consideration shall be given to the adequacy of the system of internal check and control," thus emphasizing the importance of this basic element.

Section (c) concerning the opinion of the accountant as to the financial statements covered by the certificate and the accounting principles followed is for the most part a restatement and clarification of previous rules.

Section (d) includes an important change from previous rules, in that it requires in addition to a clear identification of all exceptions that, to the extent practicable, the effect of each exception on the related financial statements be given. A clear explanation of the effect on the financial statements of the use of accounting principles to which exception is taken is deemed necessary if the statements are not to be misleading to investors.

Rule 3-07 (17 CFR, 210.3-07) incorporates the new requirement that if "any significant retroactive adjustment of the accounts of prior years has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and if the * * * adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation." [Accounting Series Release No. 21, February 5, 1941]

§ 211.22 *Independence of accountants; Indemnification by registrant.* Inquiry has been made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act of 1933 or the Securities Exchange Act of 1934 may be considered to be independent if he has entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act of 1933, as amended, or at 'common law,' other than for their willful misstatements or omissions."

The Securities Act of 1933 requires statements to be certified by independent accountants and the Securities Exchange Act of 1934 gives the Commission power to require that the certifying accountants be independent. The requirement of independence is incorporated in the several froms promulgated by the Commission and is partially defined in Rule 2-01 (b) of Regulation S-X (17 CFR, 210.2-01 (b)) which reads: "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer or employee."

This concept of independence has also been interpreted in Accounting Series Release No. 2 (17 CFR, 211.2) and in several stop-order opinions. In the matter of Cornucopia Gold Mines, 1 S. E. C. 364 (1936), the Commission held that the certification of a balance sheet prepared by an employee of the certifying accountants, who was also serving as the unsalaried but principal financial and accounting officer of the registrant, and who was a shareholder of the registrant, was not a certification by an independent accountant. In the matter of Rickard Ramore Gold Mines, Ltd., 2 S. E. C. 377 (1937), an accountant was held to be not independent by reason of the fact that he was an employee or partner of another accountant who owned a large block of stock issued to him by the registrant for services in connection with its organization. In the matter of American Terminals and Transit Company, 1 S. E. C. 701 (1936), conscious falsification of the facts by the certifying accountant was held to rebut the presumption of independence arising from an absence of direct interest or employment. In the matter of Metropolitan Personal Loan Company, 2 S. E. C. 803 (1937), it was held that accountants who completely subordinate their judgment to the desires of their client are not independent.

In the matter of *A. Hollander & Son, Inc.*, 8 S. E. C. 586 (1941), the Commission held that an accountant could not be considered independent when the combined holdings of himself, one of his partners, and their wives in the stock of the registrant had a substantial aggregate market value and constituted over a period of 4 years from 1½ percent to 9 percent of the combined personal fortunes of these persons. It was also held to be evidence of lack of independence, with respect to the registrant, that the accountant had made loans to, and received loans from, the registrant's officers and directors. In the same case, the evidence showed that registrant's president, over a period of years, had used the accountant's name as a false caption for an account on the books of an affiliate not audited by such accountant and that upon learning of these facts the accountant protested and procured a letter of indemnification in connection with such use. It was held that this continued use of the accountant's name, after his protest, and the overriding attitude apparently assumed by the registrant's president in this matter, constituted additional evidence of lack of independence.

I [1] think the purpose of requiring the certifying accountant to be independent is clear. Independence tends to assure the objective and impartial consideration which is needed for the fair solution of the complex and often controversial matters that arise in the ordinary course of audit work. On the other hand, bias due to the presence of an entangling affiliation or interest, inconsistent with proper professional relations of accountant and client, may cause loss of objectivity and impartiality and tends to cast doubt upon the reliability and fairness of the accountant's opinion and of the financial statements themselves. Lack of independence, moreover, may be established otherwise than solely by proof of misstatements and omissions in the financial statements. As was said in a recent opinion of the Commission: [2]

> We cannot, however, accept the theory advanced by counsel for the intervenors that lack of independence is established only by the actual coloring or falsification of the financial statements or actual fraud or deceit. To adopt such an interpretation would be to ignore the fact that one of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his intimate nonprofessional contacts with his client. The requirement for certification by an independent public accountant is not so much a guarantee against conscious falsification or intentional deception as it is a measure to insure complete objectivity. It is in part to protect the accounting profession from the implication that slight carelessness or the choice of a debatable accounting procedure is the result of bias or lack of independence that this Commission has in its prior decisions adopted objective standards. Viewing our requirements in this light, any inferences of a personal nature that may be directed against specific members of the accounting profession depend on the facts of a particular case and do not flow from the undifferentiated application of uniform objective standards.

While Rule 2-01 (b) (17 CFR, (210.2-01 (b)) quoted above designates certain relationships that will be considered to negative independence, it is clear from the opinions cited that other situations and relationships may also so impair the objectivity and impartiality of an accountant as to prevent him from being considered independent for the purpose of certifying statements required to be filed by a particular registrant.

In the particular case cited the accountant was indemnified and held harmless from all losses and liabilities arising out of his certification, other than those flowing from his own willful misstatements or omissions. When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, it is my opinion that one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened.[3] Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, on the basis of the facts set forth in your inquiry, it is my opinion that the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation. [Accounting Series Release No. 22, March 14, 1941]

§ 211.23 *Treatment of Federal income and excess profits taxes.* Several inquiries have been received with respect to the manner in which the normal income tax, defense tax, declared value excess profits tax, and the excess profits tax levied pursuant to the Second Revenue Act of 1940 should be reflected in profit and loss or income statements which are filed with this Commission and to which Regulation S-X (17 CFR, Part 210) is applicable.

It is my [1] opinion that in such statements Section 15 of Rule 5-03 (17 CFR, 210.5-3) contemplates that the normal income, defense, and declared value excess profits taxes should be included under subsection (a) and the excess profits tax prescribed by the Second Revenue Act of 1940 should be included under subsection (b). A similar segregation is contemplated by the comparable provisions of Rules 6-03 and 7-05 (17 CFR, 210.6-03, 210.7-05). [Accounting series Release No. 23, April 9, 1941]

§ 211.25 *Procedure in quasi-reorganization.* Inquiry has been made from time to time as to the conditions under which a quasi-reorganization may be said to have been effected. The term quasi-reorganization has come to be applied in accounting to the corporate procedure in the course of which a company, without the creation of a new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization. Certain aspects of the problem have previously been discussed in published opinions of the Commission [9] and in three published opinions of the chief accountant.[10] In the amendments to Rules 6-02, 12-19, 12-20, 12-21, and 12-22 of Regulation S-X (17 CFR, 210.6-02, 210.12-19, 210.12-20, 210.12-21, 210.12-22) which were recently adopted in conjunction with the promulgation of a form for registration of investment companies under the Investment Company Act of 1940, the term is used in definition of circumstances under which there may be shown in lieu of the cost of securities the written-down amounts resulting from quasi-reorganization.

It has been the Commission's view for some time that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:

(1) Earned surplus as of the date selected is exhausted;

(2) Upon consummation of the quasi-reorganization no deficit exists in any surplus account;

(3) The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions;

(4) The procedure accomplishes with respect to the accounts substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital

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[1] Chief Accountant.

[2] In the matter of A. Hollander & Son, Inc., *supra*.

[3] It may be noted that sec. 152 of the English Companies Act (1929) makes comparable indemnity agreements void:

"152. Subject as hereinafter provided, any provision, whether contained in the article of a company or in any contract with a company or otherwise, for exempting any director, manager or officer of the company, or any person (whether an officer of the company or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company shall be void."

[9] See particularly Associated Gas and Electric Corporation, 6 S. E. C. 605 (1940).

[10] Accounting Series Releases Nos. 1 (17 CFR, 211.1), discussing the propriety of charging losses to capital surplus rather than earned surplus; 15 (17 CFR, 211.15), discussing the nature of the disclosure to be made in subsequent statements; and 16 (17 CFR, 211.16), discussing the disclosure necessary where consent of stockholders was not obtained, such action being permissible under the applicable State law.

and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

It is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relative permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. It is also implicit in a procedure of this kind that it is not to be employed recurrently but only under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole or principal purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses.

In the case of the quasi-reorganization of a parent company it is an implicit result of such procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Hence, dividends subsequently received from subsidiaries should be treated as income only to the extent that they are declared by subsidiaries out of earnings subsequent to the effective date. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet [Accounting Series Relief No. 25, May 29, 1941]

§ 211.26 *Interpretation of Rule 5–02 of Regulation S–X (17 CFR, 210.5–02) regarding the omission of an analysis of registrant's surplus accounts.* You inquire whether the instruction relative to an analysis of surplus set forth in paragraph 34 (b) of Rule 5–02 of Regulation S–X (17 CFR, 210.5–02) implies that an analysis of the registrant's surplus accounts may be omitted when, pursuant to instructions such as those set forth under Item 8–I–A (2) (a) in the instruction book for Form 10–K, there may be filed in lieu of an individual profit and loss statement of the registrant, a consolidated statement of the registrant and certain totally held subsidiaries. The portion of the above instruction here pertinent reads as follows:

Provided, however, That in lieu of such profit and loss statement there may be filed a profit and loss statement consolidating the accounts of the registrant and one or more of its subsidiaries (hereinafter called "included subsidiaries"), if all the following conditions exist:

(i) The registrant is primarily an operating company;

(ii) Other than directors' qualifying shares, all classes of outstanding securities, other than those evidencing long-term or funded debt, of the included subsidiaries are owned in their entirety by the registrant and/or the included subsidiaries;

(iii) No one of the included subsidiaries owes to any person other than the registrant any long-term or funded debt of an amount which is significant in relation to the particular subsidiary;

(iv) The included subsidiaries are, in practical effect, operating divisions of the registrant; * * *

The above permission, you will note, extends only to the registrant's profit and loss statement and does not permit the omission of the registrant's balance sheet. Therefore, pursuant to such instructions, it would be permissible to omit supplementary schedules required to be filed in support of detailed items in profit and loss statements; but it would not be permissable to omit schedules required to be filed in support of particular balance sheet items, nor to omit analyses of the surplus accounts appearing on such balance sheet. Such balance sheet schedules and analyses should be filed for each period covered by the substituted consolidated profit and loss statements.

Item 34 (b) of Rule 5–02 of Regulation S–X (17 CFR, 210.5–02) to which you specifically refer reads in part as follows: "An analysis of each surplus account setting forth the information prescribed in Rule 11–02 (17 CFR, 210.11–02) shall be given for each period for which a profit and loss statement is filed * * *." As indicated in its preface, Regulation S–X (17 CFR, Part 210) relates to the form and content of financial statements, while the instructions to the applicable forms determine what financial statements are to be filed. The cited portion of Item 34 (b) of Regulation S–X (17 CFR, 210.5–02) must therefore be read in the light of the pertinent instructions, in the applicable form, as for example those quoted from Item 8 of Form 10–K (17 CFR, 249.310).

Accordingly, it is my[1] opinion that the language of Item 34 (b) should be considered as indicating the period or periods for which the required information must set forth and may not be construed as permitting the omission of an analysis of the registrant's surplus accounts. [Accounting Series, Release No. 26, July 1, 1941]

§ 211.27 *The nature of the examination and certificate required by paragraph (4) of Rule N–17F–1 and paragraph (7) of Rule N–17F–2 (17 CFR, 270.17f–1, 270.17f–2) under the Investment Company Act of 1940.* Inquiry has been made as to the nature of the examination and certificate required by paragraph (4) of Rule N17F–1 and paragraph (7) of Rule N–17F–2 (17 CFR, 270.17f–1, 270.17f–2) promulgated under the Investment Company Act of 1940.

Rule N–17F–2 (17 CFR, 270.17f–2) sets up certain standards to be followed by management investment companies registered under the Investment Company Act of 1940 which maintain in their own custody their portfolio securities and similar investments. Paragraph (7) of that rule is as follows:

Such securities and investments shall be verified by complete examination by an independent public accountant retained by such registered company at least three times during the fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company. A certificate of such accountant, stating that he has made an examination of such securities and investments and describing the nature and extent of the examination, shall be transmitted to the Commission promptly after each such examination.

The securities and investments referred to in the quoted paragraph are identified by paragraphs (1) and (2) of the rule as (a) securities on deposit in a vault or other depository maintained by a bank or other company whose function and physical facilities are supervised by Federal or State authority; (b) securities which are collateralized to the extent of their full market value; (c) securities hypothecated, pledged, or placed in escrow for the account of such registered company; and (d) securities in transit. The examination and certificate required by the quoted paragraphs should therefore cover all of the securities listed in paragraphs (1) and (2).

In order to make a complete examination of the securities, it is, in my[1] opinion, necessary for the accountant not only to make a physical examination of the securities themselves, or in certain cases to obtain confirmation, but also to reconcile the physical count or confirmation with the book records. Furthermore, in my opinion it is a necessary prerequisite to such a reconciliation that there have been made an appropriate examination of the investment accounts and supporting records, including an adequate check or analysis of the security transactions since the last examination and the entries pertaining thereto. While the certificate filed must describe the nature and extent of the examination made, it is not necessary that each step taken be set out; instead, there should be included in the certificate in general terms an appropriate description of the scope of the examination of the accounts and the physical examination or confirmation of the securities.

Finally, in order to meet the requirements of paragraph (7) of Rule N–17F–2 (17 CFR, 270.17f–2) the certificate should comply with the usual technical requirements as to dating, salutation and manual signature and, in addition to the description of the examination made, should set forth:

(a) The date of the physical count and verification, and the period for which the investment accounts and transactions were examined;

(b) A clear designation of the depository;

(c) Whether the examination was made without prior notice to the company; and

(d) The results of the examination.

Rule N–17F–1 (17 CFR, 270.17f–1) specifies the conditions under which a registered management investment company may place or maintain its securities and investments in the custody of a company which is a member of a national securities exchange. Paragraph (4) of that rule calls for periodic examinations of the securities and investments so placed or maintained and for certificates as to the verification thereof. In my opinion the requirements of such paragraph (4) involve substantially the same considerations as those of paragraph (7) of Rule N–17F–2 and the above discussion is therefore likewise applicable to the examination and certificate required by such paragraph (4). [Accounting Release Series No. 27, December 11, 1941]

§ 211.30 *Auditing of inventories under wartime conditions.* To avoid any possible interruption in the production or de-

[1] Chief Accountant.

livery of war materials, the Securities and Exchange Commission today announced the establishment of a liberalized policy with respect to its requirements regarding physical inventory verification by independent public accountants.

Where the customary taking of inventory (including observance or test-checking by auditors) would curtail production of war materials, such procedures may be omitted so long as all reasonable and practical alternative measures are taken by the company and its independent public accountants to assure the substantial fairness of inventory amounts stated in the financial statements and proper disclosure is made.

Whenever inquiries on this point have been received from registrants engaged in the production of war materials, it has been the policy to discuss with the registrant and its accountants the extent to which normal procedures may be followed without curtailment of production, and the extent to which it is reasonable and practicable to employ alternative procedures or to extend other normal procedures with a view to obtaining the most satisfactory possible determination and review of inventory amounts. Through the use of extended or substitute procedures, it has ordinarily been possible in these cases, for the independent public accountants to satisfy themselves as to the substantial fairness of the inventory amounts and thus to express their opinion without taking exception to the substantial fairness of the representations as to inventories, although their certificate indicated the extent to which the normal auditing procedures of observation or test-checking of the inventory had not been employed.

On the basis of such conferences and correspondence where full disclosure of the circumstances has been made in the financial statements and certificates, no objections have been raised to the omission of normal procedures with respect to statements for the current reporting period of companies engaged in the production of war materials.

The following statement of procedure, prepared by William W. Werntz, chief accountant, will be of assistance to registrants and their accountants faced with circumstances which make it necessary to curtail or omit certain normal auditing procedures as to inventories in order to avoid delay in production and delivery of war materials:

The taking of an inventory has always been considered an important part of the accounting of a corporation in reporting its position and the results of its operations. Observation of the taking of inventory or the test-checking of the inventory has for some time been recognized as a normal procedure to be followed by independent public accountants in audits made for the purpose of expressing their professional opinion as to whether the financial statements fairly reflect the financial position of a company and the results of its operations in accordance with generally accepted accounting principles and practices applied on a basis consistent with that of the preceding year.[11] Under paragraph (b) (i) of Rule 2-02 of Regulation S-X (17 CFR, 210.2-02), failure to employ any procedure generally recognized as normal must be disclosed and the reasons for such omission given. Paragraph (b) (ii) of such rule further calls for a representation as to whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. Failure to employ the procedure under discussion would, where inventories were of material amount, necessitate an exception to any positive statement that such standards had been observed.[12] The existence of such an exception, moreover, would make the certificate subject to the citation of a deficiency in respect thereto. It may also be noted that it is generally recognized that where an exception is sufficiently material to negative the expression of an opinion as to the fairness of the presentation made by the financial statements, the auditor should refrain from giving any opinion at all.[13]

Under present circumstances, however, it may in particular cases be impossible to take a satisfactory physical inventory without interruption of the production and delivery of war materials. It may also be impossible for the independent accountants to have such physical contact with the inventory as normal auditing procedure calls for. Where the book inventory records provide sufficient control over inventories, a temporary cessation of the periodic comparison with the physical stocktakings would ordinarily be less serious than where book records are inadequate or lacking. However, it is clearly in the public interest that as positive and effective substantiation of the inventory amounts be made as circumstances permit. The auditor by devising supplemental procedures based on the circumstances of the particular case and by extending the scope of normal procedures which do not require cessation of production should endeavor wherever possible so to satisfy himself as to the substantial fairness of the inventory amounts that his certificate, while indicating the omission of the normal procedure of observation or test-checking, need not contain an exception to the substantial fairness of the presentation of inventories.

Where circumstances show that the observance of normal procedures with respect to inventories would result in interruption of production or delivery of war materials, it is t' e administrative policy of the Commission not to object to the omission, provided all reasonable and practical alternative and additional measures are taken by the company and its accountants to support the substantial fairness of the amounts at which inventories are included in the financial statements and provided further that by means of a letter the company indicates the necessity for omitting such procedures, and the financial statements and accountants' certificate contain appropriate disclosures and representations. In the letter to the Commission accompanying or preceding the annual or other report, but not as a part thereof, the company should give the following information:

(1) Its priority ratings and the extent to which the company is engaged in production of war materials, in terms for example of the proportion of inventories, production or other appropriate basis.

(2) A statement as to whether normal procedures in the taking of inventories are to be followed except where interruption to the production of war materials would result.

(3) The delay that would be caused by shutting down to take inventory.

(4) A statement as to whether it is feasible or practicable for the particular company to take reasonably accurate physical inventories while the plants are in operation or at times when the plants are shut down for other purposes. Such evidence would ordinarily include an indication of the number of shifts per day, the number of days worked per week or other standard period, and whether shut-downs as for repairs or rearrangements may be utilized for inventory taking.

(5) If at the time of the last physical inventory it was necessary ta make significant adjustments in order to reconcile book and physical inventories, a summarized statement of the general nature and amounts of such adjustments.

Under the circumstances of cases of this kind Rule 2-02 of Regulation S-X requires, in my opinion, that the accountants' certificate contain at least the following information:

(a) A specific statement of the extent to which normal procedures as to physical inventories were omitted, indicating if such information is not given in the statements themselves, the amount of inventories involved.

(b) A specific statement of the reason why normal physical inventory procedures were omitted, that is, because their observance would result in a material interruption in the production of war materials.

(c) A specific statement as to the extent of the accounting records and controls as to inventories and as to whether the accountants consider them adequate.

(d) A description of the supplementary or extended procedures undertaken by the accountants in view of the absence of a physical inventory and the omission of normal auditing procedures in connection therewith. Such description need not be detailed beyond the point necessary to indicate the general nature and extent of the supplementary or extended procedures undertaken.

In many cases, it is probable that by means of their alternative and extended procedures the independent public accountants will have satisfied themselves as to the substantial fairness of the amounts at which inventories are stated, and in such case a positive statement to that effect should be made. In some cases it may be that, while the scope of procedures followed will not be such as to have so satisfied the accountants, they will be able to take the position that on the basis of the work done they have no reason to believe that the inventories reflected in the statements are unfairly stated.

Of course, if the scope of the work done or the results obtained from the procedures followed or the data on which to base an opinion are so unsatisfactory to the accountants as to preclude any expression of opinion, or to require an adverse opinion, that situation must be disclosed not only by an exception running to the scope of the audit, but also by means of an exception in the opinion paragraph as to the fairness of the presentation made by the financial statements. However, in such case, the company and its certifying accountants will be asked to furnish the Commission a statement showing that unusual circumstances exist which prevent the accountants from undertaking such additional procedures as would in the accountants' judgment enable them to satisfy themselves as to the substantial fairness of the inventory amounts. Ordinarily, such state-

[11] See Securities and Exchange Commission, Report on Investigation In the matter of McKesson & Robbins, Inc. (1940), particularly pp. 399 ff.; Testimony of Expert Witnesses In the matter of McKesson & Robbins, Inc. (1939), pp. 38 ff., 150 ff., 199 ff., 250 ff., 295 ff., 348 ff., 405 ff., 460 ff., 512 ff., 564 ff., and 603 ff. For a statement of present practice see American Institute of Accountants, Statements on Auditing Procedure, Bulletins No. 1 (October 1939) and No. 3 (February 1940).

[12] See Accounting Series Release No. 21, p. 30 (February 5, 1941).

[13] See, for example, American Institute of Accountants, Statements on Auditing Procedure, Bulletins No. 2 (December 1939) and No. 8 (September 1941); and Rule 5 of the Rules of Professional Conduct of the American Institute of Accountants as revised and adopted January 6, 1941.

ment should be transmitted to the Commission in advance of filing.

The disclosure made in the financial statements and certificate will of course be subject to the usual review in the light of the Commission's requirements and the circumstances of the particular case. It is implicit that, at the earliest opportunity, every reasonable effort will be made to take physical inventory, with normal observation and test-checking by the certifying accountants, and that any practicable improvements in the accounting records and controls of inventory will be undertaken. Finally, it should be understood that waiver of objections with respect to the current annual report will not necessarily constitute a basis for similar action in respect of annual reports for subsequent years or statements filed in registrations for the sale of securities.

[Accounting Series Release No. 30, January 22, 1942]

§ 211.32 *Accountants' certificates. Application of Rules 2–02, 3–07, 4–02, and 4–04 of Regulation S–X (17 CFR 210.2–02, 210.3–07, 210.4–02, 210.4–04) regarding requirements as to disclosure by independent public accountants of the principle followed in including or excluding subsidiaries in consolidated statements.* Inquiry has been made whether, under the rules of the Commission, it is necessary for an independent public accountant to indicate in his certificate that generally accepted accounting principles and practices have not been applied on a basis consistent with that of the preceding year where a wholly owned subsidiary consolidated in the preceding year is not to be consolidated in the year under review. The inquiry assumed that the registrant's policy in the past had been to consolidate all wholly owned subsidiaries and that the current exclusion of the subsidiary from consolidation was due to changed conditions and was made with a view to more fairly presenting the financial condition and results of operations of the registrant and its subsidiaries.

The portions of Regulation S–X which seem directly involved are Rules 4–02, 4–04, 3–07, and 2–02 (c) (17 CFR 210.4–02, 210.4–04, 210.3–07, 210.2–02 (c)). Rule 4–02 provides, in part, that:

> The registrant shall follow in the consolidated statements principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries.

Rule 4–04 (a) requires that:

> The principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance sheet and in each group balance sheet of unconsolidated subsidiaries shall be stated in a note to the respective balance sheet.

Rule 3–07 requires disclosure of any significant change in accounting principle or practice and, if the change substantially affects proper comparison with the preceding fiscal period, the necessary explanation. Finally, subdivision (ii) of Rule 2–02 (c) requires the accountant's certificate to state clearly "the opinion of the accountant as to any changes in accounting principles or practices required to be set forth by Rule 3–07."

To my[1] mind it would be necessary under the rules of the Commission, unless the subsidiary involved was so small as to be immaterial, for the accountant to indicate in his certificate that generally accepted accounting principles and practices had not been applied on a basis consistent with that of the preceding year. In stating the principles of inclusion or exclusion followed in a particular consolidation it is not sufficient under Rules 4–02 and 4–04 (a) merely to indicate that the registrant is following in the consolidated statements principles of inclusion or exclusion which will clearly reflect the financial condition and results of operations of the registrant and its subsidiaries. A statement such as this would give no satisfactory information to the reader and, indeed, would permit the use of widely different and shifting consolidations without constituting a change in the principles followed. Instead, the language of Rule 4–02 should be considered as setting a test which the specific principles adopted in a given case must meet.

The specific principles followed should be objective and definite, such as, for example, that the registrant includes in consolidation all wholly owned subsidiaries, or all domestic wholly owned subsidiaries or all wholly owned manufacturing subsidiaries. Any such principles would, of course, have to meet the general test prescribed in Rule 4–02. Furthermore, unless all subsidiaries which fall within the class designated by the specific principles of consolidation are, in fact, consolidated, the specific statement is clearly inaccurate and misleading. It is therefore my opinion that the exclusion of the subsidiary in the case under discussion constitutes a change in the principles of consolidation followed.

I think the operation of the rules referred to can best be indicated by the following illustration. Let us assume that a given registrant in its 1940 statements consolidated all of its wholly owned subsidiaries. In the 1941 statements one significant wholly owned foreign subsidiary was excluded by reason of the registrant's inability to obtain statements therefor. Under such circumstances Rule 4–04 (b) would require that the name of the excluded subsidiary be given. The statement of the principles of consolidation required by Rule 4–04 (a) would have to be appropriately modified to indicate that the wholly owned subsidiary was not consolidated. Rule 3–07 would require, if the change substantially affected comparison with prior years, an appropriate explanation. Rule 2–02 (c) (ii) would require a statement in the certificate of the accountant's opinion as to the change in the principles of consolidation employed.

Thus, it would not be proper, in my opinion, for the accountant to represent that the statements presented fairly the financial condition of the company and its consolidated subsidiaries and the results of their operations for the fiscal year, in conformity with generally accepted accounting principles and practices applied on a basis consistent with that of the preceding year. Instead, it would, in my opinion, be necessary to indicate that the principles of consolidation had been changed. If the new basis met with the approval of the accountant, as it presumably would, a positive statement to that effect should be made. If it did not, it would seem necessary to take an exception which would run to the fairness of the presentation.

The above conclusion may be contrasted with a case similar in all respects except that the subsidiary is dropped from consolidation because of sale of the investment therein. In cases such as this no change in the principles of consolidation results, since all subsidiaries wholly owned at the date of the statement are included in the consolidation. Disclosure that the former subsidiary is not included would, however, be required by Rule 4–04 (b) and, under certain circumstances, Rule 3–06 might require that additional information, such as the reason for the change, be included either in the financial statements or in the accountant's certificate. [Accounting Series Release No. 32, March 10, 1942]

§ 211.35 *Disclosure to be given to certain types of provisions and conditions that limit the availability of surplus for dividend purposes.* Inquiry has been made from time to time as to the necessity of disclosing, in financial statements filed with the Commission, provisions and conditions which in the particular case materially limit the availability of surplus for dividend purposes. The following are characteristic situations:

1. Treasury stock has been acquired.
2. Dividend arrearages exist on cumulative preferred stock.
3. The preference of preferred shares upon involuntary liquidation exceeds the par or stated value[14] of such shares.
4. The provisions of a trust indenture or loan agreement permit dividends on common or preferred stock to be paid only from earnings accumulated subsequent to a specified date or if surplus exceeds a certain amount.
5. The provisions of a trust indenture or loan agreement prohibit the payment of dividends when such payment would reduce the margin of current assets over current liabilities below a stated minimum.
6. The articles of incorporation require that an amount equivalent to a certain percentage of the par value of the greatest number of preferred shares outstanding at any one time is to be set aside semiannually out of surplus or net profit before dividends may be paid on common stock.
7. A loan agreement provides that dividends may only be paid after securing the consent of the lender.
8. An order or requirement of a regulatory agency having jurisdiction limits the right to declare or pay dividends.

In my[1] opinion, generally accepted and sound accounting practice requires the disclosure of these and similar re-

[1] Chief Accountant.

[14] *Cf.* Rule 3–18 (d) (3) of Regulation S–X, and also Accounting Series Release No. 9 which requires that in most cases an opinion of counsel be given as to whether this condition constitutes a restriction on surplus.

strictions on surplus.[15] Otherwise, an erroneous impression is likely to be given the reader of the financial statements. Since Rule 3-06 of Regulation S-X (17 CFR, 210.3-06) provides that:

> The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading,

it is clear that in all statements filed with the Commission appropriate disclosure of material restrictions on surplus should be made.

Minimum disclosure, in my opinion, would consist of a description of the restriction, indicating briefly its source, its pertinent provisions, and, where appropriate and determinable, the amount of the surplus so restricted. Such disclosure should be made either in a note to the balance sheet or in an appropriate place in the surplus section of the balance sheet. Also, any statement of surplus, such as is prescribed in Rule 11-02 of Regulation S-X (17 CFR, 210.11-02), should contain similar information or should refer to the disclosure made in the balance sheet. Since the declaration and payment of dividends depends on many factors, other than the mere absence of restrictions of the type under discussion, disclosure pursuant to the above requirement should not be made in such a way as improperly to leave an inference that dividends will or may necessarily be declared from surplus in excess of the restrictions noted. [Accounting Series Release No. 35, September 3, 1942]

§ 211.36 *Treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were purchased.* Question has been raised as to the treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were acquired. In the particular case an investment company purchased, at a "flat" price of $260,000, $1,000,000 principal amount of bonds with attached defaulted interest coupons amounting to $250,000. The company subsequent to the purchase received an interest payment of $40,000 on account of defaulted interest coupons for periods prior to the purchase.

Where a purchase is made of defaulted bonds with defaulted interest coupons attached, it is clear that the purchase price covers not only the right to receive the principal of the bond itself, but also the right to receive any payments made on the defaulted interest coupons purchased. Under these circumstances the price paid cannot be deemed to reflect only the cost of acquisition of the issuer's obligation to pay the principal sum, but must instead be considered to reflect as well the cost of acquisition of the issuer's existing obligation to pay the interest coupons already matured. In the usual case, moreover, there is no satisfactory basis on which to allocate the total price between the bond on the one hand and the defaulted interest coupons on the other. Under such circumstances the bond and defaulted coupons should be treated as a unit for accounting purposes, and collections on account of the defaulted interest coupons should be treated not as interest on the sum invested, but rather as repayments thereof. Moreover, in view of the uncertainty of eventually receiving payments in excess of the purchase price, it is my[1] opinion that ordinarily no part of any payment, whether on account of principal or the defaulted interest, should be considered as profit until the full purchase price has been recovered.

In the instant case, therefore, the receipt of the $40,000 interest payment should, in my opinion, be treated as a reduction of the cost of the investment and not as interest income, or as a profit on the investment. After payments are received on account of the principal and defaulted interest in an amount equal to the purchase price, any further collections thereon should be treated, in my opinion, not as interest, but as profit on securities purchased. On the other hand, it seems clear that collection of interest coupons covering periods subsequent to the purchase may be treated as interest income unless the circumstances of a particular case are such as to indicate that, despite the apparent nature of the payment, recovery of the cost of the investment through sale or redemption is so uncertain as to make it necessary to treat the payment as a reduction of the investment. [Accounting Series Release No. 36, November 6, 1942]

§ 211.37 *Amendment of Rule 2-01 of Regulation S-X (17 CFR, 210.2-01)—qualifications of accountants certifying to financial statements required to be filed with the Commission. Superseded by Release No. 44 (17 CFR, 211.44).* Paragraph (c), which was added to Rule 2-01 by this amendment, was amended on May 24, 1943, and accordingly is not reproduced here.

At the time the amendment was adopted the following statement was made:

> The amendment makes it clear that, in determining whether certifying accountants are in fact independent as to a particular company, there should be taken into account the circumstances surrounding not only the work done in certifying statements filed with the Commission, but also other work done for the particular company by such accountants, including the certification of any financial statements which have been published or otherwise made generally available to security holders, creditors, or the public.
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> The new rule codifies principles to be applied by the Commission in considering questions of independence. It appears desirable to incorporate these principles in the published rules and regulations, in view of cases in which substantial amounts due from officers and directors were shown separately in balance sheets filed with the Commission but, in the balance sheet contained in the annual report to stockholders, were included without disclosure under the caption "Accounts and notes receivable, less reserves."
>
> Underlying the Commission's requirement that clear disclosure be made of the amounts due from officers, directors, and principal stockholders[16] is the principle that such persons have obligations and responsibilities comparable to those of a fiduciary, and that therefore the financial statements should clearly reveal amounts due from such persons, accompanied, where the amounts involved are substantial, by appropriate supporting details. Where an indebtedness results from a transaction between the company and one or more of the management, as individuals, the certifying accountants should employ every means at their disposal to insist upon full disclosure by the company and, failing persuasion of the company, should as a minimum qualify their certificate or disclose therein the information not set forth in the statements. Perhaps the most critical test of the actuality of an accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals; accession to the wishes of the management in such cases must inevitably raise a serious question as to whether the accountant is in fact independent. Moreover, in considering whether an accountant is in fact independent, such accession to the wishes of the management is no less significant when it occurs with respect to the financial statements included in an annual report to security holders or otherwise made public than when it occurs with respect to statements required to be filed with the Commission.

[Accounting Series Release No. 37, November 7, 1942]

§ 211.38 *Treatment in financial statements of post-war refunds of Federal excess profits taxes.* You have inquired with respect to the propriety of the manner in which the company proposes to reflect in its financial statements the post-war refunds of Federal excess profits taxes which are provided for by Section 250 of the Revenue Act of 1942.[17] You state that the corporation's tax return will indicate that the corporation will be subject to an excess profits tax of $1,000,000, that the company will therefore be entitled under the statute to a post-war refund credit amounting to $100,000, and that within 3 months after the payment of the tax the company will be entitled to receive bonds of the United States in an aggregate face amount equal to the credit so established. You note that the Act provides that such bonds shall bear no interest, and only after, and not before, cessation of hostilities in the present war may the bonds be transferred by sale, exchange, assignment, pledge, hypothecation, or otherwise.

As I[1] understand it, you propose to deduct in your profit and loss statement excess profits taxes in the amount of $900,000, the net amount of such taxes ultimately payable. However, disclosure will be made of the gross amount of the tax and of the net credit thereagainst.

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[15] *Cf.* American Institute of Accountants, Examination of Financial Statements (1936), p. 29.

[1] Chief Accountant.

[16] The requirements of Rule 5-02 (7) and Schedule II of Rule 5-04 of Regulation S-X (17 CFR, 210.5-02 (7), 210.5-04) except trade accounts subject to the usual trade terms, ordinary travel and expense advances, and other such items arising in the ordinary course of business.

[17] New Part III, comprising sections 780-783, Subchapter E of Chapter 2, Internal Revenue Code.

Concurrently, you propose to set up an asset account in the amount of $100,000 to reflect the amount receivable as a post-war refund and to reflect $1,000,000 as a current liability. When bonds are received the caption of the account will be altered to indicate that fact. You thus proposed to treat the total amount payable as, in effect, partially a payment of taxes and partially, to the extent of the post-war credit, as an investment in a special type of Government bonds.

Upon the basis of the facts stated, the treatment you propose is, in my opinion, in accordance with sound and generally accepted accounting principles and practice and should be followed. However, in view of its special characteristics, the amount receivable as a post-war refund should not, in my opinion, be presently classified as current assets or investments, but should rather be shown among "other assets." [Accounting Series Release No. 38, December 19, 1942]

§ 211.41 *Conditions under which companies reporting on Forms 10–K (17 CFR, 249.310) and N–30A–1 (17 CFR, 274.101) may file copies of their regular annual reports to stockholders in place of certain of the financial statements required to be filed by such forms.* A recent amendment of Form 10–K (17 CFR, 249.310) provides that in partial response to the requirements for filing financial statements a registrant may if it wishes file a copy of its regular annual report to stockholders and incorporate by reference the financial statements contained in such report. This procedure may be followed, however, only if the financial statements included in the report to stockholders substantially conform to the requirements of Regulation S–X (17 CFR, Part 210). Of course, any financial statements or schedules required by the instructions that are not included in the stockholders' report must also be furnished.

A review of numerous stockholders' reports covering the year 1941 indicates that in many cases the financial statements included are identical with those filed subsequently as part of the annual report on Form 10–K except that a number of relatively minor items shown separately in the report on Form 10–K are grouped, or combined with closely similar items in the report to stockholders. Inquiries have been received as to whether, where condensation of this type exists, the statements may nevertheless be considered to conform substantially to the requirements of Regulation S–X (17 CFR, Part 210).

The provisions of Article 5 of Regulation S–X (17 CFR, Part 210) contain a general statement of the details to be shown in balance sheets and income statements filed by commercial and industrial companies. Such requirements are, however, supplemented by and subject to the general rules contained in Article 3. Rule 3–06 (17 CFR, 210.3–06) thereof provides, on the one hand, that, in applying the requirements to the circumstances of an individual case, there shall be given, in addition to the required information, such further information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. On the other hand, Rule 3–02 provides that, if the amount to be shown under any particular caption is not significant, the caption need not be separately set forth. The effect of these two general requirements is to require the disclosure of significant information not specifically called for, but to permit the omission of information, even though covered by a specific requirement, if the item involved is not significant. It should be pointed out, however, that in some cases the significance of an item may be independent of the amount involved. For example, amounts due to and from officers and directors, because of their special nature and origin, ought generally to bet forth separately even though the dollar amounts involved are relatively small. Likewise, disclosure of the various types of surplus, the important reserve accounts, and, under present conditions, the accrued liability for taxes is of importance. In the same way, in the corporate income statement of a company having large investments in subsidiaries or in the securities of unaffiliated companies, the disclosure of income from dividends and interest is necessary irrespective of the amount, since the absence or smallness of dividend and interest income is of as great importance as the exact amount thereof. In the income statement generally, it is important that the major elements such as sales and cost of sales, substantial items of other income and income deductions, and the provision for income and excess profits taxes be separately disclosed, unless to do so would violate the provisions of the Code of Wartime Practices. Finally, care should be taken that the necessary descriptive and explanatory footnotes applicable to the particular statements are set forth.

On the other hand, the combination under a miscellaneous caption of minor items among the current assets or liabilities resulting from the ordinary course of business, or their combination with closely similar items that are large in amount, is, in my opinion, permissible and, where minor items are numerous, would tend to improve the legibility of the statements. Similar combinations appear to be permissible within the other major categories of items customarily appearing in the financial statements, such as deferred charges, prepaid expenses, and fixed assets. Generally, however, condensation in the balance sheet would not appear appropriate with respect to an item amounting to more than 10 percent of its immediate category, such as deferred charges, or more than 5 percent of total assets. Where, however, the immediate category is less than 5 percent of total assets, it would generally appear permissible to combine all components of the category under a suitable caption.

If such condensation as may exist in the financial statements included in the regular annual report to stockholders has been made along the lines indicated, such financial statements would in my opinion substantially conform to the requirements of Regulation S-X and could, therefore, under the recent amendment to Form 10–K, be incorporated by reference in annual reports on that form. Of course, care should be taken that the captions used are not such as to be misleading.

Form N–30A–1, the annual report form for investment companies subject to the Investment Company Act of 1940, has been amended in the same manner as Form 10–K. While the discussion above relates to the financial statements of commercial, industrial, and utility companies using Form 10–K, comparable principles are applicable to investment companies using this form. [Accounting Series Release No. 41, December 22, 1942]

§ 211.42 *Disclosure to be made in financial statements with respect to reserves established to provide for possible losses and other contingencies arising out of existing war conditions.* In view of the material effects which war conditions may have on the results of operations and the financial condition of corporations, careful consideration must be given to the need for establishing appropriate reserves intended to provide for final settlement of war production contracts, for post-war readjustments, and for other possible losses or adjustments resulting from present conditions. Where such reserves are established a full and accurate disclosure of the reserves established and the purposes thereof is required by Regulation S–X (17 CFR, Part 210) in financial statements filed with the Commission.[1]

Since reserves such as those mentioned will differ in character, depending on the purpose underlying their establishment, the provisions of Regulation S–X (17 CFR, Part 210) that will be applicable depend to some extent upon the nature of the particular reserves. Reserves in the nature of valuation or qualifying reserves are required to be deducted from the assets to which they apply in conformity to Rule 3–11 of Regulation S–X (17 CFR, 210.3–11). Others not relating to specific assets should properly be shown under Caption 32 of Rule 5–02 (17 CFR, 210.5–02)—Reserves, not elsewhere shown. In still other cases the contingency or condition against which the reserve is provided may be so indefinite and problematical that the reserve is in effect no more than earmarked earned surplus and can best be shown as a subdivision thereof. Finally, in certain cases the reserve may reflect the estimated amount of an actual liability and should be shown as such. In any case the caption of each reserve or major class of reserves should be clearly descriptive of the purpose for which the reserve has been established. It should further be noted that Rule 12–13 (17 CFR, 210.12–19), which asks for supporting data as to all reserves not included in specific schedules, requires that the reserves be grouped and listed according to major classes under properly descriptive titles. While the instructions permit the grouping of special contingency reserves it would be improper, in my[1] opinion, so to group reserves of the character under discussion or to combine them with other reserves as to fail to disclose clearly the

[1] Chief Accountant.

[1] *Cf.* American Institute of Accountants, Accounting Research Bulletin No. 13, "Accounting for Special Reserves Arising Out of the War," dated January 1942.

various types of war contingencies and conditions for which reserves have been established.

Classification and description of the charges made in establishing such reserves should likewise be given careful attention. In this connection it should be noted that Rule 3-19 (c) (17 CFR, § 210.3-19 (c)) requires disclosure of the policy followed as to providing for depreciation, depletion, obsolescence, and amortization. Where establishment of a reserve of the type under discussion involves a modification of any of such policies, a clear statement is called for by the rule. Where the offsetting charges are not made to the profit and loss or income statement it will be noted that the schedules required in support of reserves call for a clear description of the circumstances. Where the offsetting charges are made to the income statement, it will be noted that Rule 5-03 requires the amounts if significant, to be stated separately and clearly described, unless properly includible under the caption "Cost of sales," which caption the rule does not require to be subdivided.

Particular attention is also directed to the fact that the requirements of Regulation S-X (17 CFR, part 210) are to be considered to be minimum requirements and that Rule 3-06 (17 CFR, 210.3-06) specifically requires that there "shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." However, care should be taken that no disclosure of information is made which would contravene the Code of Wartime Practices.

Reserves of the character under discussion may in some cases indicate a future need of cash, as for example in the case of reserves for separation allowances. While the provision of funds to meet necessary expenditures is not a matter of accounting policy, it may be appropriate to point out that the mere establishment of a reserve will not of itself ensure the accumulation and availability of such liquid funds as may be required. Where such future cash requirements exist, independent consideration should be given, as a matter of financial policy, to the desirability of taking additional steps toward providing such funds, as by "funding" the reserve through accumulation and possibly segregation of cash or liquid assets equivalent to the reserves established. [Accounting Series Release No. 42, January 8, 1943]

§ 211.44 *Amendments to Rule 2-01 of Regulation S-X (17 CFR 210.2-01) regarding qualifications of accountants certifying to financial statements required to be filed with the Commission.* Subsequent to the adoption, on November 7, 1942, of the present subsection (c) of Rule 2-01 (17 CFR, 210.2-01), representatives of the accounting profession made inquiry as to whether the language "in determining whether an accountant is in fact independent with respect to a particular company, appropriate consideration shall be given to the propriety of the relationships and practices involved in all services performed for the company by such accountant" implied that the Commission would seek to determine the "propriety" of all such relationships in and of themselves. In discussions and conferences arising out of such inquiries, the Commisison made it clear that it was interested in relationships between a certifying accountant and a registrant only insofar as the existence of particular relationships might be relevant to its determination whether the accountant was in fact independent. In order to avoid any possible misinterpretation of its policy in this respect, the Commission has amended Rule 2-01 (c) (17 CFR, 210.2-01) so as to restate its objectives in more general terms, thus avoiding the misunderstanding apparently resulting from the use of more particularized language in the original rule.

At the same time Rule 2-01 (b) (17 CFR, 210.2-01) has been amended to make it clear that the relationships listed therein are not the only relationships which would prevent an accountant from being independent in fact. In this connection, attention is directed to Accounting Series Releases Nos. 2, 22, 28, and 37 (17 CFR, 211.2, 211.22, 211.28, 211.37), which contain statements of administrative policy and opinions of the Chief Accountant on the question of independence. Release 22 (17 CFR 211.22), moreover, includes a summary of the principal Commission decisions involving independence of accountants. A summary of informal decisions on the question will be issued at a later date. [Accounting Series Release No. 44, May 24, 1943]

§ 211.45 *Treatment of premiums paid upon the redemption of preferred stock.* Inquiry has frequently been made as to whether a premium paid on the redemption of preferred stock in excess of the amounts paid in thereon may properly be charged against capital contributed by another class of shareholders or whether, when earned surplus is present, the excess premium should be charged thereagainst. The following case is typical. The A Corporation has outstanding 10,000 shares of $100 par value 6 percent cumulative preferred stock which was sold at 105 and is redeemable at the option of the company on any dividend date at 110. There are also outstanding 40,000 shares of $50 par value common stock which were sold at $60 per share. At the time the corporation proposes to call the preferred shares for redemption, the balance sheet reflects earned surplus of $300,000 and capital surplus of $450,000. The capital surplus consists of $50,000 paid in by preferred shareholders and $400,000 paid in by common shareholders.

The case presented involves a fundamental principle of accounting maintenance of the distinction between capital and income. In recognition of this principle, it has long been agreed that paid-in capital may not be used to absorb expenses or charges that should be deducted from gross income or revenue to determine net income.[19] While the charge involved in the instant case is not relevant to a determination of the amount of net income, it does raise the cognate question of whether payment of redemption premiums in excess of the amount paid in on the shares being retired should first be considered to be distributions of available earned surplus, rather than of amounts paid in on shares still outstanding.

In order to maintain a proper distinction between capital and income, it is my [1] opinion that it is necessary to consider the entire amount contributed by shareholders as capital regardless of whether reflected in the accounts as capital stock or as capital or paid-in surplus. When a corporation by appropriate legal action classifies its share capital, with resulting distinctions in dividend rights, assets priorities, voting powers, and other matters, adherence to the principles mentioned, in my opinion, requires appropriate accounting recognition of the classification of shares not only in respect of the legal or stated capital but also in respect of the related contributions in excess of legal or stated capital. In my opinion, reflection of a redemption premium paid to one class of shareholders as a diminution or utilization of amounts contributed by another class, or by shares of the same class still outstanding, would ordinarily be inconsistent with recognition of these principles in that the capital contribution shown for outstanding shares would thenceforth be less than the amount actually paid in on such shares although (1) no amounts were in fact repaid in respect of the outstanding shares; (2) at the time of the disbursement there existed accumulated earned surplus; and (3) such earned surplus would therefore be available for distribution as apparently earned dividends, although in fact capital contributed in respect of the outstanding shares had not been maintained intact.

It is, therefore, my opinion that in the case cited the amount paid preferred shareholders in excess of the amounts contributed by them should be charged to earned surplus. Also, if at the time of redemption any amounts are paid on account of accumulated unpaid dividends, such amounts should likewise be charged to earned surplus.

In the above example an entire issue of preferred shares was assumed to have been redeemed. If less than an entire issue were redeemed it would not, in my opinion, ordinarily be proper, in the light of the above discussion, to charge against capital surplus contributed by the preferred stock an amount per share in excess of the pro-rata portion of such capital surplus applicable to each share of preferred stock outstanding prior to the redemption in question.

In the case cited, all of the capital surplus represented amounts paid in on shares still outstanding. In some cases a part of capital surplus may have resulted from the prior reacquisition and retirement of preferred or common shares at

[19] In the course of a formal reorganization, or a quasi-reorganization, a deficit in earned surplus may be charged to capital surplus. See Accounting Series Releases Nos. 1, 15, 16, and 25.

[1] Chief Accountant.

less than the amounts paid in thereon.[20] Such capital surplus does not therefore represent any amounts paid in on shares still outstanding. Where this condition exists, I would ordinarily see no objection to utilizing such capital surplus for the purpose of absorbing the excess of the redemption price over the amounts paid in on the shares being retired.

There remain to be considered cases in which outstanding preferred stock is retired and replaced by new preferred stock, usually bearing a lower dividend rate. In such case, of course, a saving to junior security holders is accomplished which will be reflected in increased earnings applicable to junior securities, and unless distributed, in increased balances of earned surplus. In a number of such cases arising under the Public Utility Holding Company Act of 1935, where earned surplus was absent or inadequate, the Commission has as a matter of administrative policy raised no objection to a procedure designed to offset the redemption premiums against subsequent earnings. However, in such cases it has ordinarily been required that the annual offset be not less than the savings effected by the lower dividend rate on the new stock and that in any case the premiums be fully offset within a reasonably short period. [Accounting Series Release No. 45, June 21, 1943].

§ 211.47 *Independence of certifying accountants; Summary of past releases of the Commission and a compilation of hitherto unpublished cases or inquiries arising under several of the Acts administered by the Commission.* Various statutes administered by the Securities and Exchange Commission recognize the necessity of independence on the part of an accountant who certifies financial statements. In administering these Acts the Commission has consistently held that the question of independence is one of fact, to be determined in the light of all the pertinent circumstances in a particular case. For this reason it has not been practicable, and the Commission has made no attempt, to catalog all of the relationships or situations that might prevent an accountant from being independent. However, in Rule 2–01 (b) of Regulation S–X (17 CFR, 210.2–01 (b)) the Commission has indicated certain relationships such as those of officer, director, or employee which it believes are so likely to prevent a completely objective review of the financial statements of a registrant as to preclude its recognizing an accountant occupying such a position as independent.

In addition to summarizing past releases of the Commission on the question of independence, the new release includes a compilation of hitherto unpublished rulings in cases or inquiries arising under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. Preparation of this compilation, announced in Accounting Series Release No. 44 (17 CFR, 211.44), was undertaken as a result of a suggestion by representatives of professional accounting societies that knowledge of informal rulings would be of particular assistance to accountants and others interested in determining the circumstances under which a certifying accountant is likely to be considered to be not in fact independent.

The release, prepared by the Chief Accountant, follows:

> The requirements of the Securities and Exchange Commission that an accountant be in fact independent with respect to a company whose financial statements he certifies is grounded on the conviction that the existence of certain types of relationships between a company and its certifying accountant might bias the accountant's judgment on accounting and auditing matters. Certain relationships between an accountant and his client appear so apt to prevent the accountant from reviewing the financial statements and accounting procedures of a registrant with complete objectivity that the Commission has taken the position that existence of these relationships will preclude its finding that the accountant is, in fact, independent. Accordingly, Rule 2–01 (b) of Regulation S–X (17 CFR, 210.2–01 (b) provides that "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee." In addition, Accounting Series Release No. 2 (17 CFR, 211.2) indicated that an accountant was not to be considered independent with respect to a particular company when his holdings of the capital stock of that company were substantial in amount and were significant with respect to the company's total capital or the accountant's personal fortune. A test of 1 percent was suggested in the latter connection. Also, Accounting Series Release No. 22 (17 CFR, 211.22) indicated that an accountant would not be considered to be independent if the company whose financial statements he certified had indemnified him against all losses, claims, and damages arising out of such certification other than as a result of the accountant's willful misstatements or omissions.
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> In a number of its Findings and Opinions the Commission had occasion to discuss the question of independence in the light of the facts of a particular case. The earlier Commission decisions and releases have been summarized in Accounting Series Release No. 22 (17 CFR, 211.22). Subsequent to the issuance of this release several other decisions involving the question of independence have been issued. In In the matter of Southeastern Industrial Loan Company (Securities Act of 1933, Release No. 2726) it was held that the nature of the business relationships between the accounting on the one hand and the registrant, its parents, and its affiliates on the other were such as to destroy the accountant's independence. In In the matter of Kenneth N. Logan (Securities Exchange Act of 1934, Release No. 3111; Accounting Series Release No. 28) (17 CFR, 211.28) the Commission held an accountant to be not independent where he had a substantial investment in the registrant, the cost of which amounted to about 8 percent of his net worth, and where he had approved or acquiesced in procedures that were designed to conceal a speculative use to which funds of the registrant had been put. While in In the matter of Associated Gas and Electric Company (Securities Exchange Act of 1934, Release No. 3285A) the question of the independence of the certifying accounts was not raised in the order for hearing and so no finding was made on this point, yet the Commission did state in the course of its discussion that "* * * an accountant who consistently submerges his preferences or convictions as to accounting principles to the wishes of his client is not in fact independent." Finally, in adopting Rule 2–01 (c) of Regulations S–X (17 CFR, 210.2–01 (c)),[21] the Commission said in Accounting Series Release No. 37 (17 CFR 211.37): "Perhaps the most critical test of the actuality of an accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals * * *"
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> In the case of the great majority of financial statements filed with the Commission no question has been raised as to the independence of the certifying accountant. However, in addition to the formal decisions referred to above there have been many informal rulings in cases arising under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. It is not feasible to present adequately in summarized form the circumstances existing in particular cases in which it was determined not to question an accountant's independence. The following compilation therefore includes only representative examples of cases in which an accountant was considered not to be independent with respect to a particular company.
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> 1. An accountant held an investment of about $200,000 in the capital stock of a registrant. This investment constituted about 25 percent of the accountant's personal fortune and was about 2 percent of the company's total outstanding capital stock. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.
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> 2. An accountant's wife held a trust certificate issued by an investment trust on which had been paid an amount equal to 3 percent of the combined personal fortunes of the accountant and his wife. The withdrawal value of the trust certificate was less than $1,000 and was about 1½ percent of their personal fortunes. The accountant certified the financial statements of the investment trust as well as the financial statements of the corporation that sponsored the trust. The sponsor had no equity in the assets of the trust, but derived virtually all of its income from its activities as sponsor. Held, the accountant could not be considered independent with respect to the investment trust. Held, the facts given tended to indicate that the accountant was not independent with respect to the sponsoring corporation.
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> 3. An accountant had some years earlier invested a substantial amount of money in securities of a registrant. The fair current value of this investment exceeded 50 percent of the accountant's personal fortune. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.
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> 4. An accountant had loaned $5,000 to a registrant. A business associate of the accountant had loaned an additional $15,000 to the registrant. These loans bore interest and were secured by a 2½-percent share in the net profits of the registrant. A son of the accountant was an officer of the registrant. Held, the accountant could not be considered independent for the purpose of

[20] When capital stock is reacquired and retired, it is recognized that any surplus arising therefrom is capital and should be accounted for as such. See Accounting Series Release No. 6 (1938 (17 CFR, 211.6)); American Institute of Accountants, Accounting Research Bulletin No. 1 (1939).

[21] The language of Rule 2–01 (c) was subsequently clarified by an amendment announced in Accounting Series Release No. 44 (1943).

certifying the financial statements of the registrant.

5. An accountant had for some time endeavored to persuade a department store that was his client to add a new department to its business. The registrant finally agreed to set up the department provided the accountant would finance the cost thereof. The accountant advanced the necessary funds and the department proved successful. The new department contributed less than 5 percent of the total revenues of the registrant. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

6. An accounting firm had rendered services to a registrant for which the registrant had not been able to pay. To guarantee payment of the account the registrant had pledged shares of its own stock. In addition it had given the accountants an option to purchase the pledged securities at the market price existing at the date the option was given. Held, the accounting firm could no longer be considered independent for the purpose of certifying the financial statements of the registrant.

7. A registrant owned a small percentage of the stock of a sales company that sold some of the registrant's products. The accountant who certified the financial statements of the registrant was the treasurer and one of the stockholders of the sales company. Held, if the shares held by the registrant and the nature of the sales relationship were such as to give the registrant a significant element of indirect control over the sales company, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

8. A partner in an accounting firm was serving as a member of the board of directors of a registrant. This accountant did not participate in any way in the accounting firm's audit of the registrant. Held, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

9. A partner in an accounting firm was serving as a member of the board of directors of a registrant. Another partner in the same accounting firm conducted the audit of the registrant and certified the financial statements in his own name, not the firm name. Held, the certifying accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

10. A partner in an accounting firm had served on the board of directors of a registrant but had resigned from that position prior to the close of the most recent fiscal year. This accountant had not participated in any way in the accounting firm's audits of the registrant. Held, that the accounting firm could not be considered independent for the purpose of certifying financial statements of the registrant covering any period during which a partner of the accounting firm was a director of the registrant.

11. A partner in an accounting firm was serving as a member of the board of directors of a registrant, having been appointed to that position by a Federal court following a reorganization. Held, the accounting firm of which this individual was a member could not be considered independent for the purpose of certifying the financial statements of the registrant.

12. A partner in an accounting firm was a member of the board of directors of a registrant and was also one of the voting trustees of the registrant's stock. The voting trust had been established at the request of a lending bank that desired thereby to assure continuity of the registrant's management. Held, the accounting firm of which this accountant was a member could not be considered independent for the purpose of certifying the financial statements of this registrant.

13. A partner in an accounting firm was one of three trustees of a voting trust in which shares of preferred stock of a registrant had been deposited. Dividends had not been paid on the preferred stock and it had become entitled to elect a majority of the board of directors. The voting trust had been set up to assure continuity of the existing management, and was in a position to exercise ultimate control over the registrant. Held, the accounting firm, of which one of the voting trustees was a member, could not be considered independent for the purpose of certifying the financial statements of the registrant.

14. The board of directors of a registrant had established an "operating committee" in which had been vested all powers necessary and appropriate to the supervision of the management of the business. It was intended that the principal duty of the committee would be the making of recommendations to the board of directors. The committee consisted of two members of the board of directors and a member of the accounting firm that regularly certified the financial statements of the registrant. Held, neither the individual accountant nor his firm could be considered independent for the purpose of certifying the financial statements of the registrant.

15. A registrant filed certified financial statements of two subsidiary companies. The financial statements of one subsidiary had been certified by a member of an accounting firm who also served as assistant secretary of the subsidiary. The financial statements of the other subsidiary had been certified by a member of another accounting firm who served as assistant secretary and assistant treasurer of that subsidiary. Neither accountant received any remuneration for serving as officers of these subsidiaries. Held, the accounting firms involved could not be considered independent for the purpose of certifying the financial statements of the company in which one of their members served as an officer.

16. An individual serving as assistant treasurer and chief accountant of a registrant was the son of a partner in the accounting firm that certified the financial statements of the registrant. The son was living with his father at the time. The son served the registrant under the direction and supervision of the treasurer of the company. Held, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

17. A senior staff member of an accounting firm was appointed controller of a registrant as successor to a controller who had entered the armed forces of the United States during the war emergency. This employee, who had formerly been in charge of the audit of the registrant, remained on the staff of the accounting firm but relinquished all responsibility for the audit of the registrant, and did no work for the accounting firm in connection therewith. Held, the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant. Held, further, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant if the senior staff member were to leave the employ of the accounting firm and be paid by the registrant, but this arrangement was subject to the understanding among the several parties that upon the termination of the war emergency he would return to the staff of the accounting firm.

18. The accountant who audited the financial statements of an investment trust had been given office space in the office of the sponsor of the investment trust. The accountant regularly gave advice concerning the internal accounting policies of the trust. The sponsor of the trust had agreed to pay the accountant a stipulated amount per year less whatever the accountant was able to earn from the investment trust and his other clients. Held, that accountant could not be considered independent for the purpose of certifying the financial statements of the investment trust.

19. The accounting firm that certified the financial statements of a particular registrant had in the past followed the practice of drawing up the monthly journal records of the company from underlying documents that had been prepared by the registrant's staff. These journal records were posted to the appropriate ledgers by the certifying accountants. At the end of the year the audit engagement was undertaken by personnel of the certifying accountant that was not connected with the original recording of the accounting data. Held, the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant.

20. A small loan company kept its accounting records on a cash basis. The primary records of the company consisted of daily cash reports that were prepared by the cashier and signed by the manager. The accountant who certified the financial statement of this company took no part in the preparation of these basic records. However, he did audit these cash reports each month and then proceeded to enter the totals in a summary record which he in turn posted to the general ledger. The certifying accountant also made adjusting journal entries each month with respect to insurance, taxes, depreciation, and similar items. The company was small and did not require the services of a full-time bookkeeper. The certifying accountant devoted about one day a month to the clerical or bookkeeping tasks described above. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.

[Accounting Series Release No. 47, January 25, 1944]

§ 211.50 *The propriety of writing down goodwill by means of charges to capital surplus.* Inquiry has been made as to whether in a financial statement required to be filed with the Commission goodwill may be written down or written off by means of charges to capital surplus. The goodwill in question resulted from the acquisition during the year of the assets and business of a going concern at a price of $2,000,000, payable in cash or its equivalent. It was determined that $1,750,000 was paid for the physical assets acquired and $250,000 for goodwill. It is now proposed to write off this goodwill by a charge to capital surplus.

In my opinion [1] the proposed charge to capital surplus is contrary to sound accounting principles. It is clear that if the goodwill here involved is, or were to become, worthless, it would be necessary to write it off. Preferably such write-off should have been accomplished through timely charges to income, but in no event would it be permissible, under sound accounting principles, to charge the loss to capital surplus. The procedure being proposed would, however, evade such charges to income or earned surplus and would consequently result in an overstatement of income and earned surplus and an understatement of capital.

This position was expressly taken in the following paragraph of the Commis-

[1] Chief Accountant.

sion's opinion in In the Matter of Associated Gas and Electric Company, 11 S. E. C. 1025:

[the] position [taken] with respect to intangibles not subject to amortization assumes that as long as the write-off is made because of conservatism before actual realization of the loss, the write-off may be made to capital surplus. This practice would permit a corporation to circumvent charges which should be made against income or earned surplus by recognizing them in advance as a charge against capital surplus and, in our opinion, it is not consistent with the fundamental principle that a distinction should be maintained between capital and income.

[Accounting Series Release No. 50, January 20, 1945]

§ 211.51 *Disposition of Rule II (e) (17 CFR 201.2) proceedings against certifying accountant failing to observe appropriate audit requirements as to financial statements of broker-dealer under Rule X–17A–5 (17 CFR, 240.17a–5).* The Securities and Exchange Commission today made public the following information concerning private proceedings involving a certified public accountant. The accountant in question had certified the financial statements of a registered broker-dealer filed as part of a report pursuant to the requirements of Rule X–17A–5 (17 CFR, 240.17a–5), adopted under Section 17 (a) of the Securities Exchange Act of 1934. The proceedings were instituted to determine whether, pursuant to Rule II (e) (17 CFR, 201.2) of the Commission's Rules of Practice, the accountant in question should be temporarily or permanently denied the privilege of practicing before the Commission.

The statement of the broker-dealer in question, a corporation, was required to include financial statements certified by an independent certified public accountant or independent public accountant. The certificate of the respondent in these proceedings read, in part, as follows:

I have reviewed your accounting records and procedures, analyzed and verified all accounts with debit as well as credit balances and examined or verified all securities and cash items, underlying customers, brokers, officers, and inventory or trading accounts in accordance with the generally accepted audit standards applicable to brokers.

I hereby certify that the Balance Sheet headed Exhibit A together with the supporting schedules and details corresponding to the questions contained in S. E. C. Form X–17A–5 (17 CFR, 249.617) entered in on the Table of Contents attached to my report herewith, in my opinion correctly reflects the financial status of your corporation as at * * *.

Subsequent examination of the records of the broker-dealer by the Commission's staff indicated that as of the date the above report was filed the corporation was insolvent; that customers' free securities had been wrongfully hypothecated in connection with notes payable to banks; other customers' free securities had been treated as securities of officers pledged to secure such officers' debit balances due to the corporation; and that certain notes payable to banks, secured by customers' free securities, and the collateral thereto were not recorded on the books of the broker-dealer and were not included in the liabilities shown in the certified statement of financial condition filed with the Commission.

The certifying accountant stipulated that his testimony given during the course of the Commission's investigation of the broker-dealer involved could be made a part of the record in these proceedings. From his testimony, the following facts were established as to the circumstances of his engagement and the scope and nature of his audit:

The auditor was a certified public accountant of some thirty years' experience, but was actually engaged mostly in income and other tax work; only twice before had he made audits of a broker-dealer;

He had met the broker-dealer's president through another client some months before he obtained the present engagement but had done no work for the broker-dealer previously; arrangements for the engagement were made by an officer of the broker-dealer who was also the firm's bookkeeper;

Prior to his audit in connection with the Form X–17A–5 filed by the broker-dealer he had read the instructions applicable to the form including the minimum audit requirements prescribed therein;

His "audit" consisted primarily of (1) the preparation of a trial balance of the general ledger, (2) the examination of securities on hand at a date several days subsequent to the date of statement, (3) comparison of such securities with a purported inventory of securities handed him by the bookkeeper, (4) reconciliation, as of the date of the audit, of two bank statements which were given to him, together with the applicable cancelled checks, by the firm's president; and (5) examination of some correspondence in the firm's files and of certain "confirmations" of bank loans and the underlying collateral obtained by the president.

The audit made thus failed to include a number of procedures and safeguards which are prescribed in the instructions to Form X–17A–5 as minimum audit requirements for the proper substantiation of a statement of the financial condition of a broker-dealer. The more important procedures omitted in this case were:

(*a*) Verification of securities in transit or transfer;

(*b*) Obtaining of written confirmations by direct correspondence in respect of bank balances, money borrowed and collateral pledged thereagainst, accounts and securities carried for others, securities borrowed and loaned, securities failed to deliver and failed to receive, and accounts with customers, officers and directors; and

(*c*) Review of the methods of internal accounting control of the broker-dealer and its procedures for safeguarding securities.

In the course of his testimony the accountant stated that he "didn't complete the thing, perhaps, the way I should have * * * perhaps not as thoroughly as I should * * * I was anxious to get away. I went down to Florida and this engagement was the last one I had prior to going, and I was more or less in a hurry * * * We agreed on a price of $125 to do the work in connection with the balance sheet audit and I believe I did $125 worth of work. That is about the size of it * * * I did what I would ordinarily do unless there was something that came up that was peculiar or different or I suspected anything, but in this case I didn't and actually I had only this short experience in connection with brokers * * * If I suspected there was anything wrong one thousand dollars wouldn't have covered the thing. I mean, whatever you have to go through I—in other words, I wouldn't have taken the engagement at all because I was in a hurry to get away * * *

It does not appear that the failure of the certified public accountant to perform a satisfactory audit contributed to the fraud perpetrated by the broker-dealer involved, nor apparently did his extreme laxity occasion losses to investors of the brokerage firm. For these reasons and since the accountant has filed a stipulation in which he has admitted that he was familiar with the Commission's Rule X–17A–5 (17 CFR, 240.17a–5) and with Form X–17A–5 (17 CFR, 249.617); that he had not observed the minimum audit requirements prescribed by that form; and that he would never again practice before this Commission as an accountant, the proceedings with respect to him were discontinued. [Accounting Series Release No. 51, January 26, 1945]

§ 241.52 *Presentation in financial statements of Federal income and excess profits taxes in cases where a company for which individual statements are filed pays its tax as a member of a consolidated group of companies.* Inquiry has been made as to the method to be followed in reporting Federal income and excess profits taxes pursuant to the provisions of caption 15 of Rule 5–03 of Regulation S–X (17 CFR, 210.5–03). In the case cited the company files for tax purposes as a member of a consolidated group but files with the Commission its individual financial statements. It is stated that on an individual basis the company would have been liable for $1,000,000 of Federal normal income and excess profits taxes; and that $400,000 of this amount represented excess profits taxes. As a member of a consolidated group its share of the consolidated income and excess profits taxes was $700,000.

Caption 15 of Rule 5–03 of Regulation S–X (17 CFR, 210.5–03) requires that there be stated separately "(*a*) Federal normal income and excess profits taxes; (*b*) other Federal income taxes; and (*c*) other income taxes.[2] Where a company is filing individual financial statements and reports on the same basis for tax purposes, the above breakdown of the total provision for Federal income and excess profits taxes should be made. Likewise, where consolidated financial statements are being filed, the above breakdown should be made.

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[2] In Accounting Series Release No. 23 (April 9, 1941) (17 CFR, 211.23) it was indicated that caption 15 contemplated "that the normal income, defense, and declared value excess profits taxes should be included under subsection (a) and the excess profits tax prescribed by the Second Revenue Act of 1940 should be included under subsection (b)." The excess profits taxes presently in effect should therefore be shown under (b).

In the case cited, however, the provision made by the individual reporting company for income and excess profits taxes represents merely a provision for its share of the income and excess profits taxes of the consolidated group of companies. In the instant case, the share of the aggregate consolidated tax apportioned to an individual member of the group was, I [1] understand, determined on the basis of the ratio of the total tax that would have been paid by a particular company to the combined tax that would have been paid had all members of the group filed on an individual basis. Under such circumstances, I am of the opinion that an allocation of an individual company's share of the aggregate tax as between excess profits taxes on the one hand and normal and surtax on the other hand would be arbitrary and of little significance. For this reason I feel it would be appropriate for a member of the group to combine in its individual statements subdivisions (a) and (b) of caption 15 and to show its provision for Federal income and excess profits taxes as a single item. By means of footnotes, however, there should be shown the estimated amount of Federal income and excess profits taxes applicable to the company had it filed on an individual basis, with an indication of the estimated amount of excess profits taxes involved. [Accounting Series Release No. 52, May 10, 1945]

§ 211.53 *Statement of the Commission's opinion regarding "charges in lieu of income taxes" and "Provisions for income taxes" in the profit and loss statement.* The purpose of this statement is to outline the Commission's views in the matter of so-called "Charges in lieu of income taxes" and of "Provisions for income taxes" which are intentionally in excess of those actually expected to be payable; to give the reasons for that opinion; and to state its views on the points which certain accounting firms have made in connection with the principles discussed herein.

For some time there has been growing up a practice, tolerated by some accountants and sincerely advocated by others, pursuant to which the current income account is charged under the heading of income taxes or charges in lieu of income taxes, not only with the income taxes expected to be paid by the company but also with an additional sum equivalent to the reduction in taxes brought about by unusual circumstances in a particular year.[1a] Certain public utility companies have included such charges and excessive income tax provisions among their Operating Expenses. This additional charge against income is, in most cases, offset either by a credit to surplus or by utilizing the reduction for some special purpose such as eliminating a portion of unamortized discount on bonds. The amount of the estimated reduction has been colloquially termed a "tax saving" and the general problem is loosely referred to as the "treatment of tax savings." [2]

This practice with its variants has caused the Commission some concern and it seems desirable now to state our views as to the accounting procedures appropriate in such situations and to give the reasons for them. In summary, our conclusions are as follows:

(1) The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws.

(2) It may be appropriate, and under some circumstances such as a cash refunding operation it is ordinarily necessary, to accelerate the amortization of deferred items by charges against income when such items have been treated as deductions for tax purposes.[3]

(3) The use of the caption "Charges or provisions in lieu of taxes" is not acceptable.

(4) If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses being written off.

(5) The location within the income statement of any such special charge should depend on the nature of the item being written off. In the case of a public utility, for example, a special amortization of bond discount and expense should not be shown as an operating expense but should be classified as a special item along with other interest and debt service charges in the "other deductions" section.

(6) It is appropriate to call attention to the existence of the special charge by the use of appropriate explanatory language in connection with intermediate balances and totals.

(7) In the preparation of statements reflecting estimates of future earnings, it is ordinarily permissible to reflect as income taxes the amount which it is expected will be payable if such earnings are realized, provided, of course, the assumptions as to the tax rates are disclosed.

(8) In the preparation of statements which are designed to "give effect" to specified transactions, the provision for taxes may, depending on all the facts and circumstances, properly represent either (a) the actual taxes paid during the period adjusted to give effect to the specified transactions, or, (b) an estimate of the taxes that it is expected will be payable should the income of future years be equal in amount to the adjusted income shown in the statement. The statement should, of course, clearly show what the provision for taxes purports to represent.

The reasons for our views can best be developed by using the facts relating to a registration statement recently filed by the Virginia Electric and Power Company (VEPCO) under the Securities Act of 1933 in which we took a position in the matter. This case is chosen not only because its facts are typical of most cases in which this problem arises but also because the public accountants who certified the financial statements in that case have since appeared before us and presented in detail their views in the matter.[4] The discussion of this case and of the general problem which it typifies will be presented under the following main headings:

(a) *The background of the Vepco Case.* A brief description of the registration and of the transactions giving rise to the problem.

(b) *The certified financial statements originally filed.* A description of the certified financial statements originally filed, pointing out briefly our difficulties with the way in which the so-called "tax saving" was handled.

(c) *Amendments to the certified statements.* A description of the certified income statements after each of the amendments, pointing out briefly in each case our objections to the treatment accorded tax provisions and "tax savings."

(d) *The pro forma income statements.* A brief description of the pro forma statements

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[1] Chief Accountant.

[1a] In general, the unusual circumstances are based on differences in the accounting treatment of certain items for income tax purposes and for general financial purposes. For example, losses and expenses which had to be taken as income tax deductions in a given period were not also taken as deductions in the profit and loss statement for the same period. Instead, because of differences in accounting methods, such items had already been charged off against income in previous years, or were being charged off directly to surplus or reserves, or were to be deferred and charged off against income in future years.

[2] We think this terminology is undesirable in principle and possibly misleading. Our preference is to call them "tax reductions." See footnote 23, *infra*.

[3] Under the controlling decisions of the Federal courts (*Helvering* v. *California Oregon Power Co.*, 75 F. (2d) 644 (1935), D. of C., *Helvering* v. *Union Public Service Co.*, 75 F. (2d) 723 (1935), Eighth Circuit), unamortized bond discount and expense applicable to bonds being refunded through the issuance of new bonds for cash are deductible for purposes of the Federal income tax in the year in which the refunding takes place. Not all accountants, however, are in accord that such items must as a matter of sound accounting be immediately written off. Many believe that such items should preferably be amortized against income over the life of the refunding issue if a correct statement of the cost of money is to be obtained. (Cf., Healy, *Treatment of Debt, Discount and Premium Upon Refunding*, 73 Journal of Accountancy, 199 (March 1942).)

[4] In the summer of 1944, we caused to be circulated for comment a proposed Accounting Series release containing a tentative statement of our conclusions in this matter. Comments were received from accountants, registrants and others interested in the problem and a number of informal conferences were arranged with the staff and the Commission. Of the twenty-eight letters and comments received, five individuals or firms and a committee of the American Institute of Accountants objected to the general position taken in the draft. Subsequently, in December 1944, the Committee on Accounting Procedure of the American Institute of Accountants issued a bulletin "Accounting for Income Taxes" which in a number of important respects is inconsistent with the conclusions we have reached. In January 1945, the Committee on Accounting Principles and Practice of the New Jersey Society of Certified Public Accountants issued a statement with respect to the A. I. A. bulletin, taking some exception to the proposals made as to the treatment of "tax savings." In coming to a final conclusion in this matter, we have given extensive consideration to the views expressed and the points made by those commenting on the tentative statement of our views, as well as to the contrary position taken in the bulletin mentioned.

filed, pointing out our objections to the treatment of taxes in the statements originally filed.

(e) *The findings and opinion of the Commission in the related case, in the Matter of Virginia Electric and Power Company (H. C. A. Release 5741).* A description of the financial statements and ratios set forth in that opinion which were criticized in some respects by the certifying accountants in their discussion of this problem.

(f) *The treatment of "Tax Savings" in financial statements filed with this Commission.* A detailed discussion of the considerations underlying our views as to the treatment of income taxes and of so-called "tax savings."

(a) *The background of the Vepco Case.* On March 23, 1945 the Virginia Electric and Power Company (VEPCO) filed with this Commission under the Securities Act of 1933 a registration statement covering its First and Refunding Mortgage Bonds, Series E. The statement after being amended several times became effective on April 20, 1945 as to $59,000,000 of such bonds. Certain financial statements of VEPCO included in the registration statement were certified by Lybrand, Ross Brothers & Montgomery. Those of Virginia Public Service Company, a company recently merged with VEPCO, were certified by Arthur Anderson & Co. Several days after the amended statement became effective, representatives of both firms of certifying accountants appeared before the Commission to discuss certain accounting questions as to the treatment of income taxes and of the so-called "tax savings."

In the registration statement filed by VEPCO, certified financial statements for the years 1942, 1943 and 1944 were filed for VEPCO, for Virginia Public Service Company which had been merged with VEPCO on May 26, 1944, and for the two companies combined. In addition, there were filed "adjusted" balance sheets and income statements designed to give effect to the merger with Virginia Public Service Company, the sale of certain transportation properties, the proposed refinancing and certain related adjustments.

The accounting and "tax savings" issues centered on the treatment to be accorded the following three items which arose out of transactions that had occurred in 1944:

(1) Premiums and expenses incurred in refunding VEPCO's bonds, amounting to $2,383,096.46.[5]

(2) A loss of $3,418,715.16 sustained upon the sale by VEPCO of certain transportation properties.

(3) An item of $600,949 said to arise out of the asserted fact that the normal depreciation on certain plant facilities was substantially less than the amortization of such facilities taken for tax purposes at 20% per annum under Section 124 of the Internal Revenue Code.[6]

In the original registration statement, and in all of the amendments, the registrant and its accountants took the position that the income statements should be prepared in such a way as to reflect therein charges equal to what it was estimated Federal excess profits taxes would have been had not the special transactions occurred. In the original filing the provision for excess profits taxes was shown as an operating expense not in the amount expected to be paid but in the amount that would have been payable had not the three special items existed. After the second amendment, the provision for excess profits taxes was shown at what was actually estimated to be payable for the current year under the applicable tax law, but a separate additional charge, specially described, was also included among the operating expenses in an amount equal to the difference between the provision for actual taxes and the estimated provision that would have been needed had not the three items existed. The third and fourth amendments altered the description of these special charges, and their position in the income account. The wording of some of the other related captions was also modified. As finally amended, special charges representing portions of the premium and expenses on redemption of the bonds and of loss on sale of properties were wholly excluded from the operating expenses and set out as a separate item of "deductions from income." The adjustment within the income account based on the treatment of emergency facilities was eliminated. The extent to which this presentation reflects the views expressed in this opinion will be pointed out later.

In Exhibits A, B, C and D there are presented the relevant portions of the 1944 income statement as originally filed and after each amendment.

(b) *The certified financial statements originally filed.* The Commission's directly applicable accounting requirements are found in Rules 3-01 (a), 3-06, 5-03 and 11-02 of Regulation S-X. (17 CFR, 210.3, 210.3-06, 210.5-03, 210.11-02). The pertinent portions of the rules are reprinted in the margin:[7]

It is apparent that these rules called for the careful segregation and clear description of any nonrecurring or unusual items charged or credited to the income account or to earned surplus. The plain import of caption 15 of Rule 5-03 is that there shall be shown thereunder only amounts actually provided for income taxes.

With those requirements in mind we turn to the income statement originally filed by the registrant, and certified by its accountants, purportedly in conformity to the requirements of the Securities Act and the rules and regulations issued thereunder.

As will be seen from Exhibit A, there was set forth in the 1944 income statement as an operating expense, an amount for excess profits taxes equal to what the registrant computed would have been the amount of such taxes had none of the three special items existed. This excess profits tax figure appeared under the caption, "Taxes, excluding reductions shown separately below or applied against items charged directly to surplus."

The reduction in taxes attributed by the registrant to the excess of the tax amortization of emergency facilities over the normal depreciation thereon was

[5] In 1942 Virginia Public Service Company called for redemption certain of its outstanding bonds. Unamortized debt discount and expense, call premium and expenses applicable to the redeemed bonds amounted to $2,021,703.13. Solely in order to simplify the present discussion, this item is not discussed in detail although its treatment involved much the same problems as the 1944 refunding.

[6] Section 124 of the Internal Revenue Code provides for the deduction by taxpayers, at their election, of accelerated amortization of property (including land) constituting an "emergency facility" by reason of certification by designated Government authorities that the property was necessary in the interest of national defense. Such amortization, which is is lieu of a deduction for ordinary depreciation usually at a much lower annual rate, is based on an arbitrary five-year life period but this may be amended to such shorter period as will end with the date officially declared as the end of the emergency war period. The President, by Proclamation, terminated the emergency period referred to in § 124 as of September 29, 1945. The VEPCO statements do not indicate the dollar amounts of such facilities, the normal depreciation taken, or the amortization taken for tax purposes. The figure of $609,949 represents the company's estimate of the amount by which Federal taxes would have been increased had only the normal depreciation been taken for tax purposes.

[7] a. Rule 5-03 (17 CFR, 210.5-03 (Profit and Loss or Income Statements) Caption 15 *Provision for income and excess profits taxes.* State separately (a) Federal normal income and excess profits taxes; (b) other Federal income taxes; and (c) other income taxes.

b. Rule 5-03, (17 CFR, 210.5-03) Caption 12; *Miscellaneous income deductions.* State separately, with explanations, any significant amounts, designating clearly the nature of the transactions out of which the items arose.

c. Rule 11-02 (17 CFR, 210.11-02) (Statement of Surplus) Captions 3 and 4. 3. *Other additions to surplus.* Specify. If two or more of the classes of surplus specified in the rule as to the form and content of the particular balance sheet are stated in one amount, the nature of other additions to surplus (caption 3) and of other deductions from surplus (caption 4) shall nevertheless be so designated as to indicate clearly their classification in accordance with such applicable rule. 4. *Deductions from surplus other than dividends.* Specify. See caption 3.

d. The second sentence of Caption 2B of Rule 5-03 (17 CFR, 210.5-03): A public utility company using a uniform system of accounts or a form for annual report prescribed by Federal or State authorities, or a similar system or report, may follow the general segregation of operating expenses prescribed by such system or report.

e. Rule 3-01 (a) (17 CFR, 210.3-01 (a)). Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto.

f. Rule 3-06, The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of statements required to be filed in the first instance with other governmental agencies.

added back to net income at the very bottom of the statement under this caption:

Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed through their normal life and not to replace existing facilities	$609,949

The sum of this item and of a figure labelled "Net Income" was described as "Balance transferred to earned surplus ——"

In the related surplus statements, charges were set forth in respect of the refunding costs and the loss on sale of transportation properties as follows:

Loss arising in connection with sale in 1944 of transportation property, less resulting reduction in Federal taxes on income	$1,361,842.16
Redemption premiums and expenses in connection with refunding of bonds, less resulting reduction in Federal taxes on income	291,919.46

There were no notes to the certified income or surplus statements in further explanation of these items.[8]

[8] In the 1942 income statements of Virginia Public Service Company a similar transaction was explained by means of a footnote which if read in conjunction with the surplus statement disclosed the total refunding expenses. The note read as follows:

(C) Federal Income and Excess Profits Taxes:

Virginia Public Service Company and subsidiaries—The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting amortized debt discount and expense, call premiums and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring deductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of income for 1942 as special amortization of debt discount and expense. The balance of unamortized debt discount and expense, call premiums and duplicate interest on long-term debt called for redemption in 1942 was charged against earned surplus.

However, the taxable net income as computed did not reflect the deduction, for tax purposes, of losses upon sales of ice and railway property, and certain other items charged to surplus. As a result, provisions charged to income in 1942 were approximately $330,000 in excess of the company's liability for Federal income taxes as shown in its tax return for that year. Pending review of the returns, this excess provision is included in accrued Federal income and excess profits taxes at December 31, 1943.

In 1943 the company filed a claim for refund of 1941 Federal taxes in the net amount of approximately $297,000 under the carry-back provisions of the 1942 Revenue Act. However, this amount is subject to such adjustments as may result from review by the U. S. Treasury Department and the claim has not been recorded upon the books of the company. * * * See also Exhibit A.

The total refunding expenses can be computed by adding the disclosed reduction of $1,571,158 to the $450,549.98 which is shown as a net direct debit to earned surplus.

The 1944 income statement as originally filed by the registrant and certified by its public accountants, did not comply with the applicable requirements and in our opinion was clearly misleading in the following important respects:

1. The total loss on sale of transportation properties was not shown.
2. The amount of refunding expenses in 1944 could not be determined.
3. The amount provided for the estimated tax liability for 1944 could not be determined.
4. The treatment and disclosure of similar transactions was different. In 1942 the amount of the estimated reduction in taxes due to the refunding was stated; this was not done as to the 1944 refunding. Also the treatment accorded tax deductible losses charged to surplus was different in 1942 than in 1944.

An investor could thus determine from the certified financial statements only that the sum of the tax liability plus loss on transportation properties plus the refunding expenses amounted to a certain figure as follows:

Provision for taxes as shown in the income statement):	
Federal Income Tax	$2,139,496.39
Federal Excess Profits	8,164,870.79
Post-War Credit	(351,081.99)
Total tax provision	9,953,285.19
Surplus charges, less resulting reduction in Federal taxes on income:	
Loss on transportation properties	1,361,842.16
Refunding expenses	291,919.46
	11,607,046.81
Less: Reduction due to amortization of emergency facilities (as shown in the income statement)	609,949.00
Balance	10,997,097.81

It is true that by reference to the uncertified pro forma or adjusted income statements it can be determined that the reduction in taxes due to the items charged to surplus was $4,148,050. It is obviously unsound, however, to expect that a collateral disclosure in one set of statements will be inevitably and clearly connected by the reader with the information given in another and certified set of statements, at least without a clear cut cross reference.[9] This was apparently recognized since in the first amendment a paragraph was added to Note C to the income statement disclosing the $4,148,050 figure.[10] However, even with this figure before him the reader could determine only the aggregate reduction attributed to two wholly disparate items. It seems self-evident that the actual total loss on transaction properties sold and the total amount of refunding expenses are material facts. We think it equally apparent that the estimated amount of actual taxes is an important fact.[11]

There is another, though less patent difficulty. The amount shown for excess profits taxes was $8,164,870.79. The postwar credit against excess profits taxes was shown as $351,081.99, or at the rate of about 4.3%. Since the postwar credit is normally 10% of the excess profits tax, the disparate relationship of these two figures should raise a question to even the average reader of the statement. There was, however, no explanation directed to this point. When the figure shown for excess profits taxes was reduced to the actual amount believed to be payable ($3,406,871.79) no change was made in the amount shown for the postwar credit. Apparently the amount by which the excess profits tax provision was increased on account of the charges to surplus was net of the statutory 10% credit. In other words, the figure shown as a provision for excess profits taxes was doubly a hybrid. First it combined actual taxes with "tax savings." Second to the extent of the estimated actual liability it was computed at the rate of 95%, but as to amounts in excess of actual liability, the rate used appears to have been 85.5%—that is, the full 95% less the 10% postwar credit.

There remains a final point—the caption under which the tax provision was set forth. The language "Taxes—excluding reductions shown separately below or applied against items charged directly to surplus" in our opinion scarcely lends itself to ready understanding but instead is apt very easily to convey exactly the opposite of its intended meaning through its use of "exclude me in" language. In our opinion such a description of this hybrid item represents a distinct barrier rather than an aid to understanding.[12]

In addition to all of the above difficulties, two much more basic questions are presented by the registrant's accounts: (1) whether there may or should be included in the operating expenses of a regulated public utility, under the cap-

[9] As we said in our opinion in the matter of *Universal Camera Corporation* (Securities Act Release 3076, June 29, 1945): "A disclosure which makes the facts available in such form that their significance is apparent only upon searching analysis by experts does not meet the standards imposed by the Securities Act of 1933 as we understand that Act."

[10] The first amendment was filed before the staff issued its letter of deficiencies.

[11] The treatment in this case is particularly unsatisfactory since the aggregate "reduction" is not divided proportionately between the two items. From the amended statements, it appears that the *total* loss on transportation properties was $3,418,715.16 of which $1,361,842.16 or about 40% appeared as a charge to surplus. In the case of the refunding expenses the total amount was $2,583,096.46 of which, however, only $291,919.46 or about *12%* was charged to surplus. Inquiry developed that these differences were due first to the fact that in computing the estimated actual tax for the year, the amount recognized as an allowable tax deduction was about $1,000,000 less than the $3,418,715 recorded as a loss on the books; and second, to the fact that the refunding expenses used as a tax deduction amounted to about $63,000 more than those written off in the accounts. The amount of the reduction in taxes due to each of these two items was computed by applying a rate of 35.5%, that is, the 95% excess profits tax rate less the 10% postwar credit. Without knowledge of these important facts, even an expert could do no more than guess at what had been done with the accounts.

[12] See footnote 9, *supra*.

tion of taxes, any amount in excess of the amount estimated to be actually payable under the applicable provisions of the tax laws; and (2) whether any amount should be included in or with such operating expenses to compensate for the reduction in taxes due to items like those in question here. These issues are raised more clearly by the statements in their amended form and discussion of them will be deferred until the amendments have been described.

(c) *Amendments to the certified financial statements.* In view of objections on the part of the Commission's staff to the income statements as originally filed, a formal letter of deficiencies was sent on April 14, 1945 specifically criticizing the presentation of the items under discussion as follows:

Financial Statements

Income Statements

It is noted that the earned surplus statement for the year 1942 reflects charges aggregating $497,288.10 representing "Unamortized debt discount and expense, call premiums and duplicate interest on long-term debt called for redemption, less resulting reduction in Federal taxes on income." It is also noted that the earned surplus statement for the year 1944 reflects charges of $1,261,842.16 and $291,919.46 representing "Loss arising in connection with sale in 1944 of transportation property" and "Redemption premium and expenses in connection with refunding of bonds" respectively, less, in each instance, "resulting reduction in Federal taxes on income." Further, it is noted that the 1944 income statements reflect "tax savings" aggregating $609,949.00 resulting from special amortization of emergency facilities.

It appears that the total effective charges to savings in Federal income and excess profits taxes resulting from the above redemption of bonds, sale of property and special amortization of emergency facilities should be reflected separately in the income account under an appropriate descriptive title. In this connection, the title "charge in lieu of taxes" will not meet such requirement. Such amounts should be shown immediately below the total of "Operating Expenses and Taxes." [12]

Following the filing of the first amendment on April 2, there occurred several discussions with the staff based generally on the position taken in the letter of deficiencies dated April 14. In these discussions it was made clear that the staff took the position that the tax provision should not exceed the estimated amount believed to be payable and that charges to the income account "in lieu of taxes" could not be considered operating expenses. The staff also took the position that it would not object to charging the income account with so much of the two items charged to surplus (loss on sale of transportation properties and refunding expenses) as was equal to the company's estimate of the reduction in taxes caused by such items.

[12] We do not construe this paragraph to mean that charges may be made to income for the so-called "tax savings," provided only they are separately set forth. If it does, we disagree. We construe the language to mean rather that where taxes are reduced due to special circumstances special charges of an equivalent amount may be made to the income account, if the particular item involved is one that may properly be made to income and if the special charge is clearly described for what it is, for example, "Special charge-off of unamortized bond discount."

The second amendment was filed on April 16, 1945, substantially revising the certified income statement for 1944. In the amended statement, the provision for excess profits taxes was shown at the amount estimated to be actually payable. The following new item, equal to the reduction in the amount shown as excess profits taxes, was inserted under the general heading "Operating Expenses and Taxes."

Special charges equivalent to reduction in Federal excess profits taxes resulting from special amortization of emergency facilities (reduction shown separately below) and from redemption of bonds and sale of property (reductions applied against related items charged to surplus)	$4,757,999

The item was inserted immediately after a total captioned "Total Operating expenses and taxes before special charges." The sum of the special charges and the above caption was labelled: "Total operating expenses and taxes including special charges" and this item was then deducted from the total of operating revenues to arrive at a figure labelled: "Net operating revenues." The remainder of the income statement, and the surplus accounts were the same as in the original filing except that a paragraph added by amendment #1 to Note C to the income statement was dropped, presumably because the $4,148,050 figure it disclosed could now be derived from data given in the income statement.[14] It will be recalled that this figure was the total amount by which taxes were estimated to have been reduced because of the loss on transportation properties and the refunding expenses.

The changes made are summarized in the following table:

	As originally filed	After 2d amendment
Operating revenues	$51,681,778	$51,681,778
Operating expenses and taxes:		
Other than taxes	28,237,367	28,237,367
Taxes, excluding reductions shown separately below or applied against items charged directly to surplus [13]		
Taxes:		
Federal income	2,139,496	2,139,496
Federal excess profits	8,164,572	3,406,571
Post-war credit	(351,082)	(351,082)
Other	4,131,408	4,131,408
Total	42,322,060	
Total operating expenses and taxes before special charges		37,564,061
Special charges, etc.		4,757,999
Total operating expenses and taxes, including special charges		42,322,060
Net operating revenues	9,359,718	9,359,718

[14] See Exhibit B. The $4,148,050 figure can be derived as follows:

Special charges	$4,757,999
Reduction due to amortization of emergency facilities (shown as last item of income statement)	609,949
Remainder applicable to the two surplus items	$4,148,050

[13] This caption was deleted by the second amendment and the caption "Taxes" substituted therefor.

The amended presentation was further questioned by the staff on these points:

1. The continued failure to disclose either the total loss on sale of transportation properties or the total refunding expense.
2. The impropriety of adding the special charges to operating expenses.
3. The propriety of the adjustment within the income account in respect of the amortization of emergency facilities.

The second of these points to some extent may conflict with the last sentence of the deficiency letter, quoted earlier, which read:

Such amounts (i. e., special charges) should be shown immediately below the total of "Operating Expenses and Taxes."

Physically, of course, registrant's amended statement conforms to the deficiency letter by placing the special charges immediately after the total mentioned. It was the staff's position, however, that the deficiency called for their inclusion at that point as a separate, distinct and different item, rather than in such a way as to imply that the special charges were true operating expenses, though perhaps nonrecurring in nature. We feel that the language of the deficiency letter might well have been more explicit and so more in conformity with the oral statements made by staff members. In any event, however, the point is now moot since when the case was presented to us for directions, it was determined not to permit inclusion of such charges in or with operating expenses.

After some further discussion of the matter with the registrant and its accountants, the staff brought the case to the Commission for directions, presenting for consideration the history of the case and the views of the registrant and its accountants both in this and other similar cases. We thereupon directed the staff to advise the registrant to the following effect:

1. That no adjustment should be made within the income statement based on the estimated reduction of income taxes due to the amortization of emergency facilities.[16]
2. That no objection would be raised to the inclusion in the income statement of an item of $4,148,050 representing so much of the refunding expenses [17] and of the loss on disposition of property as was equal to the estimated reduction in income taxes attributable thereto, the remainder of both these items being charged directly to surplus: *Provided, however,* (a) That the caption for the item indicates clearly the nature and amount of the item being charged off and (b) that the special charge be excluded from operating expenses and shown as a deduction from gross income.

After being advised as to our views, the registrant on April 19, 1945 filed a third amendment. In the revised income statement, the $609,949 adjustment based on the amortization of emergency facilities was omitted and taxes were shown at the actual estimated amount thereof. The $4,148,050 of Special Charges was set forth as a separate item in the following manner:

[16] Our views as to this particular variant of the general problem are outlined in footnote 35.

[17] According to the registration statement these costs consisted of redemption premiums and expenses in connection with the refunding of the bonds.

Gross income (before special charges below)	$14,072,358.24
Special charges equivalent to reduction in Federal excess profits taxes resulting from redemption of bonds ($2,091,177) and sale of property ($2,056,873) (reductions applied against related items charged to surplus)	4,148,050.00
Gross income (after special charges)	9,924,308.24
Deductions from income	3,719,526.80
Net income	6,204,781.44

The qualification "before special charges below" was also added to two prior captions so that they read as follows:

Total operating expenses and taxes (before special charges below).

Net operating revenues (before special charges below).

In addition Note C to the tax item was amended to disclose that no adjustment had been made in the income statement on account of the difference between depreciation taken therein on emergency facilities and the amount claimed therefor as amortization under Section 124 of the Revenue Code. The amount by which taxes were affected through this difference was given.

The staff brought the revised statements to our attention and we indicated that in our view the special charges should be classified as "other deductions" inasmuch as they represented items which, if charged to income, should, under the classifications of accounts to which the registrant was subject, be charged as an item of other deductions.

Upon being advised of these views the registrant filed its fourth amendment on April 20 in which the special charges were classified as an item of other deductions and Note C was expanded somewhat to set forth specifically the amounts charged to income in respect of the refunding expenses and the loss on transportation properties. As revised, the note no longer stated the amount of the tax reduction attributed by the registrant to the difference between the amount of depreciation and amortization taken on the emergency facilities. However, this amount can be derived from the other figures shown.

In transmitting to the registrant our views on the income statement as set forth in the third amendment, the staff indicated that the use of the words "before special charges below" in the several captions mentioned above was objectionable. We do not believe this position to be wholly sound. We feel that the existence of large special and unusual transactions ought properly to be forcefully brought to the attention of the reader of the statement. We feel also that the use of appropriate qualifying words such as "see special charges" in connection with the pertinent captions is an appropriate means of warning the reader of the existence of such items as were present in this case.

(d) *The pro forma income statements.* In addition to the certified income statements for the years 1942–44, the registrant filed uncertified pro forma income statements under the following general title:

Virginia Electric and Power Company Pro Forma Income Statement for 12 months ended December 31, 1944, Giving estimated effect as at January 1, 1944 to Merger, Sale of Transportation Properties and Proposed Refinancing.

The actual 1944 income statements of VEPCO, and of Virginia Public Service prior to its merger with VEPCO on May 26, 1944, were shown in two separate columns. In five additional columns there were shown (1) adjustments to give effect to the merger, (2) adjustments reflecting the sale of transportation properties, (3) adjusted statements prior to the proposed refinancing, (4) the refinancing adjustments, and (5) adjusted statements after the refinancing. We are here concerned primarily with the treatment accorded the tax items although some reference to other adjustments may be necessary.

In general, the presentation followed quite closely that used in the certified statements. As originally filed the total of income tax items shown in the two "actual" columns was the same as that shown in the certified statements, $9,953,285. This figure and the adjusted figure were both described as "Taxes—Federal income and excess profits (excluding reductions (1) as shown separately below and (2) of $4,148,050 related to and applied against items charged directly to surplus.") As pointed out earlier, these uncertified statements disclosed that which the original certified statements did not—the aggregate tax reduction resulting from the two items charged to surplus. In the statements filed adjustments of the "actual" tax figure were as follows: [15]

Tax provision as shown in the certified statements	$9,953,285
Add:	
Increase due to 1944 merger and refinancing	362,473
Increase due to redemption of series B, C and D bonds and issuance of series E bonds	294,552
	10,610,310
Less: Reduction resulting from sale of transportation properties	2,793,565
Adjusted or "pro forma" tax provision	7,816,745

A note keyed to the adjusted tax figure read:

The amount shown above for Federal income taxes includes provision for estimated excess profits taxes of $5,661,205 before reductions (1) as shown separately in the income statement and (2) of $4,148,050 related to and applied against items charged directly to surplus, and after deducting estimated post war credit of $328,900.

Finally, the $609,949 adjustment relating to the emergency facilities was added back at the foot of the income statement just as was done in the certified statements.

The form of this pro forma statement of income was not criticized in the letter of deficiencies dated April 14 and no change was made by the second amendment. However, when the case was brought to us for directions, as noted above, we indicated that the same treatment should be accorded the pro forma statements as in the case of the certified statements.

In the third amendment, therefore, the pro forma statement was revised by eliminating the adjustment related to the emergency facilities, by reducing the initial and adjusted tax figures to the estimated amount of actual liability therefor, and by segregating the "special charges" so as to show them, in conformity with the certified statements after the third amendment, as a deduction from "Gross income (before special charges below)." The balance was entitled "Gross income (after special charges)." Note C was also revised to read:

The amount shown above for Federal income taxes includes provision for estimated excess profits taxes (after deducting estimated post-war credit of $100,356) of $903,206 which is after reductions (1) of $609,949 resulting from amortization of emergency facilities and (2) of $4,148,050 related to and applied against items charged directly to surplus.

In the fourth amendment the form of the pro forma statement was again changed. A figure was now shown labelled "gross income" after which were shown three items; namely, the "special charges" of $4,148,050; interest and amortization, $2,409,075, and amortization of plant acquisition adjustments, $693,168. These were deducted as a group from the gross income figure to give a balance labelled "Net Income." Note C was amended to add the following, "but does not give effect to tax savings of $2,379,096 which are expected to result from the proposed refinancing." [16]

In our opinion, it would be most difficult to prescribe a rigid rule for the handling in "pro forma" statements of items such as are here in issue. The difficulty is due very largely to the variety of situations dealt with under the name of "pro forma" statements. For example, that term has been used to describe estimates of future earnings when cast in the form of an income statement. It is also used, as here, to describe a statement in which the actual operations of some past period are altered or adjusted either to "give effect" retroactively to certain specific transactions which have since taken place, or to "give effect" to

[15] The first amendment raised the amount of bonds being registered from $33,000,000 to $59,000,000. This change required alteration of the amounts of some of the adjustments. However, the form of presentation was not changed from the original filing.

[16] This change is not germane to the present discussion which relates to the costs of a previous refunding.

certain proposed transactions.[20] Where a pro forma statement reflects a straightforward estimate of future earnings, it would seem that the problem under discussion does not exist, since clearly any amount shown therein as taxes would be based on estimates of future tax rates and future taxable income. In such circumstances there would rarely, if ever, be any occasion for "charges in lieu of taxes" or "tax savings." Here the situation is different. The VEPCO "pro forma" statements are based on the actual statements for the year 1944. A limited number of adjustments to the actual figures are made to illustrate how certain specified events might reasonably be expected to have altered 1944 reports had such events occurred at the beginning of 1944. In this case these events are (1) the merger with Virginia Public Service on May 26, 1944 and the 1944 refinancing; (2) the sale of certain transportation properties during the year and (3) the proposed refinancing. On the other hand no retroactive adjustment was made as to a rate reduction which took effect on April 1, 1945. Such adjusted statements are, of course, useful to the extent they shed light on the future by illustrating the probable scope of the changes now being carried out. They are, accordingly, a hybrid form, being neither statements of actual operations nor thoroughgoing estimates of future earnings. In the present case, the changes made are relatively few so that, on balance, the adjusted statements are much closer in nature to an actual statement than an estimate of earnings. For that reason, we feel that our views as to the certified statements are applicable to the adjusted statement under discussion. We point out again, however, that here as in the certified statements it is proper to add an appropriate qualifying phrase to such captions as "gross income."

(e) *The findings and opinion of the Commission in the related case under the Public Utility Holding Company Act of 1935.* In their appearance before us the certifying accountants criticized certain data as to VEPCO that was included in our opinion in this case under the Holding Company Act.[21] Under the caption "Earnings" we set forth the following:

> Attached hereto as Exhibit B is an income statement of VEPCO for the twelve months ended December 31, 1944 adjusted to reflect the merger of Virginia Public Service Company and the recent sale of transportation properties and pro forma to reflect the proposed refinancing.
>
> Gross income, interest and amortization, and pertinent ratios are as follows:

TABLE IV

	Adjusted	Effect of refinancing	Pro forma
Gross income before Federal taxes on income	16,234,038		16,234,038
Federal taxes on income [1]	2,764,194	294,552	[2] 3,058,746
Gross income	13,469,844	294,552	13,175,292
Interest and amortization	2,760,710	331,635	2,409,075
Ratio of gross income before Federal taxes on income to interest and amortization	5.92		6.74
Ratio of gross income to interest and amortization [3]	4.91		5.47

[1] Reflects reduction in 1944 taxes of $2,091,177 resulting from redemption of bonds and $2,056,873 resulting from loss on sale of property.

[2] Does not reflect additional reduction in taxes of $2,379,096 to arise from payment of call premium in connection with the instant refunding.

The accountants pointed out that the ratios of gross income to interest and amortization were not at all representative of what might be expected for the future, since the provision for taxes was $4,148,050 less and gross income $4,148,050 more than they would have been had the refunding and sale of transportation properties not taken place. They further pointed out that under their proposal either to increase the amount shown for taxes by $4,148,050 or to deduct a special charge of that amount before arriving at gross income the resulting ratios would be 3.40 and 3.75 before and after adjustment for the proposed refinancing. These ratios they believed were far more reliable indications of what might be expected for the future.

The materials included in our opinion show on their face the basis on which the ratios in question were computed. They are, in our opinion, a correct reflection of what occurred in the period. On the other hand, we agree with the certifying accountants that the current period was unusual to the extent at least of the three transactions under discussion.[22] For that reason neither the current period nor ratios based on current results are fairly indicative of future possibilities. However, as will be pointed out in more detail later, we do not think the method of handling such a situation should be to alter or obscure the actual results of operation. Instead, we feel such a situation calls for a clear explanation of the circumstances. In this case, we feel that our opinion should have more graphically explained the situation by giving an additional set of clearly described ratios derived from the adjusted gross income figure referred to by the certifying accountants.

(f) *The treatment of "tax savings" in financial statements filed with this commission.* Cases involving the treatment of so-called "tax savings" [23] in financial statements have arisen with increasing frequency in recent months. For that reason, as stated earlier, we feel it desirable to state our views as to the treatment to be accorded such items in statements filed with us and to point out the reasons which have led us to those conclusions.

It is first necessary to state briefly certain of our general views as to the functions of financial accounting and the purpose of the income statement. In our opinion financial accounting is essentially historical in nature—it consists of an accounting for costs that have actually been incurred by the business and for the revenues that have been actually derived from the business. From a balance sheet point of view, the question is what part of past expenditures may still be treated as valuable assets, of benefit to future operations, and what part of such expenditures must be considered as having been used up or expired. In order to prepare an income statement, it is necessary to decide what part of the costs that have been incurred should be treated as expenses, and what part of the revenues obtained may be treated as income. Technically this process is sometimes spoken of as matching costs against revenues, the difference being, of course, profit or loss. The principal statement reflecting this matching up process for a particular period is the income statement.

In order to arrive at a more precise matching of revenues and costs, accountancy has developed many proce-

[20] Rule 170 of the General Rules and Regulations under the Securities Act of 1933 prohibits the use of pro forma statements which purport to give effect to the receipt and application of any part of the proceeds from the sale of securities for cash unless the sale of securities is underwritten and the underwriters are to be irrevocably bound, on or before the date of the public offering, to take the issue. *Cf.* Rule X-15C1-9 under the Securities Exchange Act of 1934.

[21] In the Matter of Virginia Electric and Power Company, H. C. A. Release No. 5741, April 20, 1945.

[22] It should be noted, however, that three of the four years from 1942 through 1945 are "unusual" by this test. In 1942 there were "Special charges" of $1,571,158 in connection with a refunding in that year. In 1944, there were the $4,148,050 "Special charges" in issue here. In 1945, it is estimated there will be $2,379,096 "Special charges" due to the proposed refunding. Only in 1943 were there no "Special charges." For the four years average gross income was $10,808,313 and average "Special charges" were $2,024,576.

[23] We think it undesirable in principle and possibly misleading to refer to this problem as involving "tax savings" although due to the general use of the term in this sense we have adopted that nomenclature here. It seems to us that the term "tax saving" is apt to connote some sort of standard or normal tax law and a standard or normal earnings year to which that law applies. The facts are, of course, that there has not been a static or standard or "normal" tax law or tax status; nor has it been possible except in most unusual cases to characterize any particular fiscal year of a company as a "normal earnings" year, from which all others are to be regarded as a departure. Under such conditions, each year's tax is whatever happens to result from the application of the computation formula, provided by the tax law of that year, to the sum total of taxable transactions and tax deductions resulting from whatever business may have been done in that particular year. Moreover, the past few years during which the term and the problem of "tax savings" appeared have clearly been unusual in nearly every respect. Finally, if the phenomenon in question is to be described as a "tax saving" it would seem necessary to describe as a "tax loss" the failure to carry through a transaction which it can be said would have resulted in a "tax saving." And if taxes in one year are higher should not that increase itself be considered to be a "tax loss." Our strong preference is to describe the problem as involving "tax reductions."

dures for handling particular transactions where the cost is incurred at one time and the benefit is received at another time, either earlier or later.

Much the same treatment is accorded cases in which a company receives revenue either before or after it delivers the goods or services contemplated. Ordinarily, such receipts will be treated as realized income, not necessarily in the year in which the cash is received, but rather in the year in which goods are delivered or in which the service is rendered or the costs of rendering that service are incurred.

It is also necessary as a part of this process of matching costs and revenues, for the purpose of determining income, to consider at appropriate intervals whether any amounts presently reflected as assets in the accounts should in the light of present conditions be written off or reserved against. Finally, consideration must be given to whether there exist contingencies for which provision should be presently made either by recognizing an actual, though perhaps estimated, liability, or by providing an appropriate reserve.

We have elaborated these underlying accounting assumptions in order to demonstrate further that financial accounting is in our opinion concerned with what did happen, not with what might have happened had conditions been different. And it does not attempt to forecast the future even though it supplies much of the material used in making such a forecast.[24]

There is, on the other hand, another field of financial statistics in which statements are used which in form and language are closely similar to the financial statements used in presenting actual balance sheets and income statements. This is the field of financial analysis and forecasting. In essence, the analyst begins with reports of actual operations and conditions and adjusts them to give effect to expected future changes and events in order to arrive at his estimate of future earnings. In one form of analysis and forecasting the analyst is content to comment upon the actual past results, to point out what parts of the past results are due to factors which are not expected to continue and how the existence of new factors and conditions is expected to alter past results. At times, however, the analyst goes further and attempts to prepare an "adjusted" statement which purports to show how past operations would have worked out had certain specified subsequent events taken place earlier. Finally, the analyst may seek to forecast as accurately as may be what he expects will be the results of future operations. Frequently, in such cases, his forecast takes a form very like that used in portraying the results of past operations.

The validity of such analyses and forecasts, whether in the form of comments, of adjusted statements, or of estimated future income statements, is clearly no greater than the soundness of the prophecies and estimates upon which they are based. The results shown, however, are meaningful to a reader only to the extent he is aware of and agrees with or understands the nature of assumptions and estimates made. In contrast to such forecasts, a statement of past operations, even though it is based in important part on opinion and judgment is primarily an historical record of actual events, not of prophesied future events.

The two types of financial statements are obviously in wholly different categories and have different uses in examining the investment merits of a security. Particularly because of the similarity in form, great care must be taken to ensure that the reader will be aware of the nature of the particular statement. Nothing, in our opinion, would be more misleading than to present, in the guise of an actual earnings statement, data which, in fact, was an estimate either of expected future earnings or of the effects of subsequent conditions and transactions on prior operations. The dangers inherent in the situation led us some years ago to adopt rules under the 1933 and 1934 Acts forbidding the use of "pro forma" statements unless a clear indication is given of the assumptions on which they are based.[25] Also under the 1933 Act we have by rule prohibited altogether the use of "pro forma" statements in certain cases. Apparently with a similar appreciation of the danger of confusing actual and pro forma income statements the American Institute of Accountants has for many years included in its Rules of Professional Conduct the following:

> 12. A member or an associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.

Notwithstanding the uncertainty inherent in estimates of future earnings, it is apparent that the formation of a considered investment judgment ordinarily involves a conclusion as to the future prospects of the company. It is necessary in the administration of the Public utility Holding Company Act in arriving at a decision as to the propriety of a particular security in relation to the capitalization and earnings, or as to the fairness of the price at which securities or assets are proposed to be sold. Under the Chandler Act it is a necessary step in arriving at a conclusion as to whether a proposed reorganization is fair and equitable and feasible.

In reaching a judgment as to the future prospects of a company it is customary to begin with a statement of actual operations for an appropriate past period. Because of this use of actual statements of operations, an effort is ordinarily made to present the results of prior years' operations in a form that is as readily usable as possible for that purpose. In general, what is done is to segregate and ear-mark what are considered to be unusual and non-recurring items of income, expense and loss so that the reader will be warned of them and so may arrive at a conclusion as to whether such items can be expected to recur. In addition, special treatment is accorded items of income or loss or expense that have been reported in the financial statements of one year, say 1943, but which by reason of later events or knowledge, are now known to have been actually part of the costs or revenues applicable to another year, say 1942. In such cases, it is customary in filing comparative statements for the two years to include such items in the year to which they are now known to be related. Such adjustments are in our opinion entirely proper and ordinarily desirable provided, of course, that appropriate disclosure is made so that the comparative statements can be reconciled with the 1942 and 1943 statements as originally issued. Finally, disclosure should be made as to significant, known factors that might render past earnings statements, or particular items therein, not indicative of probable future operations.[26] With such information at hand the reader of the statement is informed

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[24] Although we here emphasize the essentially historical character of financial accounting, it is by no means to be inferred that we feel the work done by the financial accountant is therefore mechanical or routine in nature. On the contrary, proper discharge of his duties and responsibilities presupposes that the financial accountant possesses and exercises an extremely high degree of professional skill, experience and judgment.

[25] *Supra*, footnote 20.

[26] In our opinion In the Matter of The Colorado Milling & Elevator Company (S. A. Release No. 2964, December 20, 1943) we had occasion to emphasize the need for disclosure of major changes in financial and operating factors that rendered statements of past earnings not fairly indicative of what might be expected for the future. In that case the registrant had disposed of a large investment portfolio the income from which had of course been included in past earnings statements, had used the proceeds of this sale and of a $2,000,000 bank loan to pay an extraordinary cash dividend of $7,000,000 and now proposed to issue some $3,000,000 of new 4% debentures. It had entered into new agreements for lines of bank credit at a much higher interest rate. Finally it had materially increased the rate of management compensation and had determined to extend its insurance coverage at a material increase in the amount of insurance premiums payable. In view of these significant changes in financial and operating factors and their material effect on the future earnings of the company we said:

> The net effect of the foregoing will be to diminish the net income available for dividends. Profit and loss statements are required in the registration statement as an indication to prospective investors of the registrant's earning power. The nine-years' profit and loss statement contained in this registration statement reflected the results of operations during a period when the registrant had maintained continuously a financial status substantially equivalent to that existing immediately prior to this financing. By reason of the changes effected since May 22, that financial status bears little resemblance to that which obtains presently. Where such changes will have a material effect on prospective earnings, the omission to disclose those changes and their effect with relation to the profit and loss statements is as misleading as if the registrant's past earnings had been misrepresented.

of what the past operations were, and of the conditions or transaction, which in the draftsman's judgment, are apt to be unusual and not apt to recur. In our opinion, this is the boundary line of financial accounting. It is the place at which the financial accountant in his capacity as such should stop. He is, we feel, essentially a historian, not a prophet.

This desire to prepare statements in a form more readily usuable in estimating the future has led some to attempt to present what can be called a "normal" income statement, the inference being that the statement shows about what can be expected to happen year after year. The broad justification alleged for the practice is that if the actual results of the year's operations are unusual a reader may be misled into thinking the abnormalities will recur and that the best, if not the only way, to avoid such misconceptions is to "normalize" the statement—that is, to exclude therefrom the effects of some or all of the conditions which in the opinion of the draftsman are deemed to be unusual.

The dangers inherent in such a practice are numerous. In the first place, the draftsman's judgment as to what is abnormal can scarcely be considered infallible. In the second place, there is certainly as much danger that the reader will fail to understand what has been done by the draftsman as that he will fail to recognize that the unadjusted statements are abnormal. Finally, the method is extremely susceptible of misuse through conscious or unconscious bias in making decisions as to what is unusual or abnormal about the current year. To a degree, of course, the care with which disclosure is made of the extent of normalization may serve to minimize the possibility of misleading the reader. But in general we are satisfied that a statement purporting to reflect the actual results of operations is far less likely to be misleading if abnormalities are explained than if they are eliminated by adjustment in the statement even with an explanation of the elimination set forth in a note.[27] If, of course, a clear and full explanation of the adjustments made is not given, the practice is highly deceptive and may be fraudulent. It may be noted in passing that accountants have long condemned such undisclosed "adjustments" terming them at times a device akin to "equalizing earnings."

We conclude, then, that the proper function of an income statement presenting the results of operations is to present an accurate historical record. On this basis, it is evident that the items included therein should clearly and accurately reflect only actual operations. It is accordingly our view that the amounts shown should be in accordance with the historical facts and should not be altered to reflect amounts that the draftsman considers to be more "normal" or likely to recur in future years.[28]

We return now to the particular problems presented by the facts in the VEPCO case. In their appearance before us the certifying accountants objected to our position and defended their proposal on three principal grounds:

(1) That as an accounting matter it is necessary to "allocate" the actual taxes as between charges to surplus and income from operations, even if that practice results in the inclusion in the income statement of a charge (described as taxes or as charges in lieu of taxes) in excess of the actual taxes payable, with an offsetting "credit" or "negative tax" being carried to surplus in amount sufficient to reduce the charge on account of taxes to the amount actually payable.

(2) That the adjustment of the tax figure, or the inclusion of a charge in lieu of taxes in or on a parity with operating expenses, results in the income statement being more useful to investors since it is more nearly indicative of "normal" conditions and probable results in the future.

(3) That in the setting of rates for regulated public utilities it is proper to base future rates on expected future taxes, hence the adjustment method tends to conform the income statement to the basis on which the rates of the company will be set.

For convenience, we shall first discuss the latter two points leaving the allocation argument until last. The second contention we believe to be unsound for the reasons stated in our general discussion of the functions of financial accounting and of income statements reflecting the results of past operations. We think such statements should be historical records of the results of whatever financial events actually took place. It is not the role of the financial accountant to adjust them so as to eliminate the effect of unusual circumstances which actually occurred. Accordingly, we can not agree with this contention. To include under operating expenses as taxes an amount which is not taxes because the substituted amount is considered by the draftsman to be "normal" is precisely the type of adjustment which we believe unsound in a statement of actual operations. And if the amount of the adjustment is undisclosed the statements are deceptive to a point that may border on fraud. If the fact of adjustment be disclosed but not the amount, the statements are still misleading in our opinion and, at the very best, are useless as reports of actual operations.

There is a related difficulty. If the "credit" to surplus or "negative tax" figure offsetting the enlarged charge to income is netted without disclosure against the loss or expense charged to surplus, the reader will be unable to determine the actual amount of the loss or expense in question. In our opinion such an event as the sale of corporate property at a substantial loss is an important fact. It is no less important because, fortuitously or intentionally, one of these events occurs in a year of high tax rates and high income, so as to effect a substantial reduction in the income taxes payable. There are in these cases *two* facts to be disclosed—the loss on the property, and its tax consequences. Such a transaction ought to be reported in such a manner as not to conceal either the fact that a loss was suffered or the amount of the loss. To report this kind of loss net of its tax consequences is no more supportable in our judgment than to report on a similar net basis an expense such as advertising, depreciation, interest or any other item in the income account.[29]

The third argument advanced in support of the enlarged charge to taxes, or of the charge in lieu of taxes, is that the income tax figure which is a significant factor in respect of the rates of a regulated public utility is not the actual amount of taxes paid but the amount that would have been payable but for the loss or expense carried to surplus. This argument is, of course, limited in its application to public utilities whose rates are subject to governmental regulation. Such companies are ordinarily required to follow a uniform system of accounts and, in most jurisdictions, the prescribed form of income statement shows income taxes as an element of operating expenses, or as is sometimes said "above the line." Generally speaking, items included "above the line" are recognized as expenses allowable in computing the gross income for rate purposes whereas deductions made "below the line," such as interest, and items carried to surplus are not chargeable in this way.[30]

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[27] Where the tax provision is presented as in the original VEPCO statements or a charge in lieu of taxes shown, we doubt whether any but the most experienced reader of financial statements would be apt or perhaps able to make the calculations necessary to arrive at the amount of net earnings or of net earnings per share based on the actual tax payable.

[28] We do not at this time propose to discuss the practice of treating certain types of losses and income as corrections of surplus rather than as elements of profit and loss to be reflected in the year's income statement. That question is involved in certain proposed amendments to Rule 5-03 of Regulation S-X which have been distributed for comment to interested persons. The comments received have not yet been fully analyzed, and it is likely that further steps will be taken to develop the nature of the problem and any conflict of opinion as to its proper solution. We feel it inappropriate in this statement to seek to anticipate the outcome of that investigation.

[29] It will be noted that an income statement which is charged only with the estimated amount of taxes actually payable thereby reflects the tax reduction due to special items. Moreover, the benefit of the tax reduction will be reflected in earned surplus, the amount of which will ultimately be the same whichever of the several suggested treatments of these tax reductions is followed.

[30] The deductibility of income taxes in computing return for rate purposes was an issue in Galveston Electric Company v. Galveston, 258 U. S. 388, 42 Sup. Ct. 361 (1922). There the Supreme Court speaking through Mr. Justice Brandeis said "All taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between State and Federal taxes or between income taxes and others." This position was reaffirmed in Georgia Railway & Power Co. v. Georgia Railroad Commission, 262 U. S. 625, 43 Sup. Ct. 680 (1923). These decisions dealt only with the normal income tax then in effect. Therefore, because of certain observations by Justice Brandeis there are those who argue that these decisions may not be controlling as to the present Federal tax, particularly the present excess profits tax. Thus, in the Galveston case the court took care to point out that under the tax law then in effect the stockholder did not have to include

The short answer to this contention is that in most, if not all cases, the required systems of accounts do not permit a charge to operating expense accounts except for expenses actually incurred.[21] We note that the Committee on Statistics and Accounts of the National Association of Railroad and Utilities Commissioners has, in Case E–80, so interpreted the N. A. R. U. C. classification.[22]

We think, moreover, that this contention of the accountants in this case is unsound on its face. The costs and expenses, including interest, that arise from the borrowing of capital are almost universally excluded from the computation of gross income for rate making purposes. To include in operating expenses by indirection an item which is specifically excluded therefrom is obviously improper. Yet this is what is here proposed. The credits, in this case, that offset the charge in lieu of taxes have been deducted from the refunding expenses and the loss on sale of transportation properties, respectively, so that the charge to surplus is a net charge. To include in operating expenses part of the refunding expenses either directly or in the guise of a special charge in lieu of taxes is a violation of the premise that the costs of borrowing money are not a deduction in computing return for rate purposes. It would be as logical to say that the interest paid in a given period reduces the income tax payable and that therefore a charge in lieu of taxes should be included above the line with an offsetting reduction in interest expense below the line.

Finally, this contention seems to us to misconceive the relation of past results to the process of rate making. Where rates are being set for a future period, it is obvious that the actual results of past operations are only indications of what may be expected to be forth-coming in the future. The problem is, broadly, to determine what future earnings may be expected to result from particular rate structures. Consequently, it is customary to "adjust" many of the past operating expenses to bring them into line with present or anticipated conditions. Among such conditions are, of course, fu-

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dividends received from the corporation in his income subject to the normal Federal income tax and that this tax exemption was therefore, in effect, part of the return on his investment. Under the current tax law such dividends are taxable to the recipient. The court also said: "But the fact that it is the federal corporate income tax for which deduction is made, must be taken into consideration in determining what rate of return shall be deemed fair."

The Supreme Court has not yet had before it a case involving the deductibility for rate purposes of an excess profits tax actually paid by the company. Some question as to its deductibility is, however, raised by the language used by Mr. Justice Douglas in his dissenting opinion in Vinson v. Washington Gas Light Co., 321 U. S. 414, 64 Sup. Ct. 731 (1944). He there said, in discussing a provision of the Stabilization Act of 1942 which prohibits any "utility" from making "any general increase in its rates or charges which were in effect on September 15, 1942" without giving the Director of Economic Stabilization the right to intervene in the proceedings:

> I believe, moreover, that when Congress halted general rate increases and gave the Director a right to intervene, it did not sanction rate increases regardless of need and regardless of inflationary effect. I think it meant to make utility commissions at least partial participants in the war against inflation and gave them a sector of the front to control. Though it did not remove the established standards for rate-making, I do not think it intended utility commissions to proceed in disregard of the requirements of emergency price control and unmindful of the dangers of general rate increases. To the contrary, I think Congress intended that there should be as great an accommodation as possible between the old standards and the new wartime necessities. The failure of the Commission to make that accommodation is best illustrated perhaps by its treatment of taxes. The Commission allowed the company to deduct as operating expenses all income taxes up to and including 31%. That this amount includes wartime taxes is evident from the fact that the highest corporate tax rate which prevailed from 1936 to 1939 was 19%. We all know that the extraordinary expenditures incurred for the defense of the nation started with the Revenue Act of 1940. It has been accepted practice to deduct income taxes as well as other taxes from operating expenses in determining rates for public utilities. Galveston Electric Co. v. Galveston, 258 U. S. 388, 399. But this is war, not business-as-usual. When income taxes are passed on to consumers, the inflationary effect is obvious. And it is self-evident that the ability to pass present wartime income taxes on to others is a remarkable privilege indeed.

In Detroit v. Michigan Public Service Commission, —— Mich. ——, 14 N. W. (2d) 784 (1944), the Michigan Supreme Court held, with three Justices dissenting, that the Galveston case did not control the treatment in rate cases of the present Federal excess profits taxes. Writing for the majority, Justice Bushnell said, "As I read Galveston Electric Co. v. Galveston, 258 U. S. 388, 399, 66 L. ed. 678, PUR 1922 D 159, 42 S. Ct. 351, which is intimated by my brother as controlling, its authority is limited to normal taxes and not to abnormal and avoidable taxes on 'excess profits' even though it must be conceded that the term by which such tax is designated is a misnomer. Excess profits are a question of fact for determination by the Commission."

A similar result was reached by the West Virginia Supreme Court in denying the deductibility of the excess profits taxes levied during the first World War. Charleston v. Public Service Commission, 95 W. Va. 91, 120 S. E. 398 (1923).

In its decision in City of Detroit v. Panhandle Eastern Pipe Line Co., 3 F. P. C. 273 (1942), the Federal Power Commission, at p. 291, expressed its objection to the allowance of excess profits taxes in computing returns as follows:

> Thus it apears that the doctrine of unjust enrichment as well as equity and good conscience compel the conclusion that a utility should not be permitted to thwart the purpose and spirit of the war price control legislation and the revenue laws by passing such abnormal tax requirements along to its consumers as an operating expense to be collected in increased rates. Indeed, we feel increased rates on such a basis would be unjustifiable. To allow them would in effect impose upon the consumers a sales tax.
>
> So that there may be no confusion concerning the tax situation in connection with the companies subject to our jurisdiction, where necessary to stabilize utility rates at reasonable levels during the war emergency period, we propose to allow as proper operating expenses only such taxes as may be termed ordinary or normal. For the purpose of distinguishing between ordinary or normal and war emergency or abnormal taxes, we conclude that the basis prescribed in the 1940 Revenue Act establishes the highest possible level of Federal taxes which may be allowed as an element of operating expense for such purpose. The 1941 Revenue Act and the pending 1942 proposal certainly reflect abnormal tax requirements for war purposes.

The Federal Communications Commission in Re Investigation of Rates and Charges, 50 PUR (NS) 468, 489 (1943) also disallowed a deduction for excess profits taxes. The trend of a number of state utility commission decisions seems to be to limit or deny the deductibility of excess profits taxes. See In Re Los Angeles Gas & Electric Corporation, P. U. R. 1922 A, 283 (California); Re Western States Gas and Electric Co., P. U. R. 1919 B, 485, 493 (California); Re Vallejo Electric Light & Power Co.; 55 P. U. R. (N. S.) 435, 443, 454 (1944) (California); Re United Fuel Gas Co., P. U. R. 1920 C, 583, 606 (W. Va.); P. U. C. v. Springfield Gas & Elec Co, 53 P. U. R. (N. S.) 95, 105 (1944) (Missouri); Re Washington Gas Light Company, 53 P. U. R. (N. S.) 321, 327, 336 (1943) (District of Columbia); Re Northern States Power Co., 55 P. U. R. (N. S.) 257, 273 (1944) (North Dakota). cf. Re British Columbia Electric Railway Company, Ltd., et al., 53 P. U. R. (N. S.) 438, 464 (1943) (British Columbia). An excess profits tax which had been neither reported to the government nor paid was not allowed as a deduction in P. S. C. v. Utah P. & L. Co., 50 P. U. R. (N. S.) 133, 167 (1943) (Utah) But see Pfeifle v. Pennsylvania Power Light Co., 57 P. U. R. (N. S.) 1, 32 (1945) (Pennsylvania); San Antonio Pub. Service Co. v. San Antonio, P. U. R. 1924 A, 259, 263 (Texas); Detroit v. Detroit Edison Company, 50 P. U. R. (N. S.) 1, 3 (1943) (Michigan).

In the instant VEPCO case it will be noted that the registrant's computations as to the tax effect of the special items resulted in an adjustment of excess profits taxes only; no adjustment of normal taxes is indicated. See Exhibits A–D.

[21] Under our Rule U–28, moreover, a registered holding company or subsidiary company thereof is forbidden to "distribute to its security holders, or publish, financial statements which are inconsistent with the books of account of such company or financial statements filed with this Commission by, or on behalf of, such company."

[22] Case E–80 reads as follows:

> *Question:* Several utilities which have refunded bond issues, have had substantial tax savings in the year the refunding occurred, because the unamortized debt discount, expense and call premium associated with the refunded securities is permitted as an income tax deduction during the year redeemed. Instead of showing the actual taxes paid or accrued in the tax account, the utilities in question have also included therein the amount of the tax saving due to the refunding operation with an offsetting credit usually to Account 140, Unamortized Debt Discount and Expense. Is this permissible?
>
> *Answer:* No.
>
> The tax account (507) should include only provision for actual taxes and the account should not be increased by the amount which would have been paid had the refunding transaction not occurred. In other words, there was an actual saving in taxes and this saving should be reflected in the income statement because it is a fact. It is believed, too, that the text of Account 507 does not permit the accounting practice resorted to by the utilities in the illustration cited.

ture taxes and tax rates. Accordingly, in the approximations made of future expenses there would be included not the actual taxes of the past year, or even what the taxes would have been had there been no unusual transactions such as a bond refunding, but instead an amount equivalent to what the income tax will be in the future in view of the assumptions made as to future income and future tax rates.[3] The amount of past taxes would be used only if, after examination, it was concluded that tax rates and future income were not expected to change.[4]

The rate making process is thus not unlike the formulation by the investor of his judgment as to the future prospects of the company. In both cases, reports of actual past operations are used as a starting point. In both cases, these actual statements are analyzed to determine the extent to which they may be relied on as indicative of the future and, where necessary, appropriate adjustments are then made. Except that the possibility of misleading the reader is very largely absent when the user is a rate making body, the comments we have made earlier as to pro forma statements are applicable here—and with this addition that the judgment of the draftsman as to what is the normal or proper amount of taxes is less important, since for rate purposes the judgment of the rate making body on this point will generally be conclusive.

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[3] In State v. Public Service Commission, 336 Mo. 860, 81 S. W. (2d) 628 (1935) the court held that only taxes actually payable need be considered: "The ninth and last point urged in appellant's brief is that 'the Commission's action in refusing to allow the inclusion of Federal income taxes as operating expenses was error. The undisputed evidence is that the company did not pay income taxes. We are not aware of any authority holding that in such case an allowance of this kind should be made, and counsel for appellant cite none." See also Re East Ohio Gas Company, 17 P. U. R. (N. S.) 433, 445 (1937). In Public Service Commission of Utah v. Utah Power & Light Company, 50 P. U. R. (N. S.) 133, 167 (1943) the company had sought to justify the reasonableness of certain rates by including $1,480,000 of "computed" excess profits taxes in operating expenses. In fact the company neither reported on its tax returns nor paid any excess profits tax. This "computed tax" item thus resembles very closely the so-called "tax savings" in question here. The Utah Commission disallowed the claimed deduction saying: "The injustice to Utah rate payers is obvious when excessive rates and earnings are made to appear to be reasonable by means of computed excess profits taxes which have not been paid or reported to the government. We reject the company's claim that its computed (but not reported or paid) excess profits taxes should be included in the cost of service and thus passed on to the rate payers." * * *

[4] Where a "sliding scale" formula is in operation the actual results of current operations, including taxes, are determinative of future rates. In such a case there would, it seems to us, be danger of grave injustice in applying the formula to the results of actual operations for the year which, however, reflected a deduction based on income taxes that were neither paid nor payable by the company.

We come next to the remaining contention urged by the certifying accountants, that as a matter of correct accounting it is necessary to "allocate" income taxes to income and other accounts. This theory is also advocated and developed in detail in a bulletin "Accounting for income taxes" issued in December, 1944, by the Committee on Accounting Procedure of the American Institute of Accountants.

There is no doubt that allocation is a basic accounting procedure. In fact the whole process of preparing income statements is a species of allocation—of determining what revenues are allocable to the current income account and what expenditures are properly to be treated as costs allocable to the current income account. It is not therefore a demonstration of the merit of the proposed device to describe it as an allocation or to say that income taxes should be allocated. Whenever an item is charged to income, or indeed when it is excluded and carried as an asset, "allocation" in the accounting sense has taken place. The issue here is not whether income taxes should be allocated but whether the treatment of income suggested by the accountant's third contention is preferable to the method of allocation heretofore followed—that is, to show as a deduction from income of the current year the income and excess profits taxes which are believed to be actually payable, under the applicable tax law, as taxes of the current year.

In the argument before us and in the bulletin mentioned it has been urged that income taxes are an expense that should be allocated as other expenses are allocated. In neither case, however, was there any effort made to state the reasons why Federal income taxes must be considered as an expense in the same category as, let us say, wages. It is obvious, of course, that the net profit applicable to stockholders cannot be determined without first making an appropriate allowance for the amount that must be paid as income taxes. However, this fact does not dispose of the question. It is readily apparent that normal and excess profits taxes are computed as a part of taxable net income. Unlike most expenses they exist if, and only if, there is net taxable income before any deduction for such taxes. There is much to be said therefore for the position that true income taxes are in the nature of a share of profits taken by the government. If it is desired to place emphasis on the necessity of deducting them in order to arrive at net profit available to shareholders, they may perhaps be called an expense—but in such case they represent a very special class of expense, one that is incurred only by the making of a net taxable income.

Accordingly, to the extent that the propriety of the proposed treatment of income taxes depends on their classification as an expense rather than a share in profits we feel that the case remains unproven. Even if they be so classified, we feel that in view of their unusual and distinctive characteristics the propriety of the proposed treatment is not demonstrated merely by classifying them as an expense and then concluding that for that reason they should be allocated as other expenses are allocated.

We now examine the contention that income taxes should be allocated "as other expenses are allocated." The accountants who appeared before us cited to us no other expense which, for general accounting purposes, is allocated in the manner proposed for income taxes, nor have any such instances otherwise come to our attention. We note, moreover, that in a dissent to the bulletin mentioned earlier it was stated:

> No expense other than federal income and profits taxes is allocated on the basis of applying to a given transaction so much of the expense as would not have occurred if the transaction to which the expense is attributed had not taken place. The usual method is to allocate a total expense ratably to given accounts or transactions on a consistent basis.

The illustrations of expense allocation cited to us by the certifying accountants in this case appear to us to support the above statement. In each case cited there was an expense actually incurred that was first allocated to the period under the usual accrual principles and then distributed over a number of accounts. In no case was there an estimate made of what the expense would have been under other conditions. In no case cited, was there a distribution of an expense to several accounts by means of what can be termed an algebraic formula in which a negative sum is credited against one item to offset the positive charge to another item of an amount in excess of the actual expense. We do not regard such a treatment as an appropriate means of allocating income taxes in financial statements which purport to reflect the actual results of operations. We have doubt indeed that such a method can properly be termed an allocation at all, as that term is customarily used.

We note, in passing, moreover, that in the examples of expense allocation cited to us there existed a direct, almost physical association between the item being allocated and the item to which it was charged. For example, in the case of real estate taxes allocated to construction the tax item is directly and closely related to the construction. Likewise, in the case of brokerage fees, and stamp or transfer taxes, the tax item is closely and directly related to the specific transaction. In both cases, moreover, the tax is independent of any other transactions of the company. Nor is there any attempt made to increase in the course of the allocation the amount of such taxes to an estimated sum. We feel therefore that such illustrations can not properly be cited in support of the proposed treatment for income taxes.

It is also sometimes pointed out that "cost" in the case of securities or property acquired is generally considered to be the sum of the purchase price plus incidental costs such as brokerage and any specific taxes paid by the buyer and that on sale the proceeds are computed as the selling price less incidental deductions such as commissions or any specific taxes paid by the seller. By anal-

ogy and in justification of the proposed treatment of income taxes it is frequently urged that a so-called "tax saving" must be allocated or attributed to or ultimately associated with particular losses or expenses because the tax consequence of the transaction involving the loss or expense were a motivating factor in arriving at the decision to consummate it. Thus, it is claimed that a property would not have been sold but for the "tax saving" thereby effected and that for this reason it is proper to consider that the true "loss" on the sale is not the excess of cost over selling price but is equal instead to the difference between cost on the one hand and selling price *plus* "tax saving" on the other. We do not believe such an analogy is sound and we cannot accept that analysis as a basis for reporting the results of actual operations. It is undoubtedly true that the tax consequences of selling a property often are an important consideration in arriving at the decision to sell, and may in some cases have been a deciding factor. However, tax consequences undoubtedly play an important role in the making of a great variety of decisions involving the incurrence and amounts of purely operating expenses such as advertising, wage rates and bonus plans. Yet it can hardly be argued that wages or bonuses or advertising are to be reported as less in amount because income taxes would have been higher if the amounts spent on such items were less. We see no basis for adopting a different approach in figuring the "loss" involved in a sale of property. We feel instead that there has been a loss of the full difference between cost and selling price coupled with a tax benefit which is properly reflected in the lower taxes actually paid. We feel that the proposed treatment of income taxes tends to obscure these facts and that the treatment of income taxes required by our rules and heretofore almost universally followed clearly discloses what has taken place. Where the tax paid for the year is unusual in amount because of unusual conditions, an appropriate explanation would be called for as is now required in the case of other unusual events.

As to this last principal contention urged by the certifying accountants (that income taxes are an expense that should be allocated as other expenses are allocated) we feel, first, that there is grave doubt whether income taxes can properly be considered as an expense in the same category as the cost of materials or wages, and, second, that the treatment proposed does not result in the allocation of income taxes "as other expenses are allocated." We feel instead that the proposed treatment is purely an effort to have items shown in the income statement at what is considered to be a "normal" amount. We note that this objective is clearly expressed as a prime purpose of the method in the bulletin referred to earlier, which states at p. 185:

> As a result of such [unusual] transactions the income tax legally payable may not bear a *normal* relationship to the income shown in the income statement and the accounts therefore may not meet a *normal* standard of significance. [Italics supplied.]

There are, finally, a number of difficulties involved in the proposed treatment of income taxes that deserve mention even though they are not directly related to the specific contentions put forward by the certifying accountants in the case.

The first involves the preparation of general statistical data from financial reports. Under the method proposed, it is permissible to show, as taxes, an amount in excess of the taxes payable. If such items are totalled for a period of years or for groups of companies, they may well be used as evidence of the aggregate amount of taxes paid by the company or by the industry. Obviously any such representation is erroneous and will misstate, often very materially, the underlying facts. We feel that we should not permit the filing with us of income statements which readily permit, if they do not actually invite, such misuse. Even a "charge in lieu of taxes" may result in distorted overall statistics since it operates to reduce net income after taxes and so affects the ratio of actual taxes to net income. If the offsetting credit is netted against a surplus charge the distortion may be permanent.[24]

The second and somewhat technical problem is the difficulty of the computation. It is usual in contemplating the tax consequences of a proposed transaction to treat it as an incremental or marginal item. Where tax rates are graduated, this results in associating the marginal income or expense with the highest tax bracket. It is questionable, whether such a principle is realistic when applied to the results of operations for a completed year. Next taxable income is a composite of all taxable income and all deductible items applicable to the period. The propriety of singling out any specific item as the item which is taxed in the highest tax bracket, is doubtful. Moreover, in applying the theory to losses and expenses it would appear that the existence of a reduction in taxes is due not only to the expense but is equally dependent on the existence of taxable income to offset the expense. It would appear possible that some part of the benefit from the "reduction" ought to be attributed to the existence of income.[25] Even if this point be waived, however, there has been no satisfactory analysis presented of the effect to be given to the carry-back, carry-forward provisions of the present income tax law. Without exploring all of the possible difficulties, one case may be cited. Suppose that a loss has been charged to surplus but is deductible for taxes. Suppose further that in accordance with the present proposal there is charged to income, as provision for taxes, the amount of $200,000 although the actual tax amounts to only $50,000. If in the next year the company suffers an operating loss of $500,000, then in view of the carry-back provisions the reader of the two income statements would reasonably expect to find a carry-back refund of $200,000—the amount shown as taxes in the first year. However, obviously no more than $50,000 would actually be refundable. The question arises whether having overstated taxes in the first year it is not necessary, to be consistent, to overstate the refund in the second year. Finally, there are the permutations in the computation where a company pays taxes as a member of a consolidated group. In addition to the allocation of the actual tax paid among the several companies in the group, the proposed treatment raises the difficult question of whether the amount of the so-called "saving" is to be computed on the basis of a company's individual status or on that of the consolidated group and, once this is decided, of whether to allocate this "saving" as between the several companies or attribute it solely to the company having the deduction, even though perhaps it itself contributed no taxable income!

The third difficulty is the propriety of singling out the income tax items for adjustment on the ground that it does not bear a "normal" relationship to the income reported. Particularly, under conditions like the present, many if not most of the income and expense items bear unusual relationships to each other. Under the influence of the war sales volumes are often very high. Maintenance may be very high due to continuous operation of the plant, or very low because of the inability to obtain materials and labor, or very high because of the use of inexperienced labor and the inability to get new machinery, or very low because operations cannot be stopped long enough to make thorough-going maintenance possible. Selling costs may be very low because of the volume of war

[24] Under one variant of the practice no change is made in final net income. In the statements originally filed in the instant case, for example, part of the amount included as a charge among the operating expenses represented a $609,949 reduction in income taxes due to the taking for tax purposes of accelerated amortization of emergency facilities at the rate of 20% a year while in the financial statements only normal depreciation was being accrued. See Exhibit A. In the original statements this $609,949 was added back as the last item in the account. This internal in-and-out treatment appears to us to suffer from all of the difficulties we have discussed even though no change results in the amount of "net income." In our opinion, an overstatement of operating expenses is not corrected by "adding back" the amount of the overstatement at a later point in the income statement. Such treatment is in our view artificial and deceptive to all but the most experienced reader. While there may be some grounds for crediting such reductions in taxes to a special amortization reserve there is none for the equivocal practice here followed.

[25] We note the customary solution of a somewhat similar problem that arises when a group of companies files a consolidated tax return. In assigning to each constituent its fair share of the consolidated tax paid by the group it is usual to divide the actual tax among the companies who would have had to pay a tax on an individual basis. If one of the included companies operated at a loss, the consolidated tax is of course reduced, but no part of the "saving" is ordinarily paid over to the loss company by the other members of the group. Instead, only those contributing income to the consolidated return share directly in the benefit of the current reduction. This principle is incorporated in our Rule U-45 under the Public Utility Holding Company Act.

business or very high because of the use of advertising to keep restricted products in the public's mind. With many items of income and expense apt to be out of line, there appears to be little justification and a good deal of danger in singling out one item for adjustment.

EXHIBIT A

VIRGINIA ELECTRIC AND POWER COMPANY AND SUBSIDIARY AND VIRGINIA PUBLIC SERVICE COMPANY AND SUBSIDIARIES, COMBINED

Condensed certified statement of income for 1944 as shown in original registration statement and after amendment No. 1 [1]

Item	*Amount*
Operating revenues	$51,681,778
Operating expenses and taxes:	
Other than taxes	28,237,367
Taxes, excluding reductions shown separately below or applied against items charged directly to surplus:	
Federal income (note C) [1]	2,139,496
Federal excess profits (note C) [1]	8,164,872
Postwar credit	(351,082)
Other	4,131,408
Total	42,322,060
Net operating revenues	9,359,718
Other income	(45,359)
Gross income	9,314,359
Deductions from income: Interest and amortization, etc.	3,719,527
Net income	5,594,832
Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed throughout their nomal life and not to replace existing facilities	609,949
Balance transferred to earned surplus	6,204,781

[1] Note C to the income account as set forth in the registration as originally filed read as follows:

C. *Federal income and excess profits taxes. Virginia Public Service Company and subsidiaries.* The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring deductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of income for 1942 as special amortization of debt discount and expense. The balance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942 was charged against earned surplus.

However, the taxable net income as computed did not reflect the deduction, for tax purposes, of losses upon sales of ice and railway property, and certain other items charged to surplus. As a result, provisions charged to income in 1942 were approximately $330,000 in excess of the company's liability for Federal income taxes as shown in its tax return for that year. Pending review of the returns, this excess provision is included in accrued Federal income and excess profits taxes at December 31, 1943.

In 1943 the company filed a claim for refund of 1941 Federal taxes in the net amount of approximately $297,000 under the carryback provisions of the 1942 Revenue Act. However, this amount is subject to such adjustments as may result from review by the U. S. Treasury Department and the claim has not been recorded upon the books of the company.

Federal income and excess profits tax returns for the company and its subsidiaries for years prior to 1942 have been examined by the Treasury Department and those for the years prior to 1941 have been closed; except for the year 1937 in respect of which a claim for refund is pending.

First Amendment. The following paragraph was added to Note C:

Virginia Electric and Power Company. In addition to the reduction in Federal taxes on income shown in the income statement for 1944, reductions in excess profits taxes aggregating $4,148,050 have been applied against items charged directly to earned surplus.

The first paragraph of Note C as above quoted was also modified to reflect an amendment to the form of the profit and loss statement for Virginia Public Service Company. As amended the paragraph reads as follows:

Virginia Public Service Company and subsidiaries. The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed without the benefit of the deduction of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these non-recurring deductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of earned surplus for 1942 from the balance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942.

EXHIBIT B

VIRGINIA ELECTRIC AND POWER COMPANY AND SUBSIDIARY AND VIRGINIA PUBLIC SERVICE COMPANY AND SUBSIDIARIES, COMBINED

Condensed certified statement of income for 1944 as shown in amendment No. 2

Item	*Amount*
Operating revenues	$51,681,778
Operating expenses and taxes:	
Other than taxes	28,237,367
Taxes: [1]	
Federal income [2]	2,139,496
Federal excess profits [2]	3,406,871
Post-war credit	(351,082)
Other	4,131,408
Total operating expenses and taxes before especial charges	37,564,061
Special charges equivalent to reduction in Federal excess profits taxes resulting from special amortization of emergency facilities (reduction shown separately below) and from redemption of bonds and sale of property (reductions applied against related items charged to surplus)	4,757,999
Total operating expenses and taxes including special charges	42,322,060
Net operating revenues	9,359,718
Other income	(45,359)
Gross income	$9,314,359
Deductions from income: Interest and amortization, etc	3,719,527
Net income	5,594,832
Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed throughout their normal life and not to replace existing facilities	609,949
Balance transferred to earned surplus	6,204,781

[1] The language "excluding reductions shown separately below or applied against items charged directly to surplus" included in original registration and Amendment No. 1 was deleted from this caption by Amendment No. 2.

[2] *Federal income and excess profits taxes.* Notes C to the income account as shown in the registration as originally filed after Amendment No. 1 was changed by Amendment No. 2 as follows:

The paragraph added by the first amendment was deleted. Also the first paragraph of the original Note C was deleted.

EXHIBIT C

VIRGINIA ELECTRIC AND POWER COMPANY AND SUBSIDIARY AND VIRGINIA PUBLIC SERVICE COMPANY AND SUBSIDIARIES, COMBINED

Condensed certified statement of income for 1944 as shown in amendment No. 3

Item	*Amount*
Operating revenues	$51,681,778
Operating expenses and taxes:	
Other than taxes	28,237,367
Taxes:	
Federal income (note C) [1]	2,139,496
Federal excess profits (note C) [1]	3,406,872
Post-war credit	(351,082)
Other	4,131,408
Total operating expenses and taxes (before special charges below)	37,564,061
Net operating revenues (before special charges below)	14,117,717
Other income	(45,359)
Gross income (before special charges below)	14,072,358
Special charges equivalent to reduction in Federal excess profits taxes resulting from redemption of bonds ($2,091,117) and sale of property ($2,056,873) (reductions applied against related items charged to surplus)	4,148,050
Gross income (after special charges)	9,924,308
Deductions from income: Interest and amortization, etc	3,719,527
Net income	6,204,781

[1] Federal income and excess profits taxes.

Note C to the income account as shown in the registration as originally filed and after Amendments 1 and 2 was changed by Amendment No. 3 by adding the following two paragraphs:

Virginia Electric and Power Company. In addition to the reductions of Federal excess profits taxes payable for the year 1944

which resulted from costs and losses charged to surplus and for which special charges of equivalent amounts have been made in the income statement for that year, such taxes were further reduced $537,496 by reason of the deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the Company's accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.

Virginia Public Service Company and subsidiaries. Federal excess profits taxes payable for the period from January 1 through May 25, 1944 were reduced $72,453 by reason of a deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the companies' accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.

EXHIBIT D

VIRGINIA ELECTRIC AND POWER COMPANY AND SUBSIDIARY AND VIRGINIA PUBLIC SERVICE COMPANY AND SUBSIDIARIES, COMBINED

Condensed certified statement of income for 1944 as shown in amendment No. 4

Item	*Amount*
Operating revenues	$51,681,778
Operating expenses and taxes:	
Other than taxes	28,237,367
Taxes:	
Federal income (note C)[1]	2,139,496
Federal excess profits (note C)[1]	3,406,872
Post-war credit	(351,082)
Other	4,131,408
Total operating expenses and taxes	37,564,061
Net operating revenues	14,117,717
Other income	(45,359)
Gross income	14,072,358
Deductions from income:	
Interest and amortization, etc	3,719,527
Special charges of those portions of premium and expenses on redemption of bonds ($2,091,177) and of loss on sale of property ($2,056,873) which are equivalent to resulting reduction in Federal excess profits taxes	4,149,050
Net income	6,204,781

[1] *Federal income and excess profits taxes.* Note C to the income account as finally amended comprised 6 paragraphs. Three were identical with paragraphs 2, 3, and 4 of the originate note. The other three read as follows:

Virginia Electric and Power Company. Federal excess profits taxes payable for the year 1944 were reduced $4,685,546 by reason of deductions for tax purposes of redemption premiums and expenses incurred in refunding of bonds, of a loss sustained on the sale of transportation property and of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. There have been included in the income statement for 1944 as special charges those portions of the refunding costs ($2,091,177) and of the loss on sale of property ($2,056,873) which are equivalent to the reductions in taxes resulting from these particular transactions, the remainder of such costs and loss being charged against earned surplus. No provision has been made in the company's accounts or income statement for the additional amortization allowable in respect of emergency facilities, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.

Virginia Public Service Company and subsidiaries. The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting unamortized debt discount, call premium and expense on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring reductions in computing the amount of 1942 taxes payable amounts to $1,571,158 and an equal amount has been deducted in the accompanying statements of income for 1942 as a special charge of debt discount, call premium and expense. The balance of unamortized debt discount, call premium and expense on long-term debt called for redemption in 1942 was charged against earned surplus.

Federal excess profits taxes payable for the period from January 1 through May 25, 1944 were reduced $72,453 by reason of a deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the companies' accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.

[Accounting Series Release No. 53, November 16, 1945]

§ 211.54 *Statement upon adoption of amendment of Rule 5–03 of Regulation S–X (17 CFR, 210.5–03).* The Securities and Exchange Commission today announced the adoption of an amendment to Regulation S–X (17 CFR, part 210) designed to provide for special disclosure of war costs, losses, and expenses currently being recognized. The amendment adds a new subparagraph (d) to Caption 16 of Rule 5–03 of the Commission's Regulation S–X (17 CFR, 210.5–03) which governs the form and content of most financial statements required to be filed under the Securities Act of 1933 or the Securities Exchange Act of 1934.

Where war items are excluded from the income account and carried directly to surplus or reserve accounts, the new rule calls for the net aggregate amount so excluded to be set forth following the net income for the period. The nature, amount and treatment of excluded items is to be shown in an appropriate manner. If the excluded items were deductible for tax purposes, a brief explanation of their tax effect should be included. In addition the new sub-paragraph (d) requires appropriate disclosure of any substantial amounts of war items included in the income statement. If exact amounts cannot be given, the rule permits a company to explain the circumstances with an estimate of the amounts involved. Finally, a statement is required of the principle followed in classifying particular items as attributable to conditions arising out of the war or its termination.

The proposed amendments were drafted as a result of a staff survey of the practices being followed in the creation and utilization of so-called war reserves and of the character of items which were considered by various companies to be attributable to conditions arising out of the war or its termination. It appeared from the studies made that during the last five years or more many business corporations had set aside substantial amounts as reserves against anticipated, though usually indeterminate, costs and losses broadly characterized as attributable to operations during the war period. In most instances such reserves were set up by means of charges reflected in the annual income statements either before or after the determination of net income. In other instances reserves of an apparently similar character had been set up by charges against earned surplus. Finally, it appeared from collateral disclosures made in financial statements that some companies, although recognizing the possibility of such costs and losses, had set up no reserves but had instead regarded earned surplus as available to absorb any such charges.

In cases arising in recent months there has also been evidence of a correlative diversity in the accounting treatment proposed for war costs and losses consequent to the termination of war operations and conversion to peacetime business. In some instances it appeared that companies proposed to charge any such items directly to reserves. In some of these cases, moreover, the items involved were only in a general sense within the categories of items for which the reserves had been described as having been set up. In other cases, companies proposed to charge war items directly to earned surplus or to income, without regard to whether war reserves had been provided. It also appeared that little uniformity of opinion existed as to what constituted a war cost as opposed to items fairly attributable to postwar operations.

The problems of the treatment to be accorded war items may, of course, be expected to be of relatively short duration. Many companies have already indicated that they do not anticipate any further, unforeseen war items of a substantial amount. In general, moreover, it appears that by the close of the current year nearly all companies will be in a position to estimate with reasonable accuracy their further need for war reserves. As soon as this condition exists, it may be expected that companies will dispose finally of any remaining and unneeded balances of war reserves.

Under these circumstances it was determined not to adopt rules prescribing the particular treatment to be followed with respect to war items, but to require instead the special disclosures called for by the new rule.

Drafts of the amendment were sent for comment to a large and representative group of registrants, as well as to professional and technical associations, financial services, attorneys, accountants and other interested persons. A substantial majority of those from whom comments were received approved the new rule in principle although suggest-

ing a variety of technical changes. Effect has been given in the final draft to many of the technical suggestions received.

The text of the Commission's action follows:

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the Securities Act of 1933, particularly Sections 7 and 19 (a) thereof, and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15 (d), and 23 (a) thereof, and deeming such action necessary and appropriate in the public interest and for the protection of investors and necessary for the execution of the functions vested in it by said Acts, hereby amends Caption 16 of Rule 5-03 of Regulation S-X to add the following new sub-paragraph (d):

(d) *Disclosure of War costs, losses, expenses and income*—(1) *Items excluded from the profit and loss or income statement.* If any substantial amounts of costs, losses, expenses or income attributable to conditions arising out of the war or its termination have been excluded from the profit and loss or income statement and charged or credited directly to surplus or reserve accounts on the ground that such items are not considered applicable to operations during the period of report, show the net aggregate amount of all such excluded items under an appropriate separate caption set forth following caption 16 but neither added to, nor deducted from, caption 16. The following information as to such excluded items shall be given, preferably in tabular form, either under this caption or by means of a footnote or schedule referred to under this caption:

(i) The nature and amount of each major category of the excluded items.

(ii) The account or accounts to which such items were charged or credited and the amounts involved.

(2) *Items Included within the profit and loss or income statement.* If the profit and loss or income statement for the period of report includes substantial amounts of costs, losses, expenses or income (including transfers from war reserves) which in the registrant's opinion are attributable to conditions arising out of the war or its termination but are not applicable to production and sale of goods or services during the period of report, the amounts so included shall, if practicable, be segregated under appropriate captions. If segregation is not practicable, a brief statement of the circumstances shall be made as a part of the statement required by paragraph (3), together with an estimate of the amounts involved.

(3) *Statement of policy.* A concise statement shall be made in a footnote of the principle followed in determining that items of costs, loeses, expenses or income were attributable to conditions arising out of the war or its termination and were not applicable to the production and sale of goods and services during the period of report.

[Accounting Series Release No. 54, March 30, 1946]

§ 211.55 *Proposed revision of Article 6 of Regulation S-X (17 CFR, Part 210).* The Securities and Exchange Commission announced today that a public conference will be held on July 9, 1946 to consider a proposal made by its staff for the revision of Article 6 of Regulation S-X (17 CFR, part 210) which governs the form and content of financial statements of management investment companies other than those which are issuers of periodic payment plan certificates.

During the past several years the staff of the Commission has reviewed critically the financial statements and schedules being filed by management investment companies under the Investment Company Act of 1940, the Securities act of 1933 and the Securities Exchange Act of 1934. During the same period, the staff has from time to time discussed the issues involved in investment company accounting with representatives of various investment companies and their accountants, and with committees representing the National Association of Investment Companies and the American Institute of Accountants.

On May 31, 1944 the Commission authorized the staff to circulate for comment and criticism a proposed revision of Article 6 of Regulation S-X which governs the form and content of financial statements filed by management investment companies under the three Acts mentioned. The proposed draft was sent to all management investment companies, to several professional accounting societies, to the National Association of Investment Companies, and to a considerable number of public accountants and other interested persons. Thereafter, extended discussions were held between the staff and committees representing the National Association of Investment Companies and the American Institute of Accountants.

The restatement of Article 6 now proposed represents a material departure in many respects from the existing requirements of Article 6 and, if adopted, would call for important modifications in the financial reporting practices of many management investment companies. As now revised, the staff proposal gives effect to many of the suggestions and criticisms received. However, there are a number of respects in which the proposed rules are not in accord with the recommendations of those from whom comments were obtained, particularly the National Association of Investment Companies.

In view of the importance and significance of the changes proposed by the staff, the Commission has determined to hold a public conference for the purpose of ascertaining the views of all interested persons with respect to the staff proposal. For the convenience of those interested, the staff has prepared a report on the revision of Article 6 which describes in detail the changes proposed to be made and the more important considerations which it believes require these changes.

Copies of the proposed revision of Article 6 and of the staff report are available upon request. However, copies of the materials have already been mailed to all management investment companies, and to those persons to whom the draft dated May 31, 1944 was sent for comment.

The conference will open at 10:30 a. m. on July 9, 1946 at the Commission's offices in Philadelphia, 18th and Locust Streets. Written comments as to the staff proposal and report should be filed by July 1. Persons desiring to attend the conference or to be heard at that time should notify the Commission not later than June 25, indicating the amount of time desired to present their views at the conference.

All communications regarding the conference, including requests for copies of the staff report, written comments as to the proposals, and notifications by those wishing to appear or be heard, should be addressed to William W. Werntz, Chief Accountant. [Accounting Series Release No. 55, May 22, 1946.]

PART 231—INTERPRETATIVE RELEASE RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS[1] THEREUNDER

Sec.

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[1] The interpretative opinions included herein are opinions issued in the past for the guidance of the public by members of the Commission's staff (or in a few instances by the Commission) and heretofore made public pursuant to Commission authorization. The opinions are to be read as of the date of original publication and in the context of the rules, statutes and circumstances then existing. However, opinions or portions of opinions which are clearly obsolete have been omitted. While it is not clear that publication of interpretative opinions of this kind in the Federal Register is required, it is believed that such publication may be helpful to the public and that it falls within the spirit of the Administrative Procedure Act.

Where rules referring to an opinion have been renumbered since the issuance of the opinion, the new designations are indicated in brackets.

§ 231.45 *Partial text of letter of Chief of Securities Division of Federal Trade Commission relating to section 11* (e) (2).

I beg to acknowledge receipt of your letter of August 31st, enclosing a copy of an opinion rendered by ------, making certain observations with reference to liabilities imposed by the Securities Act of 1933.

Allow me to make the following observations upon their conclusions with reference to each of the numbered questions:

1. The contention is advanced that 11 (e) of the Securities Act may permit a person who sues under paragraph (2) thereof to recover damages in cases where he may have sold his stock at a price in excess of the offering price. This contention neglects the relationship of paragraph (2) of this section to paragraph (1). Paragraph (2) gives an alternative remedy for damages only where the person suing no longer owns the security. Where he owns the security, he can recover back the consideration paid for it, but under section 11 (g) this cannot exceed the price at which it was offered to the public. But an alternative remedy is provided, in order not to compel the holder of a security in order to have a remedy to hold that security until he is enabled to bring suit.

Instead he may seek to cut his losses, so far as he is able, by disposing of the security. This obviously should not deprive him of a right which he would possess if he continued to hold the security. Viewed in this light the alternative right given by paragraph (2) is really derivative from (1), and consequently the damages recoverable under that paragraph must be computed on the basis of cost to the plaintiff not exceeding the price at which the security was offered to the public. In other words, if the plaintiff had disposed of the security at a price in excess of the offering price, no damages would be recoverable.

The other view neglects both the relationship of the one paragraph to the other and the practicalities of the situation.

2. The question as to whether it is at all possible for an underwriter's liability to exceed the total amount raised from the public plus interest thereon, must be approached with one caveat. Our legal system, adequate or inadequate as it may be, on occasions does bring about the conviction and execution of the innocent despite the safeguards with which we surround the accused. Your question must then be reduced to the more reasonable one as to whether such a legal happening is at all likely.

Such an occasion could happen only as the result of a series of suits occurring under paragraph (2) of section 11 (e) upon the same security by different plaintiffs, because, as I indicated above, the individual recovery granted to any one plaintiff could not exceed the price at which the security was originally offered to the public by the underwriter. Examination of the basis for liability under section 11—a matter which finds no consideration in the opinion submitted—shows that liability is rested upon damage consequent to material misstatements or misleading or inadequate statements of a material character in the registration statement. "Material" in this connection, as is abundantly illustrated by the cases under the English Companies Act, has a relationship to the purported value of the security as reflected in the offering price. Of course, everything that is required to be stated in the registration statement is prima facie material, but it takes little ingenuity to find matters required to be stated in that statement which, even though misstated, could not be deemed as material misstatements. Pursuing this thought further, one sees immediately that trading losses as distinguished from losses due to material, misleading or inadequate statements as of the time of offering the security, afford no ground for action. Totalling the former type of losses in the hands of successive holders of the same security may very well bring a sum in excess of the offering price of the security. But totalling the latter type of losses as a maximum can theoretically never exceed the price at which the security was offered to the public. Thus traders whose successive transactions have liquidated prior to the market's discovery of any fault in the registration statement would have no claim for market losses. Theoretically there may, indeed, be successive actions for "faulty registration losses", but practically one doubts whether the first such action will not in almost every case absorb the entire amount of such loss. Thus both theoretically and practically there is no probability of an underwriter's liability exceeding the aggregate amount at which the securities were offered to the public.

3. The third contention advanced is that there is no standard set by the act as to what facts must be disclosed by an issuer, for it is stated that the failure to disclose any material fact may involve the persons designated in section 11 in liability.

Frankly it is difficult to see just how such a conclusion can even be seriously advanced in view of the explicit statements in section 11 especially when contrasted with the difference in language used in section 12. Section 11 places liability for omission where a person has "omitted to state a material fact required to be stated therein (i. e. in the registration statement) or necessary to make the statements therein not misleading." Section 12 makes no such qualification inasmuch as it is not necessarily tied to the registration statement in the manner that section 11 is.

This conclusion is obvious on the face of the language but it gets even further emphasis from a sentence in that important interpretative document, the Statement of the Managers on the Part of the House. I quote from page 26 of that document:

"The House bill made the liability depend upon the making of untrue statements or omissions to state material facts. This phrase has been clarified in the substitute (i. e. the bill as enacted) to make the omission relate to the statements made in order that these statements shall not be misleading, rather than making mere omission (unless the act expressly requires such a fact to be stated) a ground for liability where no circumstances exist to make the omission in itself misleading."

In other words an omission of a material fact in order to create liability under Section 11 must be one of two types. It must either be an omission of a fact required to be stated in the registration statement or it must be an omission of a fact which renders the statements made in the registration statement misleading, and, in both of these instances the omission must be of material facts. To say in the light of this that the "practical effect" of the Act is substantially to make an underwriter a "guarantor against failure to disclose every material fact", neglects the express qualifications in Section 11 (a) itself, to say nothing of the provisions of that section which absolve a person of liability, if such person be not the issuer, if in any case he can prove that he exercised reasonable diligence such as that common to persons occupying fiduciary relationships.

[Securities Act Release No. 45, September 22, 1933]

§ 231.70 *Text of letter of Federal Trade Commission relating to offers of sale prior to the effective date of the registration statement.*

Your letter raises the general question as to whether an underwriter concerned in the distribution of securities registerable under the provisions of the Securities Act of 1933, may, subsequent to the filing of a registration statement but prior to its effective date, circulate literature among dealers giving them information of the character of the proposed offering.

The theory of the waiting period of twenty days—the time between the filing and the effective date of a registration statement—is fully outlined in the House Report on H. R. 5480 (the House draft of the Securities Act), and in the Statement of the Managers on the Part of the House in connection with the Conference Report on the Securities Act.

This period, says the House Report, contemplates a change from methods of distribution lately in vogue which attempted complete sale of an issue sometimes within one or at most a few days. Such methods practically compelled distributors, dealers and even salesmen as the price of participation in future issues of the underwriting house involved, to make commitments blindly.

During the waiting period, as well as prior thereto, Section 5 of the Securities Act makes it unlawful for the issuers, underwriters and dealers (to whose transactions the Act is generally applicable) to make an offer to buy or to sell a security—always remembering that "sell" carries within it the conception expressed in section 2 (3) of an offer to sell or a solicitation to buy. The same section also makes it unlawful to transmit any prospectus (the central feature of which under section 2 (10) is the fact that it offers a security for sale) relating to a security during this period prior to the effective date of a registration statement. The purposes of these sections as related to this particular problem are obvious. Dealers are not to be solicited to buy the security until a registration statement is in effect; nor are they to offer to buy such security—an injunction made necessary by the fact that otherwise priority of application during the waiting period might be made the basis for priority of allotment.

The Act, however, as you state has the purpose of hoping that public and professional scrutiny of the proposed issue will take place during this waiting period, so that, as distinguished from former days, neither the public nor the dealers will be taken unaware. Obviously this purpose cannot be accomplished merely by the filing of a registration statement with the Federal Trade Commission, even though a copy of such statement is open to public inspection, for only a limited number of the public could possibly have the opportunity to inspect this statement. To that end, the Act expressly provides that copies of this statement at a reasonable price shall be furnished by the Commission on request to those who wish them. But portions of the registration may also be furnished on similar terms. Surely, it would be odd, if what the Commission is under a duty to do, the issuer himself would be prevented from doing. In other words, the purpose of promoting general knowledge of the facts required to be stated in the registration statement is clearly set forth in the Act, and nothing in the Act restricts circulation of that knowledge to the Commission alone.

On the other hand, the Act is equally definite that no offers to sell shall be made until the expiration of the waiting period. It therefore contemplates, beyond peradventure of doubt, the circulation of knowledge concerning the matters called for in the registration statment as a preliminary to the formation of an intelligent opinion as to the desirability of a particular security prior to the arrival of the time when it permits that now ripened opinion to express itself in an offer to purchase the security. It also looks forward to this ripened opinion proving either a barrier or a harbor for such seductive arts as may still be used after the expiration of the waiting period to sell the security.

You ask whether offers to sell can be made and accepted and offers to buy made and accepted prior to the effective date of a registration statement with the full understanding that they are conditioned upon the occurrence of the effective date. Such a procedure would obviously fly in the face of the general purposes of the Act. Freedom from decision is demanded during the waiting period, and such offers induce the parties to whom they are addressed to divest themselves of a liberty of action which the Act insists that they shall have.

You ask further, however, whether circulars, describing a security in the method in which a prospectus conforming to section 10 describes a security but clearly and unmistakably marked to indicate that they are informative only, negativing without equivocation either impliedly or expressly an intent to solicit offers to buy or to make an offer to sell, can be circulated with impunity during the waiting period by an issuer or an underwriter. You assume, as I assume, that both the letter and the spirit of these markings are strictly adhered to. Such conduct seems not only allowable but one that carries out the general purposes of the Act. Prospective purchasers, whether they be dealers or the general public, should during this waiting period be educated up to the nature of an issue, which it is expected that they will shortly be asked to buy, always reminding them that no determination to buy is requested of them until the expiration of the waiting period.

Such a procedure hardly needs any expression from this Division to indicate that it is permissible under the Act. The House Report expressly states, pp. 12-13:

"The bill, apart from section 16 (b), is not concerned with communications which merely describe a security. It is, therefore, possible for underwriters who wish to inform a selling group or dealers generally of the nature of a security that will be offered for sale after the effective date of the registration statement, to circulate among them full information respecting such a security. This could easily and effectively be done by circulating the offering circular itself, if clearly marked in such a manner as to indicate that no offers to buy should be sent or would be accepted until the effective date of the registration statement."

[Securities Act Release No. 70, November 6, 1933.]

§ 231.86 *Opinion of Federal Trade Commission relating to the registration of stock issued by certain mortgage loan companies.*

Shares of stock of certain mortgage-loan companies which are obtaining loans from the Reconstruction Finance Corporation in order to re-lend the proceeds to local industries and mercantile businesses, are exempt from registration under the Securities Act according to an opinion of the Federal Trade Commission made public today.

The Commission indicated that in its view the securities would be exempt (1) where the mortgage-loan company was incorporated in the state in which it was to operate and sold its stock only to residents of that state, and (2) where the mortgage-loan company was to operate in and sell its stock outside the state of its incorporation, if the stock of the company were issued only to borrowers or if the stock issued to borrowers carried voting rights in the same proportion to their investment as that issued to others.

This statement was made in response to a letter signed by Jesse H. Jones, Chairman of the Reconstruction Finance Corporation, and addressed to the Federal Trade Commission, requesting an expression of the views of the Commission as to the application of the Securities Act to various situations arising in all parts of the country in connection with the operation of mortgage-loan companies. According to his letter, such companies are being organized in many localities to participate in the Reconstruction Finance Corporation's program of extending credit facilities and assisting business and industry in cooperation with the National Recovery Administration program.

The opinion of the Federal Trade Commission was set forth in a letter dated December 11, 1933, signed by Charles H. March, Chairman. A company which confines its business to the state of its incorporation and offers its stock only to residents of that state, the opinion stated, "may make use of the mails or of any other means of communication within the state without first registering its securities with the Federal Trade Commission." As to the companies which intend to operate and sell their stock in states other than the state of incorporation, the Commission took the view that "many mortgage-loan companies may be considered institutions similar to those specifically named in Section 3 (a) (5) of the Act." This section exempts "any security issued by a building and loan association, homestead association, savings and loan association, or similar institution, substantially all the business of which is confined to the making of loans to members". In the opinion of the Commission, an essential similarity exists between a building and loan association as the term is used in the Act and a mortgage-loan company "where the stock issued to borrowers carries voting rights adequate to assure mutuality between the members of a mortgage-loan company." In expressing the opinion that the securities would be exempt under the circumstances named, Mr. March indicated that one of the

reasons for the exemption contained in Section 3 (a) (5) of the Act was "a belief that persons joining in such cooperative projects were less likely to need the protection from each other afforded by registration than persons dealing with issuers of the usual type."

The following summary of the opinion is taken from the Chairman's letter:

1. If a mortgage loan company, incorporated in the state in which it is to operate, sells its stock and/or other securities only to residents of that state, it may under section 5 (c), make use of the mails or of any other means of communication within the state without first registering the securities with the Federal Trade Commission.

2. If the company is incorporated in another state from that in which it will operate or if it intends to do business in more than one state, its securities will be exempt from registration by reason of section 3 (a) (5) of the Securities Act, if the stock of the company is issued only to borrowers, or if the stock issued to borrowers carries voting rights in the same proportion to their investment as that issued to the organizers.

3. In the case of a company intending to lend funds in any but the state of its incorporation, certificates issued to its borrowers by a voting trust formed to hold their stock in the company will have to be registered so far as sections 5 (c) and 3 (a) (5) are concerned.

[Securities Act Release No. 86, December 13, 1933]

§ 231.97 *Extracts from letters of the Federal Trade Commission relating to the application of various sections of the Act*—(a) *Sections 2 (1), 2 (3) and 2 (4).* The facts are indicated in the following quotation:

There can be no question but that voting trust certificates are subject to the provisions of the Securities Act of 1933. The definition of the term "security" contained in section 2 (1) of the Act, expressly includes a section 2 (4), which again specifically mentions voting trust certificates, the term "issuer" means the person or persons performing the acts and assuming the duties of manager pursuant to the provisions of a trust agreement. This can mean no one other than the voting trustees themselves. If, as seems clear from these two sections, the issue of voting trust certificates was intended to be subject to the Act, the ordinary transaction in which the certificates are delivered against the deposit of securities under the trust must have been intended to be included within the concept of a sale.

(b) *Section 2 (3).* The facts are indicated in the following quotation:

The issuance of bonds carrying a conversion privilege, under Section 2 (3) of the Act, does not constitute a "sale" of or "offer to sell" the stock into which the bond is convertible only if the conversion "right cannot be exercised until some future date." According to your letter the conversion privilege attached to the proposed bonds may be exercised at any time after the bonds are issued. For this reason, the issue of the bonds will involve an offer of the stock which will require immediate registration of the latter.

(c) *Section 2 (11).* The facts are indicated in the following quotations:

In the typical reorganization procedure, the protective committee, after approval of its plan or reorganization by the bondholders, arranges the organization of the new corporation and procures the issuance of the securities of the new corporation in connection with the acquisition of the property of the old corporation. In taking these steps, the committee is representing the depositing bondholders as their agent, trustee or otherwise. It is difficult to regard such committee as falling within the definition of an underwriter (section 2 (11)) since it is neither selling the new securities for the new corporation nor purchasing them with a view to their distribution. The issuance is a "sale" of the securities to the depositing bondholders, represented by the committee, and inasmuch as this is the case, no "distribution," as the term is used in Section 2 (11) of the Act, can be deemed to take place by the committee. The "distribution" within the meaning of the Act occurs when the securities are issued to the committee as such representative.

Under certain peculiar circumstances, of course, where the committee performs services not commonly performed by such committees but of the character that would ordinarily attend the distribution of new securities by an underwriter, the committee might well be an underwriter. But this is not ordinarily the case.

(d) *Sections 2 (11) and 3 (a) (1).* A corporation made an issue of 500,000 shares on June 20, 1933. 400,000 shares were issued to former stockholders. 100,000 shares were sold outright to an underwriter and offered to the public on the same day. At about the same time the underwriter entered into contracts with certain individual stockholders in the corporation by which the underwriter agreed to purchase from the stockholders within a limited time additional stock of which the individuals were owners. The underwriter is continuing to offer shares from the 100,000 share block purchased from the company. It will later offer to sell the shares which it has agreed to purchase from the individual stockholders. Section 2 (11) provides: "The term 'underwriter' means any person who has purchased from an issuer with a view to . . . the distribution of any security . . . As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling . . . the issuer . . ." Section 3 (a) provides: ". . . The provisions of this title shall not apply to . . .: (1) Any security which, prior to or within sixty days after the enactment of this title, has been sold or disposed of by the issuer or bona fide offered to the public, but this exemption shall not apply to any new offering of any such security by an issuer or underwriter subsequent to such sixty days;". The following questions are presented:

(1) In order to continue the offering of shares from the 100,000 share block, must the underwriter cause a registration of the securities?

(2) If the shares in this block are exempt from registration, will an offering of any other stock of this issue by the underwriter require registration?

(3) Specifically, will the offering at this time of the shares which the underwriter in June, 1933, contracted to purchase from the stockholders require registration?

Section 3 (a) (1) would provide an exemption for the securities in this case unless there is involved a "new offering . . . by an underwriter". So far as the 100,000 additional shares are concerned, it appears that the continuation of their sale to the public by the underwriter would not constitute a new offering, since it was commenced before July 27, 1933. The question, therefore, is narrowed to a consideration of the shares owned by various stockholders in the corporation, which they have contracted to sell to the underwriter.

In applying the phrase "a new offering . . . by an underwriter", it is the relationship between the person alleged to be an underwriter and the securities which he offers that is to be examined. If, with reference to the block which he now offers, he is not an underwriter, the exemption to which he was entitled under Section 3 (a) (1) is not lost thereby. So the fact that the underwriter of the 100,000 shares issued by the corporation in June will now for the first time offer shares of the same stock from another block, will not necessarily cause a loss of that exemption.

It is important to notice, however, that under section 2 (11) a person may be an underwriter within the meaning of the Act if he purchases from the controlling interests in a corporation with a view to further distribution. In this case, therefore, it would be necessary to consider the position, within the corporation, of the persons who have contracted with the underwriter for the sale of some of their holdings, except for the fact that the contract of sale was made before July 27.

Even if the sellers hold the controlling interest in the corporation so that prima facie the purchaser would be considered an underwriter under section 2 (11), if such sellers had sold or disposed of the stock to the underwriter before July 27, 1933, an offer by the latter made after that date would not cause the loss of an exemption otherwise available under section 3 (a) (1). The purpose of section 3 (a) (1) was to exempt from the necessity for registration, securities belonging to a person who had purchased before the effective date of the Act, and who could not compel the issuer to register the security. An opposite conclusion would lead to a result—certainly contrary to that contemplated by the Act—that might make it impossible for an underwriter, who became such before July 27, to dispose of an issue which he had purchased if it were assumed that an offering of the issue by him after July 27 was a "new offering . . . by an underwriter," within the meaning of section 3 (a) (1).

(e) *Section 4 (1).* A corporation in default in the payment of interest on its 6% bonds outstanding proposes to the bondholders to exchange new bonds bearing lower interest. The corporation proposes to pay certain fees to brokers and investment bankers for their services in promoting the exchange.

Section 4 provides: "The provisions of section 5 shall not apply to any of the following transactions: (1) * * * Transactions by an issuer not involving any public offering * * *[1]"

Section 3 (a) of the Securities Act of 1933 provides that "* * * the provisions of this title shall not apply to any of the following classes of securities:

(9) Any security exchanged by the issuer with its security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange. * * *[2]

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[1] At the time of this opinion, section 4 (1) read: "Transactions by an issuer not with or through an underwriter and not involving any public offering."

[2] At the time of this opinion, section 3 (a) (9) was the first clause of section 4 (3) and read: "(3) The issuance of a security of a person exchanged by it with its existing security holders exclusively, where no commission or other remuneration is paid or given directly or indirectly in connection with such exchange * * *" Subsequent references in the opinion to the first clause of section 4 (3) have been changed to refer to section 3 (a) (9).

The question is whether there will be a "public offering" of the new bonds within the meaning of section 4 (1).

It seems clear that offerings addressed only to security holders of a single issuer may nevertheless be "public offerings" within the meaning of section 4 (1). Otherwise the inclusion of the first clause of section 4 (3) [section 3 (a) (9)] would have been unnecessary. If the group of security holders includes a substantial number of persons, the offering should be considered a "public" one. This interpretation has the support of the Statement of the Managers on the Part of the House, at page 25 of the Conference Report:

"Sales of stock to stockholders become subject to the act unless the stockholders are so small in number that the sale to them does not constitute a public offering."

It receives added support from the consideration that while the Uniform Sale of Securities Act and many of the State Blue Sky Laws contain specific exemptions relating to the issue of securities by a company to its own security holders, no such specific exemption was included by Congress.

(f) *Section 4 (1).* The facts are indicated in the following quotation:

It is difficult to regard the contemplated offering of stock to 2,450 employees of the X corporation as not being a "public offering" within the meaning of section 4 (1) of the Securities Act. It is clear that the word "public" as used in this provision is not limited to offers which are made indiscriminately and open to anyone. For example, an offering confined to the security holders of a corporation may nevertheless be a "public offering" within the meaning of section 4 (1). Otherwise the first clause of section 4 (9) [section 3 (a) (9)] would be superfluous. Where a substantial number of persons is involved, it would seem imprudent to rely upon the second clause of section 4 (1) to give an exemption.

(g) *Section 4 (1).* The facts are indicated in the following quotation:

Securities, issued in exchange for securities of the same issuer to existing security holders in such a way that the exchange is exempt under section 4 (9) [section 3 (a) (9)] of the Securities Act, may be traded in by dealers within a year of their last public offering, although no registration statement is in effect and no prospectus complying with section 10 is furnished.

Although section 4, as distinguished from section 3, exempts transactions and not the securities themselves, where the transaction exempted is an otherwise non-exempted offering of an issue by an issuer and consequently the issuer is relieved of the duty of filing the registration statement, the dealer may sell through the mail and in interstate commerce without a registration statement, unless, of course, there is a new offering of the security by the issuer or an underwriter. A study of the Act indicates that in every instance the duty of filing a registration statement is placed upon either the issuer or a person who can control the issuer and thus compel the issuer to file the necessary statement. This being so, an exemption as to this group of persons would carry throughout the line of distribution to the dealer. True, in the ordinary case a dealer may not sell within one year after the public offering unless a registration statement is in effect. But the ordinary case presupposes that the issuer or someone in control of the issuer must file a registration statement as a condition precedent to making the offering. This basic presupposition upon which the dealer requirement of section 4 (1) rests, being removed the dealer limitations in section 4 (1) have no applicability.

(h) *Section 4 (3) [3 (a) (9)].* The facts are indicated in the following quotation:

Your letter raises the question whether certificates of deposit representing bonds exempt under section 3 (a) (2), which are deposited under an agreement with a protective committee, enjoy any exemption under the provisions of the Act referred to. It is difficult to see how the exemption there provided could possibly be applied to such certificates. Under section 2 (4) it is clear that the Committee is the "issuer" of the certificates. Certainly the committee cannot be considered as falling within any of the classes of issuers named in section 3 (a) (2). So far as this provision of the Act is concerned, registration of the certificates appears necessary.

(i) *Section 5 (c) [8 (a) (11)].*[1] Section 5 (c) [3 (a) (11)] provides:

[Section 3 (a) provides: "* * * the provisions of this title shall not apply to any of the following classes of securities: (11) Any security which is part of an issue sold only to persons resident within a single State or Territory, where the issuer or such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."]

The holders of certain bonds of a corporation resided outside of the State in which the issuer was incorporated and doing business. In order to carry out a reorganization without registration under the Act it was proposed to have the non-resident bondholders represented by an attorney resident within the State of the issuer's incorporation.

Your inquiry is whether the exemption provided by section 5 (c) [3 (a) (11)] can be secured by having the non-resident bondholders represented by a resident attorney. The conditions of section 5 (c) [3 (a) (11)] must be met in substance, not merely in form. The submission of the plan of reorganization to an attorney for non-residents is really a submission to the non-resident principals. In such an instance, section 5 (c) [3 (a) (11)] would seem inapplicable.

(j) *Section 5 (c) [3 (a) (11)].* A company incorporated and doing business in X filed a registration statement covering a new issue of its securities. Pending the effectiveness of this statement it proposed to sell securities from this issue to residents of X by the use of the mails within that State. After the statement should become effective, it contemplated the sale of the remaining portion of its issue to non-residents.

The Securities Act will not permit you to use the mails inside the state of X for the sale of your securities until a registration statement is effective unless, in accordance with the provisions of section 5 (c) [3 (a) (11)] the entire issue is to be sold to residents of that state. It is understood that you plan to sell part of the issue to non-residents of X as soon as the registration statement becomes effective. If this is done, the conditions of section 5 (c) [3 (a) (11)] will not be met, and any use of the mails for sales within the state pending an effective registration will be a violation of the Act.

(k) *Section 5 (c) [3 (a) (11)].* The facts are indicated in the following quotation:

The conditions which must be met in order to secure the exemption provided in section 5 (c) [3 (a) (11)] of the Securities Act relate only to the original issue of the securities. The fact, therefore, that residents of the state subsequently resell to persons outside of the state does not have the effect of destroying this exemption. Of course, the conditions must be met in substance as well as in form. Sales cannot be made by the corporation to residents with a view to their distribution in other jurisdictions. If later, however, the purchaser resells outside of the state, the corporation will not be liable, as has been indicated, and the purchaser himself will not violate the Act in view of the exemption provided in the first clause of section 4 (1).

(l) *Section 5 (c) [3 (a) (11)].* The facts are indicated in the following quotation:

The forwarding of an offer of a security addressed to a person within the state to a point outside the state would not involve the loss of an exemption otherwise available under section 5 (c) [3 (a) (11)]. A subscription received from a non-resident as a result, however, should not be accepted."

(m) *Section 5 (c) [3 (a) (11)].* A company incorporated and doing business in X proposed to insert an advertisement of its new issue of securities in a newspaper published within the state, part of the circulation of which extended into other states. It proposed to insert in its advertisement the following clause: "This offer is open only to residents of the State of X."

(n) *Section 8.* After the effective date of issuer's registration statement, certain changes in the condition of the issuer occurred of which the issuer wished to give prospective investors notice. Two questions were presented—whether it was necessary to amend the registration statement and how the information should be published in any prospectus of the issuer.

Under section 11 the accuracy of the registration statement is to be judged by the date upon which it becomes effective. It is, therefore, unnecessary, and probably impossible, to amend it to include facts which occur after its effective date. It may, of course, be necessary to supplement the information contained in the prospectus in order that it may not be misleading within the meaning of sections 12 (2) and 17.

The use of supplementary information, however, does not require an amendment of the prospectus, and no further papers need, therefore, be filed with the Commission. On the other hand, if it is proposed to substitute new information for that contained in the prospectus, since under the rules of the Commission the prospectus must not omit certain items contained in the registration statement, such changes can be effected only by a regular amendment to the statement filed with the Commission. In any case in which it could properly be made, such an amendment, being filed after the effective date of the registration statement, would become effective itself, under section 8 (c) of the Act, "on such date as the Commission may determine, having due regard to the public interest and the protection of investors."

(o) *Section 17 (b).* A security statistical service company, which publishes

[1] Section 3 (a) (11) was formerly section 5 (c) as follows: "(c) The provisions of this section relating to the use of the mails shall not apply to the sale of any security where the issue of which it is a part is sold only to persons resident within a single State or Territory, where the issuer of such securities is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory." Subsequent references in the opinion to section 5 (c) have been changed to refer to section 3 (a) (11).

periodically a pamphlet containing ratings for securities and advice as to their purchase, sale, or retention, was employed to assist in the preparation of a reorganization plan. For this work it was to receive a flat fee not contingent upon the success of the reorganization. The company proposed to recommend in its periodical pamphlet that bondholders of the corporation being reorganized adhere to the plan by depositing with the committee. The question was raised by the company whether it should disclose the amount of the fee which it was to receive for its work in preparation of the plan thus recommended:

The question raised requires a consideration of section 17 (b) of the Securities Act. The provisions of that section are clear. Whether it will be necessary to state the amount of the fee received by the X Company for its services depends entirely upon whether any part of the fee was actually contracted for in the expectation or with the understanding that the reorganization plan would be recommended by the Company. Such an expectation may result from the ordinary course of business of the company. If this expectation or understanding was consideration in retaining the X Company, it seems clear that the fee paid to it will be one the receipt and amount of which must be disclosed under the Act.

[Securities Act Release No. 97, December 28, 1933]

§ 231.131 *Extract from letter of Federal Trade Commission discussing the availability of a "broker's exemption" to the customer of the broker.* The Federal Trade Commission today made public an extract from a letter in response to an inquiry concerning the application of section 4 (2) of the Securities Act. This release supplements Release No. 97 (17 CFR, 231.97), published December 28, 1933, containing extracts from other letters discussing the application of the act to various situations.

16. *Section 4 (2).* Certain corporations having unissued stock and others having treasury stock which was originally issued before the effective date of the Securities Act proposed to sell such stock through brokers on the stock exchange. The question was raised whether section 4 (2) of the Securities Act made it unnecessary for the issuing corporations to register such stock before ordering its sale. The following is the comment contained in the letter:

Apparently the exemption provided by Section 4 (2) of the Securities Act applies only to the broker's part of a broker's transaction. It does not extend to the customer. Whether the customer is excused from complying with the requirements of Section 5 depends upon his own status or upon the character of the transaction in which he, himself is engaged. In other words, therefore, an issuer selling through a broker on the stock exchange would be subject to Section 5 of the Act. This would be true whether the securities sold by the issuer were unissued or treasury stock.

The House Report on the Securities Act (H. R. No. 85, 73rd Congress, 1st Session), at page 16, contains comment on this section of the Act which involves the interpretation which I have outlined above. Under this exemption, it is stated, "Purchasers, provided they are not dealers, may thus in the event that a stop order has been entered, cut their losses immediately, if there are losses, by disposing of the securities. On the other hand, the entry of a stop order prevents any further distribution of the security." This statement indicates that dealers (in the period of one year after date of public offering) would be unable to sell through brokers, securities for which no registration statement was in effect in accordance with the provisions of section 5 (a). The same restriction must, of course, apply to issuers and underwriters. Obviously, the committee did not conceive that the exemption extended to the broker's customer.

Under this ruling, treasury stock, originally issued before the effective date of the Securities Act of 1933, must be registered under that act before it may be sold. [Securities Act Release No. 131, March 13, 1934]

§ 231.185 *Statement by Federal Trade Commission discussing the amendment of the Securities Act to include fractional undivided interests in oil, gas or other mineral rights in the definition of security.*

Application of The Securities Act of 1933 to oil and gas royalty interests. Title II of the Securities Exchange Act of 1934, effective July 1, 1934, amends section 2 (1) of the Securities Act of 1933 to read in part as follows:

"The term 'security' means any * * * fractional undivided interest in oil, gas, or other mineral rights * * *".

It also amends section 2 (4) of the Securities Act to read in part as follows: "* * * with respect to fractional undivided interest in oil, gas, or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering".

The amendment to the definition of the term "security" makes clear that the provisions of the Securities Act apply to the sale of certain oil or gas interests. The ordinary royalty interest which entitles the holder to share in the oil or gas produced from a particular tract of land clearly comes within this definition. Whether such interests are transfered by deed or contract and whether under the law of the particular state in which the tract is located such interests are regarded as real estate or as personal property makes no difference in the application of the Act. The word "rights" is broad enough to make the definition applicable to interests which are regarded as giving ownership of the oil or gas in place as well as to interests which merely afford the owner the right to produce oil or gas. The Act applies, however, only to "fractional" interests. The transfer of the whole royalty interest in any tract of land, though under the terms of the lease the holder may be entitled only to a portion of the production, is not considered the transfer of a security under the Act.

In determining who is the "issuer" of the royalty interest for the purpose of the Act three points must be considered. An issuer must be the owner of the royalty interest in question. He must create fractional interests therein. And the subdivision must be made for the purpose of public offering. The application of the definition will be best understood from the consideration of illustrative cases. Suppose that a dealer purchases the entire royalty interest in a particular tract and proceeds to offer to the public 1/32 interests therein. The dealer will be an issuer and as such would have to sign a registration statement for such royalties, unless he brings himself within the exemptions provided by the Act or by the regulations of the Commission. Suppose, however, that he sold one-half of his royalty interest to another dealer and that this latter dealer in turn proposed to offer 1/64 interests in the royalty to the public. The latter dealer also would then be an issuer and registration by him of the interests offered by him would be necessary.

The ordinary offering of a royalty by a person engaged in dealing in royalty interests would come within the concept of a public offering. Such an offering may perhaps be actively made to only a few persons but the interest is for sale to any member of the public who wishes to buy. In this connection it is important to note that it is the number of persons to whom the offering is open which is determinative rather than the number of persons to whom sales are actually made.

It is unnecessary that the public offering be made directly by the person claimed to be the issuer, so long as he is responsible for the distribution of the interests among the public. Thus if a "wholesale" dealer in oil royalties confines his offering to, say, ten or fifteen "retail" dealers, nevertheless his subdivision of the interest for sale to those dealers in connection with their offering to a group which aggregates any substantial number will make him an issuer.

Sales to such "retail" dealers are made with a view to resale by them, and the seller, therefore, is to that extent responsible for the distribution among the public. On the other hand, the original owner of the royalty interest, owner of the fee of the tract to which it applies, would usually not be considered an issuer. He is ordinarily not engaged in the process of distribution of royalties. His sale to the dealer ends his participation in the transaction. He is not responsible for the eventual offering to members of the public.

In the case outlined above, where interests purchased from a "wholesale" dealer are further subdivided by the "retail" dealer, the latter will occupy a double position. He will not only be an issuer, as previously stated, but he will also be an underwriter. And insofar as the retail, as well as the wholesale dealer, is an issuer, two and perhaps more registrations for the same interest might be necessary.

In order to avoid the necessity of multiple registration, it would seem advisable for the original owner of the interest who proposes to subdivide it for the purpose of a direct or an indirect public offering, to register the fractional interests in as small fractions as he may deem necessary to assure their ultimate placement with investors. Instead of registering, for example, a one-quarter royalty interest, he may register 32/128, if he considers that it will be unnecessary to divide the interest into portions smaller than 1/128. It will also be possible in some cases to alter the fractions in which the interest is registered by an amendment to the registration statement made even after the statement has become effective. This may avoid further subdivision by the purchaser from the registrant, and thus, as no new issuer will be involved, a second registration will be rendered unnecessary.

Apart from the exemptions provided by the regulations of the Commission, several exemptions provided by the Act have application to royalty interests. Section 3 (a) (1) exempts from registration securities "sold or disposed of by the issuer or bona fide offered to the public" before July 27, 1933 (though this exemption does not apply to new offerings of such securities by the issuer or an underwriter after that date). Therefore royalty interests sold before July 27, 1933, or offered publicly before that date, may be offered, without registration, by persons who are neither issuers within the definition of section 2 (4) nor underwriters within section 2 (11) of the Act. Even if the offeror is an issuer or underwriter, because he proposes to subdivide his holdings or because he acts as broker or agent for an issuer, he may continue to offer the particular interests offered before July 27, 1933, if no material change is made in the terms or con-

ditions of the offering sufficient to constitute it a new one.

Section 3 (a) (11) exempts securities which are part of an issue "sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within * * * such State or Territory". The availability of this exemption depends, among other things, upon the residence of the issuer. It must be remembered, as pointed out above, that there may be more than one issuer for the same royalty interest where there have been successive subdivisions. To secure this exemption, all the issuers must be residents of the State or Territory where the offering is made. In addition, the original distribution of the interests must be confined to that particular State or Territory or the exemption will be destroyed.

Finally section 4 (1) exempts "transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering". Under the provisions of this section it will be unnecessary to register royalties if the seller intends to make no public offering of the interests directly or through any dealer. Ordinary transfers between private persons will be exempt from the registration requirements. It is also important to note that since the definition of the term "issuer" in section 2 (4) was added by an amendment effective July 1, 1934, only the subdivision of an interest after that date will subject the owner of a royalty to classification as an issuer for the purposes of the Act.

[Securities Act Release No. 185, June 20, 1934]

§ 231.201 *Statement by Federal Trade Commission relating to the availability of an exemption from registration where a secondary distribution involves sales outside the state of incorporation. Inasmuch as the name of the corporation involved is not deemed material at this time, it has been deleted.*

As a result of statements appearing in newspapers last week with respect to the listing on the New York Stock Exchange of an issue of $8,000,000 ------ fifteen-year secured 6 per cent sinking fund bonds, Series A, due June 1, 1949, to the effect that the issue was listed on the stock exchange after full clearance had been received from the Federal Trade Commission, the Commission today announced that it had not in any way approved or disapproved the listing of the bonds on the New York Stock Exchange.

The Federal Trade Commission statement said the Commission understood that in the first instance the issuer and the underwriters of the ------ bond issue intended to completely distribute the bonds entirely outside of the scope of the Securities Act of 1933 by avoiding the use of any means or instruments of transportation or communication in interstate commerce or of the mails. The issuance of the securities in this manner would itself raise no question of registration or exemption. But any subsequent sale through the use of the mails or of means or instruments of communication or transportation in interstate commerce would immediately necessitate consideration of the availability of an exemption under section 3 of the Act unless the particular transaction was exempt under section 4. In the absence of an exemption applicable under section 3, the Commission expressed the opinion that without registration, a listing on an exchange such as the New York Stock Exchange might result, sooner or later, in a violation of the Securities Act.

The Federal Trade Commission statement also said it had recently been advised that counsel for ------ now consider the bonds exempted under section 3 (a) (11) of the Securities Act as being part of an issue sold only to residents of New York State where the issuer was a New York corporation doing business within the State of New York. The Commission pointed out that in order that the exemption of section 3 (a) (11) may be available for securities of any issue, it is clearly required that the securities at the time of completion of ultimate distribution shall be found only in the hands of investors resident within the State. Ultimate distribution, in the opinion of the Commission, was declared to consist not only in the delivery of the bonds from the issuer to the underwriters, and the delivery of the bonds from the underwriters to sub-underwriters and to dealers, but also in the disposition of the bonds in the hands of investors in any secondary distribution which might take place pursuant to arrangements by the issuer or underwriters. An early listing of the bonds by the issuer on an exchange such as the New York Stock Exchange might contemplate further distribution of the bonds prior to the completion of their ultimate distribution.

[Securities Act Release No. 201, July 20, 1934]

§ 231.285 *Letter of General Counsel discussing the factors to be considered in determining the availability of the exemption from registration provided by the second clause of Section 4 (1).*

The opinion has been previously expressed by this office that an offering of securities to an insubstantial number of persons is a transaction by the issuer not involving any public offering, and hence an exempted transaction under the provisions of section 4 (1) of the Securities Act. Furthermore, the opinion has been expressed that under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering.

As a result of such opinions there appears to be developing a general practice on the part of issuers desiring to avoid registration of their securities to seek to dispose of the same to insurance companies or other institutions, which, at the time of purchase, state that they are acquiring such securities for investment and not with a view to distribution.

I would call your attention to the fact that in previous opinions it has been expressly recognized that the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment. In no sense is the question to be determined exclusively by the number of prospective offerees. I conceive that the following factors in particular should be considered in determining whether a public offering is involved in a given transaction:

1. *The number of offerees and their relationship to each other and to the issuer.* You will note that this does not mean the number of actual purchasers, but the number of persons to who the security in question is offered for sale. The word "offering" in this sense should not be limited to those cases wherein a formal proposal for a firm commitment is submitted. Any attempt to dispose of a security should be regarded as an offer. I have very serious doubt as to whether in many of those cases where it is stated that an offering is to be made only to an insubstantial number of persons, there may not be preliminary conversations for the purpose of ascertaining which of various possible purchasers would be willing to accept an offer of the security in question if it were made to them. Any such preliminary negotiations or conversations with a substantial number of prospective purchasers would, in my opinion, cause the offering in question to be a public offering, thereby necessitating prior registration of the security in question.

Again, in determining what constitutes a substantial number of offerees the basis on which the offerees are selected is of the greatest importance. Thus, an offering to a given number of persons chosen from the general public on the ground that they are possible purchasers may be a public offering even though an offering to a larger number of persons who are all the members of a particular class, membership in which may be determined by the application of some pre-existing standard, would be a non-public offering. However, I have no doubt but that an offering restricted to a particular group or class may nevertheless be a public offering if it is open to a sufficient number of persons.

I also regard as significant the relationship between the issuer and the offerees. Thus, an offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage. This factor would be particularly important in offerings to employees, where a class of high executive officers would have a special relationship to the issuer which subordinate employees would not enjoy.

2. *The number of units offered.* If the denominations of the units are such that only an insubstantial number of units is offered, presumably no public offering would be involved. But where many units are offered in small denominations, or are convertible into small denominations, there is some indication that the issuer recognizes the possibility, if not the probability, of a distribution of the security to the public generally. The purpose of the exemption of non-public offerings would appear to have been to make registration unnecessary in these relatively few cases where an issuer desires to consummate a transaction or a few transactions and where the transaction or transactions are of such a nature that the securities in question are not likely to come into the hands of the general public.

In connection with a consideration of the number of units offered, I would also consider whether the same or other securities of the same issuer are being offered at the same time. I feel that this circumstance has a bearing on the character of the offering.

3. *The size of the offering.* It should be noted that the exemption of section 4 (1) is of transactions by an issuer *not involving* any public offering. In view of this language, it would appear to be proper to consider not merely the specific transaction or transactions between the issuer and the initial purchasers, but also the extent to which a later public offering of all or part of the securities sold by the issuer is likely. Hence I feel that this exemption was intended to be applied chiefly to small offerings, which in their nature are less likely to be publicly offered even if redistributed.

For the same reason I feel that a material consideration is whether the security in question is part of an issue already dealt in by the public, either on a national securities exchange or on the over-the-counter market, or, within the reasonable contemplation of the parties, is likely thus to be dealt in shortly after its issuance. This factor again may indicate whether public distribution of the security in question is likely within a reasonable time.

4. *The manner of offering.* I have already indicated my opinion that the purpose of the exemption of non-public offerings is largely limited to those cases wherein the issuer desires to consummate a few transactions with particular persons. Consequently, I feel that transactions which are effected by direct negotiation by the issuer are much more likely to be non-public than those effected through the use of the machinery of public distribution.

I have gone into this matter at length in order that you may be apprised of the many elements which in my opinion go into the determination of what constitutes a transaction not involving any public offering. There may be some situations where all the factors are so clear that it would be possible to express a definite opinion. In a situation such as you present, however, I feel that the offering would be carefully scrutinized by any court before which it may come and that any letter which purported to describe the situation, and on which my opinion would necessarily be based, could not, adequately advise as to the various factors which are involved.

I call your attention to the fact that any dealer who might subsequently purchase from an initial purchaser the securities which you propose to offer, would be required to satisfy himself that the initial purchaser had not purchased with a view to distribution. If the initial purchaser had purchased with this intent, he would be an underwriter, and sales by a dealer of securities bought by him from such an initial purchaser would, as a general rule, not be exempt until at least a year after the purchase of the securities by the dealer. The sale of unregistered securities to a limited number of initial purchasers, therefore, leads to a practical situation in which such initial purchasers may have difficulty in disposing of the securities purchased by them. Any opinion which I might render in connection with the proposed offering might, I fear, be availed of by the issuer or by an initial purchaser as a means of satisfying a dealer, at a later date, that he might purchase the securities in question and market them without risk of violating the Act. You will appreciate that my opinion would not actually have this effect, since in the case of each transaction there would be involved various matters of fact on which I am not in a position to express an opinion. * * *

[Securities Act Release No. 285, January 24, 1935]

§ 231.312 *Letter of General Counsel discussing the availability of an exemption from registration for securities issued in exchange for other securities where the terms of the issuance and exchange are subject to approval by a state public utility commission.*

Section 3 (a) (10) exempts from registration:

Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

I shall take up in order the three questions you have raised as to the interpretation of this section.

1. Is adequate notice to all persons to whom it is proposed to issue securities of the hearing on the fairness of their issuance necessary for an exemption under section 3 (a) (10)?

Although the wording of section 3 (a) (10) does not demand such notice, in my opinion this requirement is to be implied from the necessity for a "hearing * * * at which all persons to whom it is proposed to issue securities * * * shall have the right to appear". To give substance to this express requirement, some adequate form of notice seems necessary. The usual practice of giving notice to persons who will receive securities in reorganizations, mergers and consolidations supports this view. Of course, the question of what mode of notice is adequate cannot be answered in the abstract but may vary with the facts and circumstances in each case.

2. Is a grant of express authorization of law to a state governmental authority to approve the fairness of the terms and conditions of the issuance and exchange of securities necessary for an exemption under section 3 (a) (10), or is express authorization merely to approve the terms and conditions sufficient?

The punctuation and grammatical construction of the last clause of section 3 (a) (10) indicate that the words "expressly authorized * * * by law" were not intended to modify "courts or officials or agencies of the United States". In my opinion a State governmental authority (with the possible exception of a banking or insurance commission) must possess express authority of law to approve the fairness of the terms and conditions of the issuance and exchange of the securities in question. This interpretation seems necessary to give meaning to the express requirement of a hearing upon the fairness of such terms and conditions, which must subsume authority in the supervisory body to pass upon the fairness from the standpoint of the investor, as well as the issuer and consumer, and to disapprove terms and conditions because unfair either to those who are to receive the securities or to other security holders of the issuer, or to the public. This requirement seems the more essential in that the whole justification for the exemption afforded by section 3 (a) (10) is that the examination and approval by the body in question of the fairness of the issue in question is a substitute for the protection afforded to the investor by the information which would otherwise be made available to him through registration. The requisite express authorization of law to approve the fairness of such terms and conditions, however, probably need not necessarily be in haec verba but, to give effect to the words "express" and "by law", must be granted clearly and explicitly.

3. Does a hearing by an authority expressly authorized by law to hold such a hearing satisfy the requirement of a hearing in section 3 (a) (10), if the state law does not require a hearing?

I believe that, as a corollary to the view expressed in my answer to the second question, *supra*, and in order that a hearing have legal sanction, the approving authority must be expressly authorized by law to hold the hearing; but in my opinion it is unnecessary that the hearing be mandatory under applicable state law. Therefore, if state law expressly authorizes the approving authority to hold a hearing on the fairness of the terms and conditions of the issuance and exchange of securities, and such a hearing is in fact held, this requirement of section 3 (a) (10) is satisfied. As stated before, the express authority need not be in any particular language, but a clear and explicit grant of statutory power is essential.

You will appreciate that the General Counsel's office cannot attempt to interpret the relevant statutes of each state to find whether they grant state authorities the powers necessary to satisfy the requirements of section 3 (a) (10). Obviously, these are questions of local law and must be for the determination of local attorneys. For these reasons, I am not in a position to render any opinion as to whether specific legislation grants to a state authority the powers necessary for an exemption under section 3 (a) (10).

[Securities Act Release No. 312, March 15, 1935]

§ 231.401 *Letter of General Counsel discussing the availability of an exemption from registration to Collateral Trust Notes.*

Section 3 (a) (3) of the Securities Act of 1933 exempts from the registration requirements of the Act "Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited".

The question of what is a "current transaction" is one which must be considered in the light of the particular facts and business practices surrounding individual cases. In general, it would seem that the proceeds of notes having a maturity of not more than nine months, of the type normally issued by finance companies, may be regarded as used for current transactions if the following conditions are satisfied:

1. The issuer of the notes for which exemption is claimed is in the business of making loans on or purchasing notes, instalment contracts, or other evidences of indebtedness.

2. The proceeds of the notes for which exemption is claimed are used for current transactions, which may properly include either (a) the making of loans upon or the purchasing of such notes, instalment contracts, or other evidences of indebtedness in the usual course of business, or (b) the payment of outstanding notes exempt under section 3 (a) (3).

[Securities Act Release No. 401, June 18, 1935]

§ 231.464 *Letter of General Counsel discussing distribution by statistical services of bulletins of and circulars describing securities for which registration statements have been filed.*

I understand that certain bulletins compiled by your company include in summarized form information concerning particular securities. This information is taken from your files and from the registration statements and prospectuses filed in respect of such securities under the Securities Act of 1933. Although these bulletins consist primarily of statements of facts they also contain your ratings of the securities involved, together with expressions of your opinion as to their investment value. It is proposed that these bulletins be circulated by your company to its subscribers and clients prior to the effective date of the registration statements for the securities which they describe, but subsequent to the filing of such statements. It is my further understanding that your subscribers may purchase these bulletins in any quantity desired. You inquire as to the effect of the Securities Act of 1933, as amended, upon the circulation of a preliminary bulletin by your company prior to the effective date of the registration statement covering the security described therein, and as to the legality of the use of the bulletin by your subscribers both prior and subsequent to registration becoming effective.

It is my understanding that your company receives no consideration, either directly or indirectly, from any issuer, underwriter or dealer, for describing the securities in your bulletins, and is in no way interested in the sale of the described securities. Accordingly, it seems clear that the circulation by you of these bulletins, even though effected through the use of the mails or instrumentalities of interstate commerce, prior to the effective date of a registration statement

covering the described security, does not constitute a violation of the Securities Act of 1933, as amended. It seems equally clear that the circulation by you of such bulletins would not be affected by section 17 (b) of the act, since that section is applicable only if the person circulating such literature describes the security in question for a consideration received from an issuer, underwriter or dealer.

With respect to the use which underwriters or dealers (including banks) may make of such bulletins, I call your attention to Release No. 70 of the Federal Trade Commission, (17 CFR, 231.70) dated November 6, 1933, which reads in part as follows:

In response to inquiries concerning how far an underwriter may go in discussing and advertising a proposed new offering of securities prior to the effective date of a registration statement filed under the Securities Act, the Federal Trade Commission today makes public the following letter transmitted to an inquirer: * * *

You ask further, however, whether circulars, describing a security in the method in which a prospectus conforming to Section 10 describes a security but clearly and unmistakably marked to indicate that they are informative only, negativing without equivocation either impliedly or expressly an intent to solicit offers to buy or to make an offer to sell, can be circulated with impunity during the waiting period by an issuer or an underwriter. You assume, as I assume, that both the letter and the spirit of these markings are strictly adhered to. Such conduct seems not only allowable but one that carries out the general purposes of the Act. Prospective purchasers, whether they be dealers or the general public, should during this waiting period be educated up to the nature of an issue, which it is expected that they will shortly be asked to buy, always reminding them that no determination to buy is requested of them until the expiration of the waiting period.

Such a procedure hardly needs any expression from this Division to indicate that it is permissible under the Act. The House Report expressly states, pp. 12–13:

"The bill, apart from section 16 (b) [now section 17 (b)] is not concerned with communications which merely describe a security. It is, therefore, possible for underwriters who wish to inform a selling group or dealers generally of the nature of a security that will be offered for sale after the effective date of the registration statement, to circulate among them full information respecting such a security. This could easily and effectively be done by circulating the offering circular itself, if clearly marked in such a manner as to indicate that no offers to buy should be sent or would be accepted until the effective date of the registration statement."

I concur fully with the opinion expressed by the Federal Trade Commission in Release No. 70, and believe that the principles which are embodied therein are determinative in considering the use which may be made of your bulletins by those of your subscribers who are underwriters or dealers. Although that opinion was primarily concerned with the circulation of information by underwriters to dealers, the views therein expressed seem equally applicable to any information based on the registration statement filed with the Commission, even though furnished by issuers, underwriters, or dealers to potential investors since the legality of the submission of preliminary information under section 5 is dependent upon whether or not it is used in connection with, or it itself constitutes, an "offer to sell," as that term is defined in the Act. Consequently, it is immaterial whether the bulletin is sent to dealers or potential investors. However, as is pointed out in the Release, the making of any attempts to dispose of a security or to solicit offers to buy a security, fall within the prohibition of section 5 of the Act during the twenty-day period preceding the effective date of registration, as well as prior to the filing of the registration statement. Accordingly, any circulation by underwriters or dealers of a bulletin descriptive of a particular security, which is in furtherance of an offering of such security for sale prior to the effective date of registration, or of a solicitation during that period of an offer to buy the security, would fall within the prohibitions of section 5 of the Act.

On the other hand, even though your subscribers transmit these bulletins to their clientele through the mails or interstate commerce, such transmittal is not a violation of the Act if the subscriber does not in fact use the bulletins as selling literature. Whether or not a subscriber is using a bulletin as selling literature is, of course, a question of fact in each case as to which no generalization can be made. The intent with which the bulletins are used, as determined from all surrounding circumstances, would control the legality of circulation thereof by underwriters or dealers.

If an underwriter or dealer were to supplement a bulletin with selling literature or with a recommendation to the recipient as to the desirability of purchase, or were to attempt to obtain from the recipient some indication of interest however tentative, in purchasing the described security, such action, in my opinion, would almost conclusively establish that the bulletin was being used in an attempt to dispose of or to solicit an order for the purchase of the security.

In this connection I call your attention to the problem created by the insertion in the bulletins of your ratings of the described securities and of your opinion as to their investment value. As has been pointed out above, an underwriter or dealer who circulates with a bulletin or other purely descriptive matter his recommendation as to the desirability of the investor's purchase of the security would in all probability be held to have offered the security for sale. In my opinion, the insertion of such material by the statistical service creates a substantial risk that underwriters or dealers, in circulating the bulletins, would, where such opinion material is favorable, be held to have violated the Act through their participation in a recommendation of the security for purchase.

The legality of the circulation of a bulletin subsequent to the effective date of registration would be governed by those provisions of the Act which forbid the transmission through the mails or interstate commerce of selling literature unless such literature is a prospectus meeting the requirements of the Act or is accompanied or has been preceded by such a prospectus. Whether a bulletin constitutes selling literature would, as has been pointed out above, depend in large measure on the use to which it is put. If it were used by underwriters or dealers as selling literature, its circulation would be lawful only if it were accompanied or preceded by a copy of a prospectus meeting the requirements of the Act.

The General Counsel of the Commission supplemented his opinion with a suggestion that, in order to prevent any unwitting misuse by underwriters or dealers of bulletins such as those under consideration, it would be advisable to print on all bulletins a statement calling the attention of dealers to the effect of pertinent sections of the Securities Act. A statement such as the following was suggested:

Attention of underwriters and dealers is called to the fact that no attempt or offer to dispose of this security, or to solicit an offer to buy this security, may lawfully be made through the use of any agency of interstate commerce, or of the mails, until a registration statement covering this security has become effective.

In connection with any such attempt or offer to dispose of this security, or to solicit an offer to buy this security, even though made after registration is effective, this bulletin may lawfully be used by underwriters or dealers only if accompanied or preceded by a prospectus meeting the requirements of the Federal Securities Act.

[Securities Act Release No. 464, August 19, 1935]

§ 231.493 *The context of certain instructions to the use of Form E–1 (17 CFR, 239.8) for registration statements relating to the necessity of registration of securities involved in a consolidation, merger or reorganization.*

Rules as to the use of Form E–1 (17 CFR, 239.8) 1. Subject to the provisions of Rule 6 below, Form E–1 (17 CFR, 239.8) is to be used to register securities (including contracts of guaranty but excepting voting trust certificates, certificates of deposit, and certificates of interest or shares in unincorporated investment trusts of the fixed or restricted management type not having a board of directors or a board of persons performing similar functions, but having a depositor or sponsor) sold or modified in the course of a reorganization, as defined in Rule 5 below.

2. A separate registration statement shall be filed by each separate issuer, whether it be a primary issuer or a guarantor.

3. A registration statement for securities requiring registration on Form E–1 shall be effective before their "sale" by the issuer thereof or an underwriter or dealer.

A "sale" of such securities by the issuer thereof is involved in the submission of a plan or agreement for reorganization:

(a) When a opportunity to assent to or to dissent or withdraw from a plan or agreement for reorganization is given on such terms that a person so assenting or failing to dissent or withdraw within a limited time will be bound, so far as he personally is concerned, to accept such securities, unless at the same time he retains or is given a right subsequently to withdraw which is conditioned, if at all, only upon his payment of not more than his proportionate part of the expenses of reorganization, and

(b) If the plan or agreement referred to is submitted by, or with the authority of, the issuer of such securities.

A registration statement for such securities shall, therefore, be effective before such "sale" is made.

If the condition stated under (b) in the preceding paragraph is absent, either because the proposed issuer is not in existence or for any other reason, no registration of such securities is then necessary, in view of the provisions of the first clause of section 4 (1) of the Act. A registration statement for such securities shall be in effect in any event, however, before their "sale" (including their issue or modification) by their issuer or an underwriter or dealer.

4. Since the "sale" of securities registered on this form may be made under circumstances different from those subsequently existing at the date of commencement of their delivery to the ultimate holders thereof, it is required, as a condition to the continued effectiveness of a statement on this form after the latter date, that:

(1) Any document which is required as an exhibit and which becomes effective or which is put into final form subsequent to the effective date of the registration statement and prior to the commencement of the delivery of the securities to the ultimate holders thereof, and

(2) Any amendment to a document which is required under Exhibit A or D and which

becomes effective in such period, shall be filed as an amendment to the registration statement.

5. As used in these rules and the accompanying instructions:

(1) The term "reorganization" includes any transaction involving:

(a) A readjustment by modification of the terms of securities by agreement; or

(b) A readjustment by the exchange of securities by the issuer thereof for others of its securities; or

(c) The exchange of securities by the issuer thereof for securities of another issuer; or

(d) The acquisition of assets of a person, directly or indirectly, partly or wholly, in consideration of securities distributed or to be distributed as part of the same transaction directly or indirectly to holders of securities issued by such person or secured by assets of such person; [1] or

(e) A merger or consolidation.[1]

(2) The term "sale" has the meaning given in Section 2 (3) of the Act: "Any contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy."

(3) The term "security holder" includes a person holding a certificate issued against the deposit of the security referred to, whether or not he is entitled to return of the security upon surrender of the certificate.

NOTE: The Commission deems no sales to stockholders of a corporation to be involved, within the meaning of the definition quoted in Rule 5 (2), where, pursuant to statutory provisions or provisions contained in the certificate of incorporation, there is submitted to the vote of such stockholders a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person, or a plan or agreement for a statutory merger or consolidation, provided the vote of a required favorable majority:

(a) Will operate, so far as the corporation the stockholders of which are voting is concerned, to authorize the transfer or to effectuate the merger or consolidation (except for the taking of action by the directors of the corporations involved and for compliance with such statutory provisions as the filing of such plan or agreement with the appropriate state authorities), and

(b) Will bind all stockholders of such corporation, except to the extent that dissenting stockholders may, under statutory provisions or provisions contained in the certificate of incorporation, be entitled to receive the appraised or fair value of their holdings.

The Commission deems it immaterial in these circumstances whether the person the securities of which are to be issued is in existence or not; whether, if such person in existence, the plan, agreement or proposal is submitted by or with its authority; or whether, in the case of transfer of assets, such securities are to be issued to stockholders directly, or are to be distributed to them as a liquidating dividend or otherwise.

When, in accordance with this Note, submission of a plan, agreement, or proposal to the vote of stockholders involves no sale to them, the Commission deems no sales to be involved in the delivery of securities to such stockholders.

Accordingly, neither the submission to the vote of stockholders of a plan, agreement or proposal of the character specified in this Note, nor the delivery of securities thereunder to such stockholders, requires the registration of such securities or the delivery of a prospectus meeting the requirements of section 10 of the Act.

6. (a) If, in the course of a reorganization involving no sales of securities to stockholders as such (see Note above under Rule 5), other securities requiring registration are issued (as, for example, securities issued to a transferring corporation which are to be distributed by it for cash), such other securities may be registered on the form which would be appropriate if only such other securities were being issued.

(b) In accordance with Special Rule 1 as to the use of Form A–2 (17 CFR, 239.2) for Corporations, Form A–2 (17 CFR, 239.2) may be used in lieu of Form E–1 (17 CFR, 239.8) under the circumstances there described, notwithstanding the provisions of Rules 1 and 5 (1) above.

(c) In the case of any guarantee of, or assumption of liability on, securities heretofore registered on Form D–2, registration of such guaranty or assumption of liability may, at the option of the issuer, be effected on Form D–2 or Form E–1 (17 CFR, 239.8)

This amendment shall become effective September 19, 1935.

[Securities Act Release No. 493, September 20, 1935]

§ 231.538 *Letter of General Counsel discussing the availability of an exemption from registration for the issuance of securities under deposit agreements where solicitations under the agreements were begun prior to the effective date of the registration requirements of the Securities Act.*

My attention has been directed to a type of deposit agreement under which mortgage bonds or other securities have been deposited, which agreement authorizes the Committee appointed thereunder, in its discretion, to cause title to the mortgaged property to be vested in a trustee, or trustees, or in a corporation. Under such type of deposit agreement the Committee is further authorized, in its discretion, to cause the issuance and delivery to holders of certificates of deposit, of certificates of interest in, or other securities of, the trust, or certificates for shares of stock or other securities of the corporation, in which the title to the property becomes vested. The scope of the Committee's discretion is such that the transfer of title to the property and the issuance and delivery of the securities referred to above may be effected by the Committee without further authorization on the part of the holders of certificates of deposit, and without affording such holders an opportunity to withdraw deposited securities.

It is understood that the solicitation of the deposit of bonds or other securities under such type of deposit agreement was commenced prior to July 27, 1933, and has been continued subsequent to that date in such manner as not to constitute a new offering of certificates of deposit, and that the trust or corporation which is to issue the new securities has been or is to be formed at the direction of the Committee acting pursuant to authority conferred by the deposit agreement.

The effect of section 3 (a) (1) of the Securities Act of 1933, as amended, is to exempt from the registration requirements of the Act any security which, prior to July 27, 1933, was bona fide offered to the public, except that such exemption does not apply to any new offering of such security by an issuer or underwriter occurring on or after that date. The certificates of deposit issued under such type of deposit agreement, even though issued and delivered on or after July 27, 1933, are, under the circumstances outlined above, exempt from registration, since the offering of such securities was initiated by the issuer thereof prior to July 27, 1933. The further question is presented as to whether the securities ultimately deliverable to the holders of certificates of deposit after the transfer of title contemplated by the deposit agreement are exempt from registration. There may be some question whether there is any offering of such securities for sale. But it seems clear that such offering as may have been made was made prior to July 27, 1933, since the issuance of such securities was contemplated at the time of the solicitation of deposits, and, under the provisions of the deposit agreement, was authorized without further submission to holders of certificates of deposit of the terms and conditions under which the transfer of title was to be effected and the new securities issued. Such securities therefore seem likewise exempt from the registration requirements of the Act.

As has been pointed out above, the certificates of deposit and the new securities are exempt only if there has been no "new offering" thereof on or after July 27, 1933. What constitutes a "new offering" is a question of fact necessitating in each instance consideration of all of the surrounding circumstances. However, it seems that at least the following factors should be taken into account in determining whether a "new offering" is involved. If the deposit agreement specified a date beyond which deposits were not to be accepted, any amendment of the agreement, after July 27, 1933, extending such date, would seem to involve a new offering. If, however, there was no time limit originally specified in the deposit agreement, or if the time limit originally specified has not yet expired, and if deposits have been continuously acceptable, it would seem equally clear that no "new offering" has been involved.

[Securities Act Release No. 538, October 26, 1935]

§ 231.603 *Letter of General Counsel discussing the availability of the exemption from registration of the second clause of section 4 (1) where a dealer resells to the public without registration a block of securities bought from an initial purchaser who had acquired the securities in connection with a so-called "private" offering.*

I call your attention to my opinion set out in the next to the last paragraph of Release No. 295, which states in substance that the answer to your question depends upon whether the initial purchaser acquired the securities with a view to distribution, and further points out that if his acquisition was with such intent, he would be an underwriter, so that in general sales by dealers of securities bought from him would not be exempt from registration.

You will appreciate that the intent of the initial purchaser at the time of acquisition is a question of fact upon which you must satisfy yourself, and upon which I can express no opinion.

I wish to make clear, however, that I do not believe the fact that the initial purchaser has stated that his original purchase was for investment and not for resale is necessarily conclusive on this question. In my opinion there should be considered such other factors as: (1) the relation between the issuer and the initial purchaser; (2) the business of the latter, as for example, whether such purchaser is an underwriter or dealer in securities, and, if not, whether the purchase of such a block of securities for investment is consistent with its general operations; and (3) the length of time elapsing between the acquisition of the securities by the initial purchaser and the date of their proposed resale.

Of course, if the securities in question were in fact purchased by the initial purchaser for investment rather than for resale, dealers' sales thereof to the public would not necessitate registration under the Securities Act.

In conclusion, I feel that I should point out that even though a dealer is satisfied that

[1] Although a "reorganization" is involved in a given situation, consideration should be given to the Note following Rule 5 (3) in determining whether it is necessary to register securities issuable to existing stockholders in connection with such reorganization.

a particular block of unregistered securities was bought by an initial purchaser for investment, he nevertheless takes the risk that, if his determination is incorrect, sales by him of such securities will be in violation of the registration requirements of the Act.

[Securities Act Release No. 603, December 16, 1935]

§ 231.646 *Letters of General Counsel discussing the application of section 3 (a) (9).* The General Counsel's opinion indicating the inapplicability of section 3 (a) (9) to other than bona fide exchanges of securities, which was given in answer to a query concerning a proposed exchange of bonds with three noteholders, is as follows:

Section 3 (a) (9) exempts: Any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange.

I assume that no commission or other remuneration will be paid in connection with this exchange, and that the bonds will be issued only to the above-mentioned noteholders in exchange for the notes of the corporation. In such case, on the further assumption that none of the bondholders is or will be in control of your company, it seems to me likely that registration of the bonds in question will be unnecessary. However, I feel that I should point out possible limitations which I believe are inherent in section 3 (a) (9), and which might operate to prevent the applicability of the exemption of that section despite formal compliance with its conditions.

I believe section 3 (a) (9) is applicable only to exchanges which are bona fide, in the sense that they are not effected merely as a step in a plan to evade the registration requirements of the Act. For example, Corporation A, as part of such a plan, might issue a large block of its securities to Corporation B, and might then issue new securities to Corporation B in exchange for the first-issued securities, with the understanding that such new securities are to be offered to the public by Corporation B. In my opinion, the mere fact that the exchange in such case might comply with the literal conditions of section 3 (a) (9) would not avail to defeat the necessity for registration of the securities issued in such exchange. Cf. Gregory v. Helvering, 293 U. S. 465.

In determining whether a particular exchange had been effected merely as a step in a plan to evade the registration requirements of the Act, I believe that a court would take into account various factors such as the length of time during which the securities received by the issuer were outstanding prior to their surrender in exchange, the number of holders of the securities originally outstanding, the marketability of such securities, and also the question whether the exchange is one which was dictated by financial considerations of the issuer and not primarily in order to enable one or a few security holders to distribute their holdings to the public. In any event, I call your attention to the fact that in the case of Borland v. Federal Electric Company, now pending in the Federal District Court for the Northern District of Illinois, the question has been presented under the Federal Declaratory Judgment Act, as to the application of section 3 (a) (9) to a situation similar to the one which you describe. In view of this proceeding, I believe that it would be inadvisable for me to express any opinion other than that indicated above.

The second opinion of the General Counsel was in reply to an inquiry whether securities previously received by a controlling stockholder in a bona fide exchange except under section 3 (a) (9) should be registered before being offered to the public through an underwriter. The relevant portion of the opinion follows:

In order to make clear my position on this question, I must briefly review the legislative histories of the present section 3 (a) (9) and of section 2 (11) of the Securities Act of 1933.

The last sentence of section 2 (11) reads as follows: "As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

This sentence, by defining an underwriter to include a person purchasing from one in a control relation with the issuer, makes the exemption afforded by section 4 (1) inapplicable to transactions by such a person and thus necessitates registration before distribution to the public of securities acquired from a person in a control relation. The report of the House Committee, which considered the identical language in the bill then before the Committee (H. R. 5480), leaves no doubt as to the reason for this requirement:

"The last sentence of this definition, defining 'issuer' to include not only the issuer but also affiliates or subsidiaries of the issuer and persons controlling the issuer, has two functions . . . Its second function is to bring within the provisions of the bill redistribution whether of outstanding issues or issues sold subsequently to the enactment of the bill. All the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they may wish to dispose of their holdings and to make an offer of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities. Wherever such a redistribution reaches significant proportions, the distributor would be in a position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the act." H. R. 85, 73d Cong., 1st Sess., pp. 13–14.

Section 2 (11) thus gives expression to the clear intent of Congress to subject to the registration requirements of the Act any redistribution of securities purchased from persons in a control relation with the issuer.

Turning to the present section 3 (a) (9), I call your attention to the fact that, although this Section in terms excepts *securities* issued in certain transactions of exchange, its predecessor, section 4 (3) exempted only such transactions of exchange. Consequently, before the 1934 amendments, distribution by a controlling person through an underwriter of stock previously issued in a transaction exempt under form Section 4 (3), was subject to the registration requirements. The reasons for the relevant amendment therefore become important.

The question early arose whether dealers' transactions in securities exchanged in a section 4 (3) transaction were exempt from the registration requirements of the Securities Act. Section 4 (1) specifically excepts from the dealers' exemption: "transactions within one year after the first date upon which a security was bona fide offered to the public";

but in order to effectuate the evident purpose of the act, the Federal Trade Commission took the position that dealers' transactions in securities originally issued in a transaction exempt under section 4 (3) were exempt, even though such dealers' transactions were effected within a year of the first offering of such securities.

That the purpose of the amendment changing section 4 (3) to sections 3 (a) (9) and 3 (a) (10) was to incorporate in the act this opinion of the Commission appears from the statement of the report of the Conference Committee which considered these amendments.

"The amendments adding new sections 3 (a) (9), 3 (a) (10), and 3 (a) (11) are based upon sections 4 (3) and 5 (c) of the original act, which are proposed to be repealed. By placing these exemptions under section 3 it is made clear that securities entitled to exemption on original issuance retain their exemption; if the issuer is not obliged to register in order to make the original distribution, dealers within a year are subject to no restriction against dealing in the securities. The result is in line with the Commission's interpretation of the act as it stood before, but the amendment removes all doubt as to its correctness." H. R. 1838, 73d Cong., 2d Sess., p. 40.

This language clearly evidences that the congressional intent was merely to offer a more adequate statutory basis for the Commission's previous interpretation, and not to alter the fundamental requirement of section 2 (11).

Moreover, the fact that the securities in question fall within Section 3 (a) does not necessarily preclude consideration of the necessity of their registration before certain transactions therein can be effected. Sections 3 (a) (2) to 3 (a) (8) inclusive describe classes of securities which are of such an intrinsic nature that it is evident that Congress felt that, regardless of the character of the transaction in which they have been or are to be issued or publicly offered, their registration was not necessary for the protection of investors. On the other hand, your letter calls attention to the fact that Section 3 (a) (1), the exemption of which is predicated upon the time of issuance or offering of securities, regardless of their intrinsic nature, excepts from this exemption "new offerings * * * by underwriters". As your letter further states, the basis of the exemption of section 3 (a) (9) is only "the circumstances surrounding the * * * issue". This view of section 3 (a) (9) is further borne out by the report of the Committee which considered the predecessor section 4 (3). H. R. 152, 73d Cong., 1st Sess., p. 25. The anology seems to me compelling; there is nothing in the intrinsic nature of securities falling within section 3 (a) (1) or section 2 (a) (9) which justifies their permanent exemption from registration. In the language of House Report No. 85, quoted *supra*, a large public offering of such securities possesses all the dangers attendant upon a new offering by their issuer.

It seems clear that a construction of section 3 (a) (9) as permanently exempting securities offered in a transaction falling within that section, even though such securities were subsequently newly offered by persons controlling the issuer, finds no rational basis. Furthermore, the language of House Report No. 85, quoted earlier in this letter, definitely indicates that the amendment which changed section 4 (3) to section 3 (a) (9) was intended only to clarify the application of the registration requirements to dealers' transactions, and was not intended to cut into the fundamental principle embodied in section 2 (11)—that persons in control of an issuer be treated as the equivalent of the issuer.

In view of the Congressional purpose in enacting the last sentence of Section 2 (11), the legislative history of the present section 3 (a) (9), and the lack of any rational basis for the continuance of the exemption provided by section 3 (a) (9) to a later offering of securities by an underwriter, it is my opinion that securities received in a section 3 (a) (9) exchange should be registered before their public distribution through an

underwriter by a person in control of their issuer.

[Securities Act Release No. 646, February 3, 1936]

§ 231.802 *Letter by General Counsel dicussing the circulation by underwriters and dealers of summaries of information contained in registration statements prior to the effective date of such statements.*

It is my understanding that your firm is a prospective underwriter of a security for which a registration statement already filed has not yet become effective under the Securities Act, and that you propose to prepare a summary of certain information contained in such statement for circulation among your clientele prior to the effective date of the statement. I note that the summary, which apparently contains no expression of opinion relative to the securities described, will contain a superimposed legend in red ink stating in substance that the summary is furnished for informative purposes only and that it is not to constitute an offer to sell or a solicitation of an offer to buy the securities described. A further statement will be made in the red ink legend across the face of the summary that orders will not be considered prior to the effective date, and will be considered thereafter only if given by a person who has previously received a copy of the prospectus. The summary will also contain a statement calling the attention of underwriters and dealers to the fact that any use of the summary in connection with any offering for sale of the described securities prior to the effective date of the registration statement will be unlawful, and that subsequent to the effective date the summary of information may be so used if accompanied or preceded by the prospectus.

The clientele to whom the summary will be sent may include other underwriters, dealers, brokers, corporations, institutional and individual investors. The summary is not to be used subsequent to the effective date of the registration statement unless accompanied or preceded by a copy of the prospectus. You request an expression of my opinion as to whether the form, content and proposed use of this summary comply with the requirements of section 5 of the Securities Act of 1933, as amended.

As was pointed out in the opinion of the General Counsel set forth in Securities Act Release No. 464 (17 CFR, 231.464), this and similar summaries of information contained in a registration statement may, without violation of section 5 of the Act, be circulated through the mails and in interstate commerce prior to the effective date of the registration statement covering the described securities, provided that the summary does not itself constitute an offer of the securities described and is not circulated or used under such circumstances as might in fact involve its use in connection with any sale of the described securities. You will appreciate, of course, that, pursuant to section 2 (3) of the Act, any solicitation of any offer to buy, and any attempt to dispose of, a security, are, for purposes of the Securities Act, included within the definition of the term "sale". As is indicated in Release No. 464, it is a question of fact in each case whether or not any such summary is being utilized in an attempt to sell or to offer for sale the security described. The factors which would be of weight in determining whether or not the use of an informative summary involves a sale are discussed in considerable detail in that release, and I cannot give any general opinion as to whether the use which may be made by brokers, salesmen, dealers, etc., of the summaries to be prepared by your company, will involve a violation of section 5. Where, however, the summary is in fact not used in connection with any "sale" of the described securities, within the meaning of that term as defined in the Act, its transmittal through the mails or in interstate commerce would not involve a violation of the Act.

You will appreciate that I cannot undertake to examine and make the necessary analysis of all summaries of information which may be circulated by underwriters or other persons interested in the eventual sale of the securities. I may, however, say that if a summary contains no recommendation or opinion as to the merits of the security, is a fair summarization of the salient information contained in the registration statement, and does not stress or in any way emphasize the favorable as against the unfavorable aspects of such security, and if the use of such a summary is in form and substance confined within the limits indicated above and more fully set forth in Release 464 (17 CFR, 231.-464), it is my opinion that such a summary may be circulated in the manner which you suggest. Of course, any such emphasis of favorable factors or any recommendation or expression of opinion as to the merits of the security would characterize the summary as an attempt to dispose of the security, and therefore, as an offering of the security for sale, within the meaning of the Act. In this connection, I must again refer to the opinion expressed in Release No. 464 (17 CFR, 231.464), which contains a more complete analysis of this problem and to which the views herein expressed are subject.

I should be very glad to receive from you a final copy of any summary of the character considered in this letter.

[Securities Act Release No. 802, May 23, 1936]

§ 231.828 *Letter of General Counsel discussing the application of section 5 (b) (2) where a purchaser has received a copy of a prospectus from a source other than the seller.*

It is my opinion that the words, "preceded by a prospectus", in section 5 (b) (2) of the Securities Act of 1933, as amended, do not require that the prescribed prospectus must have been sent by the same person who causes the securities to be sent through the mails for the purpose of sale, or for delivery after sale. Such person would, of course, take the risk of the lack of prior transmittal of a prospectus, but, assuming that the purchaser had, in fact, received a copy thereof, it would not be necessary for the seller of the security to transmit additional copies of such prospectus at the time of transmittal of the security.

The above opinion, of course, relates only to the requirements of section 5 (b) (2) and not to section 5 (b) (1). It should be noted that the latter section provides that any prospectus which is sent through the mails or in interstate commerce must comply with the requirements of Section 10, and that any literature offering a security for sale (other than a notice meeting the requirements of section 2 (10) (b)) falls within the definition of "prospectus" contained in Section 2 (10), unless the sender thereof or his principal has previously sent or given the prospective purchaser a copy of the prescribed prospectus. Consequently, the receipt by the prospective purchaser of the prescribed prospectus from another source would not relieve a person who is subsequently circulating selling literature from the duty of seeing that such literature, in accordance with the provisions of section 5 (b) (1), meets the requirements of section 10 of the Act.

[Securities Act Release No. 828, June 4, 1936]

§ 231.874 *Opinion of the Director of the Division of Forms and Regulations relating to Rule 821 (a) (17 CFR, 230.821a).*

The rules as to the prospectus for Form A-2 (17 CFR, 239.2) provide as follows: "The information set forth in the prospectus, except as to financial statements required to be furnished, may be expressed in condensed or summarized form."

The question has been raised as to what is the effect of this permission to condense or summarize.

There must be first borne in mind the fact that the registration statement is a public document, open to inspection by any person, and that copies can be obtained by any interested person at little expense and small effort. The prospectus, on the other hand, is designed for general distribution. Plainly, the prospectus is intended to be a shorter and briefer document than the registration statement. This is further shown by the fact that, under authority granted by the Act, whole items may be omitted from the prospectus. The prospectus is meant to be an epitome, or summary, and, obviously, cannot be as discursive as the longer registration statement. The rule clearly indicates that the prospectus is not to contain the same degree of particularity as the registration statement.

It is patent, therefore, that condensation or summarization involves omission; for it is not to be assumed that surplusage is contained in the registration statement itself. Indeed, in most places in the registration statement, answers are required to be stated briefly. A summarization or condensation of matter which has already been stated briefly must, of necessity, involve a greater brevity and an increased terseness, which can be attained only by a reduction in word content. To repeat, this reduction can be achieved only by the omission of material.

As an example of the proper method of condensing information for use in the prospectus, there may be cited the case where facts stated in the registration statement are reducible to a more general statement. In such case, all that is required in the prospectus is such general statement. In other words, a series of related facts may be set forth in the prospectus in terms of their net result. An instance of this principle may be given. Item 45 in Form A-2 (17 CFR, 239.2) calls for revaluations of property since 1922. In the registration statement the actual revaluations should be set forth. In the prospectus, however, it is not only permissible, but desirable, if such can be done in the specific case, to set forth the net result of the revaluations which were made. If, for example, there have been numerous write-ups and write-downs with a final return to original cost, it would suffice to state in the prospectus that numerous revaluations had been made with the net result of finally returning the property to original cost. If a particular person should desire to obtain more precise information, that is, the times, nature, and amounts of the respective revaluations, he should consult the registration statement.

[Securities Act Release No. 874, July 2, 1936]

§ 231.929 *Letter of General Counsel discussing the question of whether a sale of a security is involved in the payment of a dividend.*

As I understand the situation, the company proposes to declare a dividend upon its common stock in the amount of one dollar in cash or one-tenth of a share of common stock for each share of common stock held. Each stockholder will be entitled to elect whether to accept the dividend in cash or in stock. Your letter is silent as to the mechanics of the declaration and distribution, and as to the nature of the rights of stockholders who fail to take affirmative action to express their election. In the absence of information regarding these important details, I can answer your question only in a general manner.

Whether or not registration is required in such a case is of course primarily dependent

upon whether the offering is of such a character as to constitute it a "sale", as that term is defined in section 2 (3) of the Securities Act. As you are aware, this definition is extremely broad in its scope, and includes every "attempt or offer to dispose of * * * a security * * * for value". The term "value" is not defined in the Act, but should in my opinion be regarded as including not only such ordinary forms of consideration as the transfer of cash or property, but also the waiver or surrender of a right or claim.

However, even though under ordinary circumstances the waiver of a right would in my opinion constitute "value", I do not believe that that term should be regarded as comprehending within its meaning the action of a stockholder, to whom alternative rights have been granted without consideration, in electing to exercise one such right, even though, under the terms of the grant, such election will have the effect of causing the lapse of the right not exercised. Consequently, if a corporation, by simultaneous action of its board of directors, declares a dividend payable at the election of the stockholder in cash or in securities, neither the declaration of the dividend, nor the distribution of securities to stockholders who elect to take the dividend in that form, would in my opinion constitute a sale within the meaning of the Securities Act, and no registration of the securities so distributed would be required under that Act.

However, according to my understanding it is well settled in general law that upon the public declaration of a cash dividend out of surplus, the holders of the stock in respect of which the dividend is declared acquire immediately the rights of creditors of the corporation, and cannot be divested of these rights by subsequent action of the board of directors. If, therefore, there is declared a cash dividend payable to all stockholders, and if the board thereafter determines to grant to stockholders the opportunity to waive their pre-existing and vested right to payment of the dividend in cash, and to receive the dividend in the form of securities, the stockholders electing to take securities would in my opinion be regarded as giving value for the securities so received. Under these circumstances I believe that the securities might well be held to be the subject of a sale.

[Securities Act Release No. 929, July 29, 1936]

§ 231.1256 *Letter of General Counsel discussing the solicitation by financial and security houses of brokerage orders for the purchase of securities prior to the effective date of a registration statement for such securities:*

As I understand the situation, in cases where corporate bonds have been called for redemption and a registration statement for new debentures of the same issuer has been filed with this Commission but is not yet effective, certain financial and securities houses propose to circularize holders of the called bonds with a view to securing orders for the purchase of the new debentures. The circular letters will contain a notification of the call of the bonds for redemption and a suggestion that the securities be presented for payment. They will further advise the bondholder that a registration statement for a new issue of debentures of the same company, bearing a specified interest rate, has been filed with this Commission, and that the new debentures are expected to be offered for subscription within a short period, and will proffer the services of the circularizing house as "buying agent" to purchase new debentures to replace the called bonds. The proposed communications will also state that these services will be confined to the execution of orders solely for the account of customers, and that no representations or recommendations are made with respect to the new debentures.

In my opinion, a circular letter of this type would obviously be a "solicitation of an offer to buy" the new debentures, and would therefore involve a "sale" of such debentures within the meaning of the term "sale" as defined in section 2 (3) of the Securities Act of 1933, as amended. Any use of the mails or means of interstate commerce by a dealer (which term, as defined in section 2 (12) of the Act, includes a broker) in circulating such a letter prior to the effective date of the registration statement covering the new debentures would consequently be in violation of section 5 (a) (1) of the Securities Act unless some exemption from the provisions of that section were available.

In view of the emphasis which the proposed circular letter places upon the fact that the senders thereof would act only in a brokerage capacity in executing orders, it is possible that you believe an exemption to be available under section 4 (2), which exempts from the operation of section 5: "Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders."

The last clause of this section clearly renders the exemption afforded thereby unavailable to a solicitation, by means of a letter of the type above described, of an order to purchase securities. Consequently, unless some other exemption is applicable, the circulation of such a letter through the mails or in interstate commerce would constitute a violation of section 5 (a) (1) of the Securities Act.

[Securities Act Release No. 1256, February 9, 1937]

§ 231.1376 *Opinion of the Director of the Division of Forms and Regulations discussing the definition of parent as used in various forms under the Securities Act of 1933 and the Securities Exchange Act of 1934.*

The term "parent" is defined in the Instruction Book to Form A-2 (17 CFR, 239.21) as "an affiliate controlling the registrant directly, or indirectly through one or more intermediaries." Several inquiries have been made as to whether an individual person may be a parent within the meaning of this definition.

These inquiries may be answered by reference to other definitions appearing in the Instruction Book to Form A-2 (17 CFR, 239.2) and in the Securities Act of 1933.

Under the definition of "affiliate" given in the Instruction Book, the term means "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the registrant." In consequence, any "person" controlling the registrant directly or indirectly is to be regarded as a "parent" of the registrant.

By the definition contained in Section 2 (2) of the Securities Act of 1933, the term "person" is defined to include "an individual" as well as corporations and other legal persons. This definition applies to the term "person" as used in the Instruction Book for Form A-2 (17 CFR, 239.2), in view of the provision in the Instruction Book under the caption "Definitions" that "all terms used in these instructions and the Form have the same meaning as in the Securities Act of 1933, as amended."

It follows, therefore, that any individual person directly or indirectly controlling the registrant is a parent of the registrant for the purposes of any item or instruction in Form A-2 (17 CFR, 239.2).

It should be noted that the definitions of "parent" and "affiliate" given in Rule 455 of the General Rules and Regulations under the Securities Act and in the various forms under that Act and the Securities Exchange Act of 1934 are identical for the present purpose with the definitions in the Instruction Book to Form A-2 (17 CFR, 239.2) quoted herein. Likewise, the definition of "person" given in section 3 (a) (9) of the Securities Exchange Act of 1934 is identical for the present purpose with the definition in the Securities Act of 1933. Accordingly, the above conclusion, that the term "parent" includes individual persons, applies to all other forms and rules adopted under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as to Form A-2 (17 CFR, 239.2).

[Securities Act Release No. 1376, April 7, 1937]

§ 231.1459 *Letter of General Counsel discussing nature of the exemption from registration provided by section 3 (a) (11)*

This is with reference to your recent letter, in which you raise a number of questions as to the meaning and application of the exemption from registration provided by section 2 (a) (11) of the Securities Act of 1933, as amended.

Answer to your inquiries may, I think, be facilitated by brief discussion of the general scope of application of section 3 (a) (11) to so-called intra-state offerings of new issues of securities. Specifically, that section exempts from the registration and prospectus requirements of the Act: "Any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

The legislative history of the Securities Act clearly shows that this exemption was designated to apply only to local financing of such a nature that it may practicably be consummated in its entirety within the single state in which the issuer is both incorporated and doing business. Accordingly this exemption, formerly contained in section 5 (c) of the Securities Act and now reenacted in section 3 (a) (11) of the Act, as amended, is so worded as to be available only to a security "which is a part of an issue sold only to persons resident within" the state in question. In any consideration of the exemption it is essential to appreciate that its application is thus expressly limited to cases in which the entire issue of securities is offered and sold exclusively to residents of the state in question.

Moreover, since the exemption is designed to cover only those security distributions, which, as a whole, are essentially local in character, it is clear that the phrase "sold only to persons resident" as used in section 3 (a) (11) cannot refer merely to the initial sales by the issuing corporation to its underwriters, or even the subsequent re-sales by the underwriters to distributing dealers. To give effect to the fundamental purpose of the exemption it is necessary to take the view expressed by the Federal Trade Commission during its administration of the Securities Act, that if the exemption is to be available "it is clearly required that the securities at the time of completion of ultimate distribution shall be found only in the hands of investors resident within the state" (Securities Act Release No. 201 (17 CFR, 231, 201)). This position was adhered to by the Securities and Exchange Commission in its decision in the Brooklyn Manhattan Transit Corporation case, 1 S. E. C. 147 (1935), that an issue of $8,000,000 principal amount of bonds approximately 15% of which, during the course of their distribution, were offered and sold to persons resident outside the State of New York could not be exempt under the former section 5 (c) or the present section 3 (a) (11), despite the fact that the issuer, a New York corporation, had in the first instance sold the entire issue to underwriting houses resident in New York State. The bonds could not be considered

to have been "sold" until they had reached the hands of purchasers buying for investment and not with a view to further distribution or for purposes of resale.

From these general principles it follows that if during the course of distribution any underwriter, any distributing dealer (whether or not a member of the formal selling or distributing group), or any dealer or other person purchasing securities form a distributing dealer for resale were to sell such securities to a non-resident, the exemption would be defeated. Moreover, since under section 3 (a) (11) the exemption is applicable only if the entire issue is distributed under the circumstances specified, any such sales to a non-resident in connection with the distribution of the new issue would destroy the exemption as to all securities which are a part of that issue. This is true regardless of whether such sales are made directly to non-residents or indirectly through residents who purchased with a view to resale and thereafter sold to non-resident; and it would furthermore be immaterial that the sales might be made without use of the mails or instruments of interstate commerce, or by persons themselves exempt from the registration and prospectus requirements, and might therefore, as isolated transactions, involve no violation of the Securities Act. Any such sales to non-residents, however few, and even though legal in themselves, would preclude compliance with the conditions of section 3 (a) (11), and would render the exemption unavailable for that portion of the issue sold to residents through use of the mails.

On the other hand, securities which have actually come to rest in the hands of resident investors—persons purchasing for investment and not with a view to further distribution or for purposes of resale—may be resold by such persons, whether directly or through dealers or brokers, to non-residents without in any way affecting the exemption of the issue. The relevance of any such resales to the existence or non-existence of the exemption would consist only in the evidentiary light which such resales might cast upon the question whether the securities had in fact come to rest in the hands of resident investors. If the securities were resold but a short time after their acquisition, this fact, although not conclusive, would strengthen the inference that their original purchase had not been for investment, and that the resale therefore constituted a part of the process of primary distribution; and a similar inference would naturally be created if the seller were a security dealer rather than a non-professional.

The foregoing general outline will indicate that, as many people fail to appreciate, the so-called "intrastate exemption" is not in any way dependent upon absence of use of the mails or instruments of transportation or communication in interstate commerce in the distribution, section 3 (a) (11) provides in effect that if the residence of the purchasers, the residence or place of incorporation of the issuer, and the place in which the issuer does business are all confined to a single state, the securities are exempt from the operation of Section 5 of the Act. Securities thus exempt may without registration be offered and sold through the mails, may be made the subject of general newspaper advertisement (provided the advertisement is appropriately limited to indicate that offers to purchase are solicited only from, and sales will be made only to, residents of the particular state involved), and may even be delivered in interstate commerce to the purchasers, if such purchasers, though resident, are temporarily out of the state or should direct delivery to some non-resident agent or custodian. Similarly, subject to the general prohibitions of the Act against the use of false or misleading statements or omission in selling literature, securities exempt under section 3 (a) (11) may be offered without compliance with the formal prospectus requirements applicable to registered securities. Exemption under section 3 (a) (11), if in fact available, removes the securities from the operation of all provisions of the Act except those of sections 12 (2) and 17.

In conclusion, I should like to stress once more the fact that section 3 (a) (11) is designed to apply only to such types of distributions as are genuinely local in character. From a practical point of view, the provisions of that section can exempt only issues which in reality represent local financing by local industries, carried out purely through local purchasing. In distributions not of this type the requirements of section 3 (a) (11) will be extremely difficult, if not impossible, to fulfill. Consequently, any dealer proposing to participate in the distribution of an issue claimed to be exempt under section 3 (a) (11), or to deal in such an issue within a year after its first public offering, should examine the character of the issue and the proposed or actual manner of its offering with the greatest care in order to satisfy himself that the distribution will not, or did not, involve the making of any sales to non-residents. Otherwise the dealer, even though his own sales may be carefully confined to resident purchasers, may subject himself to serious risk of civil liability under section 12 (1) of the Act for selling without prior registration a security not in fact entitled to exemption from registration.

[Securities Act Release No. 1459, May 29, 1937]

§ 231.1503 *Opinion of the Director of the Division of Forms and Regulations relating to Rule 821 (a) (17 CFR, 230.821 (a))*

This is in answer to your inquiry as to the extent to which the technical description of securities may be condensed in a prospectus for securities registered on Form A-2 (17 CFR, 239.2) under the Securities Act.

There is no doubt that in many instances prospectuses have been so long and cumbersome as partially to destroy their usefulness. The technical description of securities has often contributed to this undue length.

The prospectus is designed to be read by people making business judgments. Meticulousness, which lawyers use in such documents as corporate indentures, is out of place in a prospectus. The resulting verbiage is without meaning except to those skilled in legalistic language. Notwithstanding, the description of securities in prospectuses has at times consisted of virtual extracts taken from the underlying documents.

Such a presentation would seem to serve little purpose even for lawyers and technicians, since they would undoubtedly prefer to consult the original instruments, which are on file, for details in which they may be interested.

At any event, the Securities Act, and the rules adopted thereunder, do not require the amount of detail often furnished.

The answers to the items in question are required to be stated briefly, and the following general instruction, contained in the Instruction Book accompanying Form A-2 (17 CFR, 239.2) is applicable:

"6. Where 'brief' answers are required, brevity is essential. It is not intended, in such case, that a statement shall be made as to all the provisions of any document, but only, in succinct and condensed form, as to the most important thereof. In addition, the answer may incorporate by reference particular items, sections or paragraphs of any Exhibit, and may be qualified in its entirety by such reference."

In addition, there is a special instruction applicable to the items in question, reading as follows:

Items 14, 15, 16, 17, 18 and 19. The outline required by these items is to relate only to such matters as have bearing on the investment value of the security registered and as to which an average prudent investor ought reasonably to be informed before purchasing the security registered. Details which are mere mechanics are not to be set forth. What is required is such information as will reasonably inform the investor from an investment standpoint, and not from the standpoint of obtaining a full and complete legal description of the rights and duties involved. For example, in the case of conversion rights, only the general character of dilution provisions need be set forth; and in the case of sinking fund provisions only the general method of operating the sinking fund, but not the mechanical details thereof.

The outline need relate only to the provisions of the respective governing instruments, exclusive of statutes.

Furthermore, the material in the prospectus should be in even more simplified form than the answers set forth in the registration statement. Particular authorization to this effect is contained in the Instruction Book accompanying Form A-2 (17 CFR, 239.2). Paragraphs 1 and 2 under the caption "Instructions as to prospectuses other than newspaper prospectuses", read as follows:

1. The information set forth in the prospectus, except as to financial statements required to be furnished, may be expressed in condensed or summarized form. * * *

2. Where the incorporation by reference in the registration statement proper of matter contained in exhibits is permitted, a similar incorporation by reference may be made in the prospectus.

The cited rules make clear that what is required in a registration statement and particularly in a prospectus is a brief statement of th business elements involved. Compliance therewith could afford no ground for liability under the statute for section 19 (a) of the Act provides: "* * * No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason."

An example from a prospectus on file illustrates the failure to follow the above-mentioned rules. The prospectus covered a $27,500,000 issue of first mortgage bonds of an operating public utility company, showing property plant and equipment of over $48,000,000, to which there was applicable a property retirement reserve of about $9,000,000. In the opinion of counsel, the mortgage when duly recorded was to constitute a first lien, with certain minor exceptions, upon all such property.

There is required to be stated in the prospectus, as to bonds being offered, a brief outline of the provisions concerning the issuance of further securities under indenture. The purpose of the information is to show to what extent the bonds being offered may be affected by the issuance of further securities.

In that regard, the prospectus in question contained the following statement and definitions. The definitions were also applicable to other parts of the description of securities.

Definitions. The term "property additions" is defined in Section 4 of the Mortgage to mean plants, lines, pipes, mains, cables, machinery, transmission lines, pipe lines, distribution systems, service systems and supply systems, vehicles, automobiles, property, real or personal, and improvements, extensions or additions, renewals or replacements acquired by purchase, consolidation, merger, donation or in any other way whatsoever, subsequent to November 30, 1936, or made or constructed subsequent to November 30, 1936, or in the process of construction or erection in so far as actually constructed or erected subsequent to November 30, 1936, and

used or useful or to be used in the business of generating, manufacturing, gathering, transporting, transmitting, distributing or supplying electricity or gas for light, heat, power or other purposes, or steam or hot water for power or heat or other purposes.

The term "property additions" shall not, however, include (1) any securities or contracts, leases or choses in action, or (2) except as in the Mortgage otherwise specifically provided, going value, good will, franchises or governmental permits granted to or acquired by the Company, as such, separate and distinct from the property operated thereunder or in connection therewith or incident thereto, or (3) any goods, wares, merchandise, equipment, materials or supplies acquired for the purpose of sale or resale in the usual course of business or for the purpose of consumption, or (4) any natural gas wells or natural gas leases or natural gas transmission lines or pipes or other works or property used in the production of natural gas or its transmission up to the point of connection with any distribution system, or (5) any property acquired, made or constructed by the Company in keeping or maintaining the mortgaged property in good repair, working order and condition.

In section 4 of the Mortgage, it is provided that the term "net property additions" shall at any particular time mean the aggregate of all property additions up to that time at the cost thereof to the Company (to the extent not theretofore made the basis of the authentication and delivery of bonds or the withdrawal of cash deposited under section 20 or section 32 of the Mortgage or a credit under section 20 or section 40 of the Mortgage) after (A) deducting the cost of all of the mortgaged and pledged property owned by the Company on November 30, 1936, which, and of all property additions which, in either case, shall prior to the date of the particular computation, have been either retired subsequent to November 30, 1936 or released from the lien of the Mortgage and (B) adding to such balance an amount equal to the aggregate of (a) the cash and the principal amount of any purchase money obligations then held by the Trustee hereunder or by the trustee or other holder of a prior lien, as hereinafter defined, and representing the proceeds of insurance on or the release of or the taking by eminent domain of any property referred to in clause (A) above; (b) the amount of any cash which shall have been received by the Trustee as the proceeds of insurance on or the release of or the taking by eminent domain of any property referred to in clause (A) above and which shall theretofore have been used by the Trustee for the purpose of purchasing and/or redeeming bonds in accordance with the provisions of subdivisions 2 and 3 of section 63 of the Mortgage and the amount of any such cash received by the trustee or other holder of a prior lien and applied by it for the purpose of purchasing and/or redeeming prior lien bonds; and (c) an amount equal to 142⅔% of the bonds or fraction of a bond the right to the authentication of which on a basis other than cash or property additions shall have been waived in order to obtain the release of any property referred to in clause (A) above. The term "cost" as used in this definition shall mean the cost as shown on the books of the Company or if not so separately shown then the cost as estimated by the Company.

The term "funded property" is defined in Section 5 of the Mortgage to mean (a) all property owned by the Company on November 30, 1936, (b) all "property additions" to the extent that the same shall have been made the basis of the authentication and delivery of Bonds, the release of "funded property", the withdrawal of "funded cash", or a credit under section 20 of the Mortgage referred to below or a credit under section 40 of the Mortgage relating to maintenance of the mortgaged properties, or have been substituted for funded property, and (c) all property constituting repairs, renewals or replacements of or substitutions for funded property except to the extent of the excess cost thereof, such costs to be determined as provided in connection with the definition of "net property additions".

The term "funded cash" is defined in section 5 of the Mortgage to mean (a) cash (held by the Trustee under the Mortgage or by the trustee or other holder of a "prior lien") to the extent that it represents the proceeds of insurance on or the release of or the taking by eminent domain of "funded property"; (b) cash held at any time in any sinking fund or other similar device for the retirement of Bonds of one or more series issued under the Mortgage; but when all Bonds of such one or more series shall have ceased to be outstanding under the Mortgage, such cash shall no longer be deemed to be or to have been "funded cash"; and (c) any cash deposited with the Trustee under Section 32 of the Mortgage in connection with the issuance of Bonds, or under Section 48 of the Mortgage on the cancellation of "prior liens", or pursuant to section 20 of the Mortgage referred to below or pursuant to Section 40 of the Mortgage relating to maintenance of the mortgaged properties.

The term "prior lien" is defined in Section 6 of the Mortgage to mean mortgage or other lien (not including "excepted encumbrances") prior to the lien of the Mortgage, existing at any particular time upon any "property additions" (so long as such "property additions" remain subject to the lien of the Mortgage), then or theretofore, made the basis under any of the provisions of the Mortgage for the authentication and delivery of Bonds or the withdrawal of cash or the release of property or the basis of a credit under the provisions of section 20 of the Mortgage referred to below or a credit under the provisions of section 40 of the Mortgage relating to maintenance of the mortgaged properties.

The term "excepted encumbrances" as defined in section 6 of the Mortgage includes liens for taxes, assessments, governmental charges not due and delinquent; liens neither assumed by the Company nor on which it customarily pays interest existing upon real estate or rights in or relating to real estate acquired by the Company for substation, measuring station, regulating station, gathering line, transmission line, gas transportation line, distribution line or right-of-way purposes; rights in public authorities to revoke franchises, permits, etc., or to purchase or recapture property; easements or reservations in property of the Company created at or before the acquisition thereof by the Company for the purpose of roads, pipe lines, gas transportation lines, transmission lines and other like purposes.

Issuance of additional bonds. The Mortgage provides for the immediate issue upon order of the Company of $27,500,000 principal amount of 1966 Series Bonds. Additional Bonds of any one or more series in an aggregate principal amount of not exceeding $2,500,000 may be issued from time to time upon the request of the Company, provided only that the net earnings of the Company are such as would be required in the case of the issuance of additional Bonds upon the basis of property additions as referred to below.

In addition to the $27,500,000 1966 Series Bonds registered hereunder and the $2,500,000 additional Bonds referred to above, Bonds of one or more series, ranking (except insofar as any sinking fund established in accordance with the Mortgage may afford additional security for the Bonds of any particular series) pari passu with the 1966 Series Bonds as to lien, may be issued without limit subject to the restrictions contained in the Mortgage, the Bonds of other series to mature on such date and to bear such interest rate and to be in certain other respects as the Board of Directors of the Company may determine by resolution. Certain of these restrictions are as follows:

Bonds may be authenticated and delivered by the Trustee to the Company upon the basis of property additions, which are included in net property additions and which are not at the time funded property, in a principal amount not exceeding 70% of the cost or then fair value (whichever shall be less), determined as provided in the Mortgage, of such property additions. (See sections 26 and 27). If any of such property additions are subject to outstanding prior liens, the principal amount thereof (unless previously deducted) is to be deducted from the principal amount of Bonds otherwise issuable. (See section 28.) No Bonds may be authenticated and delivered on the basis of property additions subject to prior liens if the outstanding prior lien bonds (unless previously deducted) exceed 50% of the cost or the then fair value (whichever shall be less) of such property additions. No Bonds may be authenticated and delivered on the basis of property additions subject to prior liens if and so long as the principal amount of all Bonds theretofore authenticated and delivered by the Trustee upon the basis of such property additions subject to prior liens as shall have continued to be subject to prior liens exceeds 15% of the aggregate principal amount of all Bonds theretofore authenticated and delivered under the Mortgage including any Bonds then applied for. (See section 28.) The Mortgage also contains other restrictions on the authentication and delivery of Bonds in respect of property additions subject to prior liens.

Bonds may be authenticated and delivered upon the payment, retirement, redemption or cancellation of any Bonds theretofore authenticated and delivered under the Mortgage or upon the reduction of outstanding prior liens or the deposit of prior lien bonds with the Trustee or upon the deposit of money in the amount necessary for the payment, redemption or retirement of prior lien bonds or of Bonds authenticated and delivered under the Mortgage, to a principal amount equivalent to the principal amount of the Bonds authenticated and delivered under the Mortgage so paid, retired, redeemed or cancelled or for the payment or redemption of which such money has been so deposited or prior lien bonds so deposited or the amount by which outstanding prior liens have been reduced. (See sections 28 and 31.)

Bonds may be authenticated and delivered upon the deposit with the Trustee of cash equal to the principal amount of such Bonds. (See section 32.) The cash so deposited may be withdrawn in lieu of Bonds which the Company may be entitled to have authenticated and delivered to it under any of the provisions of the Mortgage, subject to the same restrictions as are imposed on the issue of Bonds for such purposes, except the restrictions as to net earnings hereinafter referred to, or, at the election of the Company, may be applied to the purchase or redemption of Bonds of any series, any such purchase to be at a price not in excess of the current redemption price of the Bonds purchased, or, in case of Bonds not redeemable, not in excess of 105% of the principal amount of such Bonds plus accrued interest: *Provided, however,* That, except to the extent of any balance of cash resulting from the purchase of any Bonds at less than the principal amount thereof, none of such cash shall be applied to the payment of more than the principal amount of any Bonds so purchased or redeemed. (See sections 33 and 34.)

No Bonds may be issued upon the basis of property additions or against the deposit of cash unless the net earnings of the Company, computed as provided in section 7 of the Mortgage (which computation does not require the deduction as an expense of, among other things, expenses or provisions for renewals, replacements, depreciation, depletion, retirement or amortization of prop-

erty or for income taxes, profits taxes and other taxes measured by net income), together with the net earnings of any property to be acquired through the issue of such Bonds, for a period of twelve consecutive calendar months selected by the Company in the fifteen calendar months immediately preceding the first day of the month in which the application is made for the authentication and delivery of such additional Bonds, shall be at least equal to two times the annual interest requirements on (1) Bonds outstanding under the Mortgage; (2) additional Bonds so to be authenticated and delivered; (3) prior lien bonds to be then outstanding; and (4) other outstanding indebtedness of the company secured by lien prior to the Mortgage. (See sections 7, 29 and 32.)

In the foregoing answer, the important statements do not stand out. They are obscured in a mass of detail.

It is clear that the instructions cited above not only permit but invite the omission of such detail.

An answer in the following form would have conveyed the information which an average prudent investor would desire and would have been in full compliance with the Securities Act and the rules and regulations thereunder:

Issuance of additional bonds. Unlimited amounts of additional bonds which will be of equal rank as to lien with the bonds presently offered may be issued; (1) If net earnings applicable to interest charges are at least twice the annual interest requirements on all outstanding indebtedness of equal or prior rank, including the additional issue; and

(2) If the principal amount of such bonds does not exceed 70% of the net additions made to the utility plant after November 30, 1936.

However, an aggregate principal amount of $2,500,000 of such bonds may be issued subject only to the above earnings requirement.

Net earnings are computed before deduction of property retirement expense, depreciation, depletion or amortization of debt discount and expense, and may include net earnings of property to be acquired through the additional issue. Any consecutive 12 months in the 15 months preceding the additional issue may be selected for the computation.

For the purpose of (2) above, properties acquired for the production and transmission of natural gas shall not be deemed additions to utility plant.

Additional bonds may be issued on the basis of property additions subject to prior liens. Among other limitations, it is provided that the aggregate amount of such bonds cannot exceed 15% of the total bonds issued.

Detailed provisions more precisely defining the foregoing matters are contained in sections 4 to 7 and 23 to 34, each inclusive, of the Indenture. Such sections also include provisions as to the issuance of bonds in special circumstances.

[Securities Act Release No. 1503, July 12, 1937]

§ 231.1580 *Letter of the Director of the Division of Forms and Regulations relating to Rule 821 (a) (17 CFR, 230,821 (a)).*

You recently inquired concerning the extent to which the technical description of securities may be condensed in a prospectus for securities registered on Form A–2 under the Securities Act (17 CFR, 239.2).

In considering the question of the contents of prospectuses, it must be borne in mind that the prospectus is a selling medium. The Securities Act was not designed to change this characteristic, but to insure that it would contain reliable information necessary for investment judgment. If the intricacy of an indenture is carried to the prospectus, the latter necessarily fails its purpose.

On July 12 of this year, I discussed this question as regards provisions concerning the issuance of additional securities. That opinion indicated that prospectuses are often excessively cumbersome. There were cited the instructions which require that answers to items in registration statements be brief, particularly with respect to summarization of documents. It was emphasized that the instructions authorize an even more condensed presentation in prospectuses. Section 19 (a) of the statute was cited to show that the instructions afforded protection under the Act. Independently thereof, the statute imposes liabilities only in regard to matters which are material.

The previous opinion discussed one instance of undue technicality. A further example may be cited, dealing with provisions as to release and substitution of property securing an issue of bonds.

This example is taken from a prospectus covering a $10,500,000 issue of first mortgage bonds. The issuer was an operating public utility company, showing property and plant of over $27,000,000 to which there was applicable a retirement and depreciation reserve of about $5,700,000. The company was essentially an electric and gas utility, but about 3% of its gross operating revenues were derived from transportation activities. With certain exceptions, the mortgage was to constitute a first lien upon the operating fixed property of the registrant other than transportation properties. Additional bonds to the amount of $2,000,000 were issuable without the necessity of property additions.

The prospectus in question contained the following statement with regard to release and substitution of property, the definitions preceding the statement being applicable to this and other parts of the prospectus:

"Property additions", (as is more full defined in Article I of the Mortgage) consist of additional property acquired after March 31, 1936, located in the State of ———— or in any other state, if connected with the properties in the State of ————, properly chargeable to fixed property accounts and useful in the electric, gas or heating business of the Company.

"Net bondable value of property additions" (as is more fully defined in Article I of the Mortgage), consists, when used with respect to property additions not subject to an unfunded prior lien, of the lesser of cost or (as to property additions not previously retired) fair value of all gross property additions not subject to an unfunded prior lien, less (i) all retirements of property of such character, other than property released by the Trustee, (ii) the excess, if any, of the bonded cost of property of such character released by the Trustee over the fair value thereof at the time of release, (iii) an amount equal to the amount of cash deposited upon release of property of such character, withdrawn on the basis of property additions of such character or applied to sinking fund payments, if any, and (iv) an amount equal to ten-sevenths (10/7ths) of the amount of additional Bonds theretofore authenticated on the basis of property additions, and ten-sevenths (10/7ths) of the amount of cash deposited against the issue of additional Bonds, theretofore withdrawn on the basis of property additions.

"Bonded Cost" when used in respect of retirements consists of (i) in the case of property owned on April 1, 1936, the book value thereof on that date, and (ii) in the case of property additions, the amount at which previously certified to the Trustee for the purpose of the issue of additional Bonds under the Mortgage or of additional unfunded prior lien bonds under the mortgage securing such prior lien bonds or for the purpose of withdrawal of cash.

An "unfunded prior lien", (as is more fully defined in Article I of the Mortgage) is a prior lien not constituting a "funded prior lien", or a "permitted lien" or a judgment lien. The First Mortgage of X Company[1] is a permitted lien.

A "funded prior lien", (as is more fully defined in Article I of the Mortgage) comprises any prior lien with respect to which cash and prior lien bonds in an amount sufficient to retire all prior lien bonds secured by such prior lien have been deposited with the Trustee under the Mortgage or with the trustee or other holder of such prior lien; and bonds secured by such prior liens are regarded as having ceased to be "outstanding" as that term is used in the Mortgage and under this caption.

Release of property. The Company is permitted, as is more fully provided in the Mortgage, to obtain the release of property (other than prior lien bonds or of X Company bonds) (a) upon depositing an amount of cash, purchase money obligations or obligations of any municipality or other governmental subdivision which may be the purchaser, equivalent to the fair value of the property to be released (less the principal amount of any outstanding prior lien bonds, if all property of the company subject to the prior lien securing them is being released), which deposit shall be made with the Trustee (or with the trustee of any prior lien to which such property released may be subject, except when all the property subject to the prior lien is being released), and (b) upon filing a certificate of an engineer, who may be employed by or affiliated with the Company, stating the fair value of the property to be released and that the release is desirable in the proper conduct of the business, or is otherwise in the best interests of the Company, which certificate is to be supplemented as to the desirability of the release by an independent engineer's certificate if the fair value of the property to be released is over $500,000, and (c) upon filing certain other certificates and opinions as provided in the Mortgage with respect to the property to be released and obligations to be acquired. The Company is permitted, as is more fully provided in the Mortgage, to obtain the release of prior lien bonds, secured by a funded prior lien, or of bonds secured by the First Mortgage of X Company,[1] only if all property subject to such lien has been released from the lien of the Mortgage, upon deposit with the Trustee of an amount of cash equal to the principal amount of such bonds being released. All bonds held by the Trustee and secured by a funded prior lien or by the X Company mortgage shall, at the request of the Company, be surrendered for the purposes specified, if all indebtedness secured thereby is discharged. The Company may require prior lien bonds, secured by a funded prior lien, to be cancelled or to be surrendered for the purpose of any sinking fund or analogous fund, with respect to such prior lien bonds, and may require the tender of X Company bonds for purchase by the trustee under the mortgage securing such bonds out of the proceeds of property released from that mortgage, but any money received therefore are to be held by the Trustee as part of the trust estate. Except in the case of default, no payment by way of interest or principal or otherwise, upon funded prior lien bonds or upon such X Company bonds held by the Trustee, shall be required unless the Company so elects, in which event the Company is to receive the payments.

The Trustee is permitted to release any property taken by eminent domain or purchased by a municipality or other governmental subdivision, pursuant to right of pur-

[1] "X Company" refers throughout this opinion to a company the property of which had been acquired by the registrant. Bonds of X Company in a principal amount of $500,000 were secured by a first lien on such property. A principal amount of $231,000 of such bonds were pledged as security for the present issue.

chase, and the proceeds of such property shall be paid to the Trustee to be held as a part of the trust estate or to any trustee of a prior lien as their interests may appear.

The proceeds of released property deposited with the Trustee may be withdrawn:

(a) In an amount equal to the "net release value of the property additions" acquired on or subsequent to the date of the release application, but no cash deposited upon the release of property not subject to an unfunded prior lien may be withdrawn upon the basis of property additions subject to an unfunded prior lien,

(b) In an amount equal to ten-sevenths (10/7ths) of the amount of Bonds issued under the Mortgage and thereafter retired (except out of the trust estate) and surrendered to the Trustee, and not theretofore made the basis for the issue of additional Bonds,

(c) In an amount equal to three-sevenths (3/7ths) of the amount of Bonds theretofore redeemed out of moneys held in the trust estate other than out of moneys deposited upon the issue of additional Bonds, and

(d) In an amount equal to ten-sevenths (10/7ths) of the amount of any of the $2,000,000 of Bonds, referred to above under "Issuance of Additional Bonds", with respect to which the Company shall have surrendered its right to have Bonds issued.

Such proceeds may also be credited to the Company on account of any sinking fund payments in cash required to be made by the Company and for the purchase by the Trustee of Bonds for any sinking fund.

Any proceeds of insurance deposited with the Trustee may be withdrawn on the same basis outlined above under (a) and (b), and also upon the basis of replacements of the property lost or destroyed.

"Net release value of property additions" (as is more fully defined in Article I of the Mortgage) means the lesser of cost or fair value of gross property additions acquired on or subsequent to the date of the release application, loss or destruction of the property on account of which the cash withdrawn was deposited, less the amount of such cash theretofore withdrawn on the basis of such property additions, and, in case such property additions are subject to an unfunded prior lien, less ten-sevenths (10/7ths) of the principal amount of the outstanding prior lien bonds secured thereby.

Cash deposited upon the release of fixed property not of the nature of property additions may be withdrawn in an amount equal to the lesser of the cost or fair value of other fixed property not of the nature of property additions acquired on or subsequent to the date of the application for such release.

Cash deposited with the Trustee upon the issue of additional Bonds may be withdrawn:

(a) In an amount equal to seventy percent (70%) of the net bondable value of property additions not subject to any unfunded prior lien, or

(b) In an amount equal to the amount of Bonds retired (except out of the trust estate) and surrendered to the Trustee and not theretofore made the basis for the issue of additional Bonds.

Cash deposited against any prior lien bonds may be paid over to the trustee or other holder of the mortgage securing such prior lien bonds at maturity or upon redemption thereof, and cash deposited on account of any prior lien bonds or X Company bonds or any judgment lien may be paid over to the Company (a) whenever the instrument securing such bonds is released or the judgment lien shall have been discharged, upon receipt by the Trustee of the resolution, certificate and opinion provided in the Mortgage, and (b) in the case of cash deposited on account of prior lien bonds (plus any cash deposited on account of interest and premium on such prior lien bonds), to the extent that any such bonds shall have been paid, reduced, or ascertained by judicial determination to be invalid or additional prior lien bonds of the same issue are deposited with the Trustee, upon receipt by the Trustee of the resolution and certificate provided in the Mortgage.

The Trustee is required, upon request by the Company, to apply any moneys held by it (other than on account of prior lien bonds or judgment liens) to the purchase or redemption of Bonds outstanding under the Mortgage.

"Trust estate" means the property subject to the lien of the Mortgage, including cash deposited upon the issue of additional Bonds or upon the release of property or as the proceeds of insurance.

No notice to bondholders required. No notice to Bondholders is required in connection with any substitution or release of property under the terms of the Mortgage.

For the purposes of a prospectus, the foregoing is manifestly too meticulous. Reduction to a readable summary involves chiefly the omission of immaterial detail.

The basic principles of the indenture concerning release are relatively simple. A statement in clear terms of those principles is all that is requisite. The prospectus in question, however, goes beyond such essentials, in that it contains details which are of a mechanical nature or relate to property of minor importance.

For example, considerable space is devoted to the withdrawal of cash deposited under various circumstances. It may be assumed that cash will not ordinarily constitute, for any appreciable length of time, a significant part of the underlying security. There are, however, numerous provisions concerning the deposit and withdrawal of cash, which are to facilitate the administration of the mortgage. Thus, cash may be deposited upon the release of property and later withdrawn when additional property is acquired. Similarly, in case of refunding, cash may be deposited upon the issuance of additional bonds and later withdrawn upon the retirement of bonds previously outstanding. The basic principle applicable is that, upon the withdrawal of deposited cash, the same ratio between bonds and property shall exist as if there had been no such intermediate deposit. The details of the intermediate operations would seem immaterial; they tend to confuse rather than enlighten.

A further instance is the statement concerning prior lien bonds. At the time of the issue there were no prior lien bonds, as the term is used in the indenture. As is usual the mortgage provides that, on the basis of property additions, additional bonds may be issued or property released. If the property addition is subject to a prior lien, it is nevertheless to be treated as not so subject, provided prior lien bonds and cash are deposited equal to the full amount of the prior lien. Under the indenture, prior lien bonds are to become a part of the trust estate only in this manner, which assures the means of discharge of the lien. The release provisions concerning the prior lien bonds so made a part of the trust estate are merely to assure the discharge thus initially provided for. They are mechanics of operation, and, as such, should be sought in the indenture rather than in the prospectus.

An answer in the following form contains the essential provisions set forth in the above quotation and complies fully with the requirement of the Securities Act and the Rules and Regulations:

Property may be released from the lien of the mortgage in an amount equivalent to:

(a) Additions made to the Company's utility plant on or after the date of the application for release;

(b) Cash, purchase money obligations on released property, or obligations of governmental purchasers of such property, deposited upon such release;

(c) 10/7ths of any of the $2,000,000 of additional bonds which are issuable without property additions and as to which the right of issuance is surrendered.

The value of the released property is determined by an engineer who may be employed by or affiliated with the company.

For the above purposes, additions to the utility plant do not include transportation properties, nor do they include property subject to a prior lien unless provision is made for satisfaction of such lien or the released property was subject to a prior lien.

No notice to bondholders is required in connection with any substitution or release of property.

Detailed provisions more precisely defining the foregoing matters, and provisions concerning releases of an incidental nature, such as those concerning prior lien bonds, cash, and proceeds of insurance, are contained in Articles I, IV, VI, VII and VIII of the Mortgage.

[Securities Act Release No. 1580, October 19, 1937]

§ 231.1862 *Opinion of General Counsel relating to Rule 142 (17 CFR, 230.142).*

Rule 142 was adopted in recognition of the value of secondary capital in facilitating the flow of investment funds into industry, and of the fact that the owners of such secondary capital cannot practicably perform the duty of thorough investigation and analysis imposed by the act of the underwriter proper. The rule in no way limits the responsibility of the underwriter who actually serves as a conduit for the distribution of securities to the public, or of the underwriter who for a commission agrees with the issuer to purchase what the issuer is unable to sell to the public—thereby furnishing to the issuer the insurance without which the distribution would probably not be undertaken. The purpose of the rule is merely to make clear, what has admittedly been the subject of some debate in the past, that a person who does no more than agree with an underwriter to take over some or all of the undistributed portion of the issue, and who purchases for investment any securities which his commitment thus obliges him to take up, does not thereby subject himself to liability as an underwriter of the securities of the issue actually distributed to the public.

In considering the application of the rule to particular situations, it should be appreciated that it applies only to persons whose connection with a distribution is essentially non-distributive in character. Any person enjoying substantial relationships with the issuer or underwriter, or engaging in the performance of any substantial functions in the organization or management of the distribution, would be outside the scope of the rule. Basically, the rule is designed to cover the conditional purchaser who, in spite of the conditional nature of his contract, is primarily interested in securing a portion of the issue for investment, and finds his incentive not in a commission based on the size of the issue or other similar factors, but in the investment advantage afforded by a discount from the public offering price. Disproportionate commissions or service fees would raise a serious doubt whether the functions of the person concerned were in fact confined as prescribed in the rule, for such disproportionate commissions or fees would tend strongly to show that such person was primarily interested as an "underwriter" in the distribution.

Some question will undoubtedly be raised as to the meaning of the term "purchases * * * for investment", as used in the rule. The application of this term is of course to be ascertained in any given case by reference to the intention of the purchaser at the time of purchase. What his intention was at that time is a question of fact.

Although it is not impossible to conceive of a situation in which a person who had purchased securities for investment changed his mind in good faith on the next day, and proceeded to dispose of the securities, it

must nevertheless be remembered that a state of mind can ordinarily be ascertained only by weighing evidentiary factors, and that a person's actions may be of far greater evidentiary significance than his statements as throwing light on what his state of mind was at a given time. Thus, self-serving statements that a particular purchase was made for investment would carry very little weight in the face of more concrete facts and circumstances inconsistent with such an intention.

Most prominent among the relevant evidentiary factors would undoubtedly be the length of time elapsing between the acquisition of the securities and their proposed resale. Although retention of the securities for any given length of time would in no event be conclusive, it is obvious that the longer they were held the easier it would be to maintain that they had originally been purchased for investment; and it is my opinion that if they were retained for a period as long as a year that fact would be sufficient, if not contradicted by other evidence, to create a strong inference that they had been purchased for investment. However, such an inference would be rebuttable; for example, it would fail in the face of evidence of a pre-arranged scheme to effect a distribution at the end of the year.

Another factor which may be of considerable importance is the character of the regular business of the person who seeks to come within the rule. Thus, I have little doubt that insurance and investment companies not ordinarily engaged in the business of dealing in securities or underwriting distributions could quite readily sustain the burden of proof that they had purchased for investment. On the other hand, in the case of a securities dealer or an investment banking house, the nature of the business ordinarily carried on would create an extremely strong presumption of purchase for resale. It is perhaps possible that a person engaged in the investment banking business or in the securities business might, under some circumstances, come within the provisions of the rule; but in order to reach this result it would be necessary to establish by the clearest kind of evidence that the scope and character of the person's business were consistent with the purchase of large blocks of securities for investment rather than with a view to distribution.

[Securities Act Release No. 1862, December 14, 1938]

§ 231.1934 *Letter of General Counsel concerning the services of former employees of the Commission in connection with matters with which such employees became familiar during their course of employment with the Commission.*

I have your recent letter, in which you inquire whether you may properly make use of the advice and assistance of an attorney formerly employed by this Commission in a matter with which he became familiar while on the Commission's staff.

Before taking up the specific situation described in your letter, I should like to express my general opinion, that any use of the services of a former employee of the Commission in a matter with which he was connected during his employment by the Commission, even though such former employee does not himself appear before the Commission, or take any part in discussions with its staff, would constitute grounds to disqualify from practice before the Commission not only the former employee but also his employer. The Commission is fully conscious of the serious consequences which may be caused by any deviation on the part of former employees from the most rigid standards of professional ethics in matters of this character, and intends to deal vigorously with any such cases that come to its attention.

In your letter you direct my attention to the fact that the Commission recently issued a stop order under Section 8 (d) of the Securities Act of 1933, suspending the effectiveness of a registration statement filed under that Act by the X. Y. Corporation, for which you are counsel. The company desires to amend the registration statement in accordance with the stop order, and you have requested a conference with members of the Commission's staff for the purpose of discussing the form and substance of these amendments. In preparing for this conference, you desire to make use of the services of Mr. A. B., a former employee of this Commission, and now an associate of your law firm. Mr. A. B. himself will neither be present at the conference nor otherwise "practice before" the Commission, within the meaning of the Commission's Rules of Practice.

The Commission's files indicate that, when he was employed by the Commission, Mr. A. B. was assigned to the Registration Division and acted as attorney for the examining group which considered the registration statement of the X. Y. Corporation to which I have referred.

The question presented is the application of Rule II (e) of the Commission's amended Rules of Practice (17 CFR § 201.2 (e), which reads as follows:

(e) The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to, any person who is found by the Commission after hearing in the matter

(1) Not to possess the requisite qualifications to represent others; or

(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct.

At the time it announced the amended Rules of Practice the Commission made the following statement concerning practice by former employees of the Commission and the present employers of such former employees (Securities Act Release No. 1761):

"Under the amended Rules of Practice any former member of the staff of the Commission who shall appear in a representative capacity in any matter, including an investigation conducted by the Commission, which was pending before the Commission, during the period of his employment and with which matter he has, by virtue of his employment with the Commission, such familiarity as to be prejudicial to the proper conduct of the case, or in which matter he acted for the Commission in such a way as to make unethical his subsequent connection therewith, and any person employing the services of any such former member of the staff in such matters, without first obtaining the consent of the Commission, may be held to be lacking in proper professional conduct."

This statement of policy is based upon the principle enunciated in Canons 36 and 37 of the Canons of Professional Ethics of the American Bar Association.

Inasmuch as the registration statement of the X. Y. Corporation was pending before the Commission at the time Mr. A. B. was in the Commission's employ, your availing yourself of his services in this matter without having obtained the consent of the Commission would in my opinion justify the institution of disqualification proceedings, pursuant to Rule II (e) (2), against both Mr. A. B. and yourself.

Although you did not expressly request it, I have, in accordance with our practice, considered your letter as an application for consent to make use of Mr. A. B.'s services in this matter and have discussed the circumstances with the Commission. The Commission has instructed me to advise you that, in view of Mr. A. B.'s close connection with the registration statement of the X. Y. Corporation during his service with the Commission in a responsible position, consent to your using his services in this matter must be denied.

Permit me to thank you for so promptly calling this situation to our attention and to assure you that none of the statements I have made in this letter is intended as a personal reflection upon either Mr. A. B. or yourself.

[Securities Act Release No. 1934, April 5, 1939]

§ 231.2029 *Letter of General Counsel relating to sections 3 (a) (9) and 4 (1).*

You have requested an opinion as to the applicability of section 3 (a) (9) and the second clause of section 4 (1) of the Securities Act of 1933 in the following circumstances:

The subject company has an "open end" mortgage upon its properties, the only issue of bonds now outstanding thereunder being denoted as Series A bonds. It is proposed to create two new series of bonds under the mortgage, to be called Series B and Series C bonds respectively, for the purpose of refunding the outstanding bonds. The Series B and Series C bonds will differ substantially from each other in respect of maturity date, interest rate, redemption prices and default provisions.

The Series B bonds will be offered in exchange to the holders of the outstanding Series A bonds on the basis of an equal principal amount of Series B bonds for those of Series A, with interest adjustment. No commission or other remuneration will be paid or given, directly or indirectly, for soliciting such exchange.

The necessary funds to redeem any unexchanged Series A bonds will be raised by the sale for cash of Series C bonds. The Series C bonds will be offered and sold to not more than twelve insurance companies, which will agree to purchase for investment and without a view to distribution.

If the proposed exchange offer and the proposed cash offer were isolated transactions, it would be clear that no registration under the Securities Act would be required. The Series B bonds would be exempted as securities "exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange;" and the offering and sale of the Series C bonds would be exempted by the second clause of section 4 (1), as "transactions by an issuer not involving any public offering." The interdependence of the two offerings, however, requires a more comprehensive analysis of the Act.

Section 3 (a) (9) contains no language expressly limiting the exemption to securities forming part of an issue the whole of which is sold as specified in the exempting provision. At first reading, therefore, section 3 (a) (9) appears to confer exemption upon any security exchanged with the issuer's existing security holders, even though other securities of the same class, as a part of the same plan of financing, are sold to others than existing security holders, or to existing security holders otherwise than by way of exchange. Such a construction, however, gives insufficient weight to the use of the word "exclusively," as employed both in section 3 (a) (9) and in its predecessor, former section 4 (3). In neither section is the grammatical function of the word entirely clear; but in order to avoid an interpretation which would reject the word as pure surplusage, it is necessary to adopt the view that the exemption is available only to securities constituting part of an issue which, as a whole, is exchanged in conformity with the requirements of the section.

This conclusion appears to be supported by the legislative history of section 3 (a) (9). At the time of the amendment of the Securities Act of 1933 by Title II of the Securities Exchange Act of 1934, the new section 3 (a) (9) proposed in H. R. 9323 as a substitute for the first clause of Section 4 (3), provided an exemption from registration for

"any security issued by a person where the issue of which it is a part is exchanged by it with its own security holders exclusively." The proposed amendment was altered in conference so as to eliminate any reference to the "issue" of which a security is a part; but it appears from the Statement of the Managers on the Part of the House in the Conference Report that the changes in the proposed section 3 (a) (9) made in conference were "intended only to clarify its meaning" (H. R. (Conf.) Rep. No. 1838, 73rd Cong., 2nd Sess., p. 40).

Interpretation of the so-called "private offering" exemption provided by the second clause of section 4 (1) presents similar considerations. You will note that the clause in question does not exempt every transaction which is not itself a public offering, but only transactions "not involving any public offering." Accordingly, I am of the opinion that the exemption is not available to securities privately offered if any other securities comprised within the same issue are made the subject of a public offering.

It appears, therefore, that both with respect to section 3 (a) (9) and with respect to section 4 (1) the necessity of registering the Series B and Series C bonds depends upon whether they should be deemed separate issues or merely parts of a single issue: I believe it unnecessary at this time to enter into any extended discussion of what constitutes an "issue" for the purposes of the Act. The opinion of the Commission in In the Matter of Unity Gold Corporation (Securities Act Release No. 1776) discusses this question as it arises under section 3 (b) of the Act. The point is also touched upon, at least inferentially, in the discussion of section 3 (a) (11) contained in Securities Act Release No. 1459. Whatever may be the precise limits of the concept of "issue" when all securities involved are of the same class, I do not believe that securities of different classes can fairly be deemed parts of a single "issue." Since on the facts submitted the Series B and Series C bonds appear to be securities of different classes, they constitute separate "issues," and may be offered and sold in the manner above described without being registered under the Securities Act.

In expressing this opinion I do not mean to imply that any difference in the incidents of two blocks of securities, however trivial, renders the blocks separate classes and consequently separate "issues" for the purposes of the Act. In this case, however, the differences between the Series B and Series C bonds are, I believe, sufficiently substantial to warrant treating them as separate classes even though they will be issued under the same mortgage indenture.

[Securities Act Release No. 2029, August 8, 1939]

§ 231.2340 *Statement of Commission policy with respect to the acceleration of the effective date of a registration statement.*

The Congress having amended Section 8 (a) of the Securities Act of 1933 to confer upon the Commission discretion to accelerate the effective date of registration statements filed under the Securities Act of 1933, the Commission declares that, pursuant to such discretionary authority, it will be the general policy of the Commission to accelerate the effective date of registration statements filed under the Securities Act of 1933 in accordance with the following procedure:

In determining the date on which a registration statement shall become effective, the Commission will consider, having due regard to the public interest and the protection of investors,

(a) The adequacy of the disclosure and compliance with the requirements of the Act, and compliance with the applicable form and instruction book and rules pertaining thereto at the time the registration statement is initially filed:

(b) The advisability of permitting the acceleration of material amendments filed after the initial filing date; and

(c) The character and date of information previously or concurrently filed under any Act Administered by the Securities and Exchange Commission or by any other Federal Agency or which is generally available to the public.

It is expected that examination by the Commission of registration statements and amendments (if any) which have been prepared with due regard to the matters set forth in (a) above, will ordinarily be completed within a few days after the filing date, so that as soon as an appropriate amendment correcting the deficiencies, if any, and an amendment setting forth the price, if the price and terms of offering were not set forth in the statement as initially filed, (or matters relating to price such as redemption or sinking fund, call prices, conversion prices or such other matters relative to price or terms of offering as the Commission may by rules and regulations determine) are filed, the Commission will, subject to the above statement of policy and the requirements of the Act, consent to the filing of the amendments and declare the statement effective as soon as practicable.

The requirements of the Trust Indenture Act of 1939 have materially increased the examination work of the Registration Division of the Commission with respect to registration statements of securities to be issued under indentures which must be qualified under that Act. It will further the effectuation of the above policy if drafts of such indentures are submitted in reasonably final form for consideration and discussion with the staff as far as possible in advance of the actual filing of the registration statement.

The Registration Division of the Commission has, in the past, made its services available to proposed issuers of securities and their counsel and accountants in order to give them advice with respect to questions which might arise in connection with the preparation of registration statements. The Commission will continue this service insofar as possible and will endeavor to assist proposed registrants, in advance of filing, in the solution of specific technical questions which may arise.

It will be the Commission's policy to cooperate with registrants in order that the effectiveness of registration statements filed under the Securities Act may be expedited as much as possible consistent with the public interest and the protection of investors.

For additional guidance, consultation with the Commission at or before the time of filing may enable the Commission, whenever possible, to indicate the approximate date on which registration may become effective.

[Securities Act Release No. 2340, August 23, 1940]

§ 231.2623 *Opinion of General Counsel concerning the application of the third clause of section 4 (1) in various situations.*

I have been asked to express my opinion as to the circumstances under which brokers and dealers must use prospectuses in connection with trading in the securities of American Telephone and Telegraph Company covered by the registration statement which became effective under the Securities Act on July 15, 1941.

In order to make my discussion more clearly understandable in its application to the various concrete situations which may arise, I shall first describe briefly the nature of the offering in question. The registration statement covered $233,584,900 in principal amount of debentures of the Company, proposed to be offered by the Company pro rata to its existing stockholders, without the intermediation of any underwriters. The statement covered also full and fractional warrants which the Company proposed to deliver to its stockholders in evidence of their right to purchase debentures from the Company. These warrants were to be issued to all stockholders of record at the close of business on July 25, 1941, and the registration statement specified that the warrants would actually be issued to stockholders on or about August 4, 1941. The warrants by their terms were required to be exercised on or before August 29, 1941. Pursuant to an order of the Commission entered on July 11, 1941, the registration statement became effective at 4:45 P. M., E. S. T., on July 15, 1941. So far as practicable, prospectuses were made generally available by the Company on July 16, 1941.

Before discussing the legal requirements which have been applicable since the registration statement became effective, I should like to point out that until the statement became effective it was illegal for any broker or dealer to use the mails or instrumentalities of interstate commerce to offer or sell either the debentures or the warrants on a when-issued basis. This was clearly stated in a release published by the Commission on July 9, 1941 (Securities Act Release No. 2613). Apparently, it was not sufficiently understood that the prohibition of the statute extended not only to offers and sales for immediate execution, but also to solicitations of orders which were not to be given and executed until after the effective date of the statement. Thus, a circular distributed by a broker or dealer to his customers, describing the debentures and the rights and suggesting that he would be glad to receive and execute orders after the statement became effective, was no less a violation of the statute than a circular inviting the immediate submission of orders before the effective date. The same would be true even if the circular carried a "hedge clause" specifically disclaiming any intent to solicit orders. If the circular in fact constituted a solicitation of orders it could not be brought within the law by mere formal disclaimers.

Now that the statement has become effective, there is no prohibition against offering rights or debentures, or soliciting orders to buy them, whether on a when-issued or an issued basis. However, the Act requires that if any prospectus relating to a registered security is transmitted through the mails or in interstate commerce, that prospectus must be in the form of, or accompanied or preceded by, the formal prospectus filed by the issuer with its registration statement. (For convenience, I shall call this prospectus a "formal prospectus." In the Act it is referred to as a "prospectus that meets the requirements of section 10.") Furthermore, even if in a particular sale no use is made of the mails or interstate commerce to offer the security, or to solicit orders to buy it, the security itself must still be accompanied or preceded by the formal prospectus when the security is delivered through the mails or in interstate commerce.

In applying these principles to particular situations, brokers and dealers should appreciate that the term "prospectus" as used in the Securities Act covers more than the kind of formal document which the layman ordinarily has in mind when he uses the term. Under the Act a "prospectus" includes every kind of written communication which attempts or offers to dispose of, or solicits an offer to buy, a security for value, or which constitutes a contract of sale or disposition of a security for value. If the term "prospectus" is construed in accordance with its language and spirit, it must in my opinion be read to cover any document which is designed to procure orders for a security, or to effectuate the disposition of a security, whether or not the document purports on its face to offer the security for sale, or otherwise to dispose of it for value.

In the light of these general principles let me discuss concrete examples which will illustrate in greater detail the application of the prospectus requirements of the Act to transactions occurring after the effective date of the registration statement.

Question 1.—John Doe, a dealer, writes a letter to Richard Roe, one of his customers, offering him warrants, on a when-issued basis, for ten $100 debentures. Must John Doe send a copy of the formal prospectus with his letter?

Answer.—Yes. John Doe's letter itself falls within the broad definition of "prospectus" in the Act. As such, it must, in order to comply with the Act, either be in the form of the formal prospectus—which it obviously is not—or else be preceded or accompanied by a formal prospectus.

Question 2.—Instead of writing a letter to Richard Roe, John Doe calls him on the telephone and offers him the warrants. Richard Roe accepts; and John Doe thereupon mails him a confirmation of the sale. Must John Doe send a copy of the formal prospectus with his confirmation?

Answer.—Yes. The term "prospectus" is defined in the Act broadly enough to include within its meaning an ordinary confirmation; and since the confirmation is not itself a formal prospectus, it, like the offering letter in Question 1, must be accompanied or preceded by a formal prospectus.

Question 3. John Doe happens to know that his customer, Richard Roe, is already a stockholder of American Telephone and Telegraph Company, and has therefore already received a prospectus from the Company itself. Must John Doe still, in the situation described in Questions 1 and 2, send Richard Roe a formal prospectus?

Answer. Yes. In requiring that a letter offering registered securities, or a confirmation, must be accompanied or preceded by a formal prospectus, the Act requires further that this formal prospectus shall have been sent or given—not by *anyone*, but by the person who sent the letter or confirmation, or by his principal. John Doe is not acting for American Telephone and Telegraph Company. Consequently, the fact that Richard Roe has received a prospectus from American Telephone and Telegraph Company does not affect the responsibility that John Doe has to comply with the prospectus requirements.

Question 4. On August 5, 1941, John Doe telephones Richard Roe, his customer, and states that he has warrants for ten $100 debentures, and will be glad to sell them to Richard Roe. Richard Roe accepts the offer. John Doe thereupon immediately puts the warrants in an envelope, and mails them to Richard Roe. Must John Doe enclose also a copy of the formal prospectus?

Answer. Yes. The Act requires that registered securities, when delivered through the mails or in interstate commerce, shall be preceded or accompanied by a formal prospectus; and since John Doe made an oral offer, without sending a formal prospectus, he must send one with the warrants.

Question 5. In the course of the conversation described in Question 4, Richard Roe mentions that he is already a stockholder of American Telephone and Telegraph Company, and so has received a copy of the prospectus. Must John Doe nevertheless send him another copy?

Answer. No. In requiring that securities, when delivered, be accompanied or preceded by a prospectus, the Act does not require that the prospectus shall have been sent or given by the person making the delivery. It is enough that the purchaser shall already have received a prospectus from some source. (Owing to the particular wording of the Act, this situation must be carefully distinguished from the case in Question 3.)

Question 6. John Doe, a broker, receives an unsolicited telephone call from Richard Roe, asking him to purchase for Richard Roe's account warrants for ten $100 debentures. John Doe does so, and sends them to Richard Roe by mail. Must he send a copy of the prospectus with the warrants?

Answer. No. The prospectus requirements of the Act do not apply to unsolicited brokers' transactions, whether executed on an exchange or over the counter.

Question 7. Richard Roe telephones John Doe, his broker, and states that he has certain warrants which he would like John Doe to sell for his account. John Doe does so, and sends him a confirmation of the transaction. Must John Doe at the same time send him a copy of the prospectus?

Answer. No. In confirming a sell order on a brokerage basis, John Doe is not within the prospectus requirements of the Act.

Question 8. Pursuant to the sell order received in Question 7, John Doe sells Richard Roe's warrants to Henry Hoe, another dealer, who purchases for his own account. Must John Doe, in confirming the sale to Henry Hoe, or in delivering the warrants to him, send him a copy of the prospectus?

Answer. No. John Doe, in making the sale, is completing the execution of an unsolicited brokerage order, and therefore is exempt from the prospectus requirements.

Question 9. John Doe writes to his customer Richard Roe, whom he knows to be a stockholder of American Telephone and Telegraph Company and offers to sell for him the warrants he has received. Must John Doe send Richard Roe a formal prospectus with his letter?

Answer. No, since he is offering to sell *for* him, not *to* him.

Question 10. As a result of the letter described in Question 9, Richard Roe gives John Doe a sell order, and John Doe sells the rights to Henry Hoe. When he mails the warrants to Henry Hoe, must he send a copy of the prospectus with them?

Answer. Yes. The transaction, although on a brokerage basis, results from a solicitation, and consequently the prospectus requirements are applicable to John Doe's sale to Henry Hoe.

Question 11. John Doe writes a letter to Richard Roe, his customer, offering to purchase rights for his account. Must John Doe enclose in his letter a copy of the prospectus?

Answer. Yes. Even though John Doe acts as broker in the transaction, he is soliciting an offer to buy, and is therefore subject to the prospectus requirements of the Act.

In an effort to be of the greatest assistance to brokers and dealers in the practical conduct of their business, I have endeavored to state the foregoing illustrative questions and answers in as non-technical a fashion as possible. Anyone desiring more detailed information as to the statutory basis for the answers I have given, or wishing information as to any situations which I have not covered, is welcome to address a further inquiry to this office.

[Securities Act Release No. 2623, July 25, 1941]

§ 231.2899 *Extract from letter of Director of the Corporation Finance Division to sections 20 and 34 (b).* This release is the same as Investment Company Act Release No. 446. (17 CFR, 271.446) [Securities Act Release No. 2899, February 5, 1943]

§ 231.2955 *Opinion of the Director of the Trading and Exchange Division relating to the violation of the anti-fraud provisions of the Securities Act by manipulation of prices of securities not registered on a national securities exchange.* This release is the same as Securities Exchange Act Release No. 3505. (17 CFR, 241.3505) [Securities Act Release No. 2955, November 16, 1943]

§ 231.2956 *Opinion of the Director of the Trading and Exchange Division relating to the violation of the anti-fraud provisions of the Securities Act in cases of a "syndicate account" while members of the syndicate or selling group are engaged in the retail distribution of such security.* This release is the same as Securities Exchange Act Release No. 3506. (17 CFR, 241.3506) [Securities Act Release No. 2956, November 11, 1943]

§ 231.2997 *Statement of the Commission relating to the anti-fraud provisions of section 17 (a) of the Securities Act of 1933 and sections 10 (b) and 15 (c) (1) of the Securities Exchange Act of 1934.* This is the same as Securities Exchange Act Release 3572. (17 CFR, 241.3572) [Securities Act Release No. 2997, June 1, 1944]

§ 231.3000 *Opinion of the Chief Counsel to the Corporation Finance Division relating to section 3 (a) (10):*

You have requested my opinion as to the legality of trading on a when-issued basis in the new common stock proposed to be issued by The Laclede Gas Light Company under a voluntary plan approved by the Commission on May 27, 1944, pursuant to section 11 (e) of the Public Utility Holding Company Act of 1935 (Holding Company Act Release No. 5071). You have inquired specifically whether the Commission's order approving the plan resulted in exempting such trading from the registration and prospectus provisions of the Securities Act of 1933 by virtue of section 3 (a) (10) of that Act.

I shall speak only of when-issued trading over the counter, because when-issued trading on a national securities exchange is subject to the Commission's Regulation X-12D3 under the Securities Exchange Act of 1934. Under that Act and Regulation registration of a security for when-issued trading on an exchange is subject to various conditions in addition to compliance with the Securities Act of 1933.

It is my opinion that the exemption afforded by section 3 (a) (10) of the Securities Act of 1933 will not be available for any when-issued sales or offers to sell until the date the plan is enforced by the appropriate United States District Court pursuant to section 11 (e) of the Public Utility Holding Company Act of 1935.

Section 5 of the Securities Act of 1933 provides in substance that no person shall sell or offer to sell any security through the mails or in interstate commerce unless a registration statement as to that security is in effect with this Commission and a specified form of prospectus is used. Section 3 (a) (10) of the Securities Act of 1933 exempts from the provisions of Section 5:

"Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval."

In my opinion the terms and conditions of the issuance and exchange of a security are not "approved" within the meaning of section 3 (a) (10) until completion of the total process of approval required in the particular case. The Commission's order approving the Laclede plan specifically provided "That this order shall not be operative to authorize the consummation of transactions proposed in the plan as amended until an appropriate federal district court shall, upon application thereto, enter an order enforcing such plan." In view of this provision, it cannot be said that the terms and conditions of the issuance and exchange of the new Laclede common have as yet been "approved" within the meaning of section 3 (a) (10) of the

Securities Act of 1933. Such approval will not occur until the date of entry of a District Court order enforcing the plan.

Consequently, any dealer who makes use of the mails or any means of interstate commerce to sell or offer to sell new Laclede common "when issued" prior to court enforcement of the plan will violate Section 5 of the Securities Act of 1933. This applies also to any broker who, as a result of the solicitation of a customer's order, sells or offers to sell "when issued" on an agency basis.

I might add that in my opinion the taking of an appeal to the Circuit Court of Appeals from the order of the District Court enforcing the plan, or the institution of further review proceedings in the Supreme Court of the United States, would not render unavailable the exemption under section 3 (a) (10) of the Securities Act, and hence would not affect the legality of when-issued trading, unless the order of the lower court were stayed pending the appeal.

[Securities Act Release No. 3000, June 7, 1944]

§ 231.3011 *Opinion of the Chief Counsel to the Corporation Finance Division relating to section 3 (a) (10).*

You have requested my opinion as to the legality of trading on a when-issued basis in the new debentures and common stock contemplated by the plan of reorganization of * * * and * * * approved by the United States District Court for the Southern District of New York on August 26, 1944, pursuant to section 174 of Chapter X of the Bankruptcy Act. It is my understanding that the plan has not yet been finally confirmed by the court pursuant to Section 221 of Chapter X. Before a confirmation order can be entered, it will, of course, be necessary for the plan to be accepted in writing by two-thirds of each class of creditors of each corporation participating in the plan.

I shall speak only of when-issued trading over the counter, because when-issued trading on a national securities exchange is subject to the Commission's Regulation X-12D3 under the Securities Exchange Act of 1934. Under that Act and Regulation registration of a security for when-issued trading on an exchange is subject to various conditions in addition to compliance with the Securities Act of 1933 and, in the case of a debt security, the Trust Indenture Act of 1939.

It is my opinion that any sales or offers of sale of the new debentures or common stock made through the mails or in interstate commerce prior to final confirmation of a plan under section 221 of Chapter X would violate the registration and prospectus provisions of Section 5 of the Securities Act of 1933. It is my opinion further that any sales or offers of sale of the new debentures made through the mails or in interstate commerce prior to qualification of an indenture with this Commission would violate the provisions of Section 306 of the Trust Indenture Act of 1939.

Section 5 of the Securities Act of 1933 provides in substance that no person shall sell or offer to sell any security through the mails or in interstate commerce unless a registration statement as to that security is in effect with this Commission and a specified form of prospectus is used. Section 306 of the Indenture Act of 1939 provides in substance that no person shall sell or offer to sell any bond or debenture or other debt security through the mails or in interstate commerce unless that security has been or is to be issued under a specified form of indenture which has been effectively qualified with this Commission.

Section 264 of Chapter X of the Bankruptcy Act exempts from the registration and prospectus provisions of Section 5 of the Securities Act of 1933 "any transaction in any security issued pursuant to a plan in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property * * *." Section 3 (a) (10) of the Securities Act of 1933 exempts from the registration and prospectus provisions of Section 5 of that Act,

"Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval."

Neither of these exemptions applies to the provisions of Section 306 of the Trust Indenture Act of 1939 requiring the qualification of an indenture in respect of any debt security.

So far as the new common stock contemplated by the plan is concerned, it is my opinion that there will be no exemption under either Section 264 of Chapter X of the Bankruptcy Act or section 3 (a) (10) of the Securities Act of 1933 until final confirmation of a plan pursuant to Section 221 of Chapter X. It seems clear that no security can be issued "pursuant to a plan," as required by Section 264, prior to its confirmation under Section 221. It seems clear also that the terms and conditions of the issuance and exchange of the new common stock cannot be said to have been "approved," as required by section 3 (a) (10), until entry of an order of confirmation by the court. As I have stated in an earlier opinion (Securities Act Release No. 3000), in which I considered the similar problem of the applicability of section 3 (a) (10) to a plan approved by this Commission pursuant to section 11 (e) of the Public Utility Holding Company Act of 1935 but not yet approved or enforced by a District Court, it is my opinion that the approval contemplated by section 3 (a) (10) is the total process of approval which is required by the particular statute relied upon to grant an exemption under that section. In the case of a reorganization under Chapter X of the Bankruptcy Act, the total process of approval required for the issuance of any security pursuant to a plan is final confirmation by the court under section 221. Neither approval of a plan by the court under Section 174 nor preliminary approval of a plan by this Commission under section 11 (f) of the Public Utility Holding Company Act of 1935 where a public utility holding company is involved, as in the present case, completes the total process of approval required.

What I have said thus far applies to the new debentures as well as the new stock. In addition, since the new debentures are subject to the Trust Indenture Act of 1939 as well as the Securities Act of 1933, and since neither the exemption in section 264 of Chapter X nor the exemption in section 3 (a) (10) of the Securities Act of 1933 applies to the Trust Indenture Act of 1939, a trust indenture for the new debentures will have to be effectively qualified with this Commission before there can be any when-issued trading in the new debentures.

Consequently, any dealer who makes use of the mails or any means of interstate commerce to sell or offer to sell new debentures or common stock on a when-issued basis prior to confirmation of a plan by the court will violate section 5 of the Securities Act of 1933 and section 306 of the Trust Indenture Act of 1939, and any dealer who makes use of the mails or any means of interstate commerce to sell or offer to sell new debentures on a when-issued basis prior to qualification of an indenture will violate section 306 of the Trust Indenture Act of 1939. This applies also to any broker who, as a result of a solicitation of a customer's order, sells or offers to sell "when issued" on an agency basis.

I might add that in my opinion the taking of an appeal from an ultimate District Court order of confirmation would have no effect upon any of the opinions here expressed unless the order of the lower court were stayed pending the appeal.

[Securities Act Release No. 3011, August 28, 1944]

§ 231.3038 *Statement by Commission relating to section 3 (a) (10).*

Although the court's confirmation of the plan exempts both bonds and stock from registration under the Securities Act of 1933, the bonds are not exempt from the necessity of qualifying an indenture under the Trust Indenture Act of 1939. No application for qualification of the indenture for these bonds has as yet been filed with the Commission.

For the reasons stated in Securities Act Release No. 3011 (August 28, 1944), it is the view of the Commission that when-issued trading in these bonds cannot legally be undertaken until an application for qualification of the indenture has become effective under the Act. Moreover, written offers of bonds will be legal thereafter only if made by or accompanied or preceded by a written statement containing an analysis of certain of the indenture provisions as required by section 305 (c) of the Trust Indenture Act.

Sales made in violation of the Trust Indenture Act will subject brokers or dealers to injunctive proceedings, criminal prosecution and other penalties imposed by law.

[Securities Act Release No. 3038, January 4, 1945]

§ 231.3043 *Opinion of Director of Trading and Exchange Division, relating to Section 206 of the Investment Advisers Act of 1940, section 17 (a) of the Securities Act of 1933, sections 10 (b) and 15 (c) (1) of the Securities Exchange Act of 1934.* This release is the same as Investment Advisers Act Release No. 40 (17 CFR § 276.40). [Securities Act Release No. 3043, February 5, 1945]

§ 231.3055 *Statement of Commission policy as to acceleration of the effective date of a registration statement where a selling stockholder does not bear his equitable proportion of the expense of registration.*

Section 8 (a) of the Securities Act of 1933 provides that "the effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the Commission may determine, having due regard to * * * the public interest and the protection of investors." In passing upon request for acceleration of the effective date of statements covering securities to be distributed for the account of selling stockholders, the Commission considers that the statutory standard is not met in cases where the selling stockholder does not bear his equitable proportion of the expense of registration, and for that reason will not order acceleration in such cases.

[Securities Act Release No. 3055, April 7, 1945]

§ 231.3061 *Statement of Commission policy as to the acceleration of the effective date of a registration statement in cases where an inadequate "red-herring" prospectus has been issued.*

Section 8 (a) of the Securities Act of 1933 provides that the "effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the Commission may determine, having due regard to the adequacy of the information respecting the issuer theretofore avail-

able to the public * * * and to the public interest and the protection of investors." In considering a request for acceleration of the effective date of a registration statement in a case where a "red herring" prospectus which was inaccurate or inadequate in material respects has been circulated the Commission considers that the statutory standards of this section have not been met. Accordingly the Commission will not order acceleration in such a case until it has received satisfactory assurances that by appropriate means the nature of the material amendments to the registration statement have been communicated to those persons to whom the "red herring" prospectus was distributed.

[Securities Act Release No. 3061, April 30, 1945]

§ 231.3115 *Statement by Commission with respect to representations that the Commission has approved the price of a security offered to the public under a registration statement.*

NOTE: Inasmuch as the name of the corporation is not deemed material at this time, it has been deleted from the statement.

The Commission's attention has been directed to the issuance of a press dispatch which states that the Commission had approved the price of $20.25 per share for the common stock of ——— ——— offered to the public on January 23 under an effective registration statement.

The Commission is not empowered under the Securities Act of 1933 either to approve or disapprove the price at which any security is publicly offered. Consequently the statement referred to is inaccurate. Moreover, the Commission under this Act does not have the power to pass upon the merits of any issue of securities.

It is unlawful under the Securities Act to make any representation that the Commission has in any way passed upon the merits of, or given approval to, securities registered with it. The primary object of that Act is to protect investors by requiring full and accurate disclosure of all material facts concerning securities publicly offered for sale.

[Securities Act Release No. 3115, January 24, 1946]

§ 231.3899 *Letter of the Director of the Corporation Finance Division relating to sections 14 and 18.* This release is the same as Securities Exchange Act Release No. 3380. (17 CFR, 341.3380) [Securities Act Release No. 3899, February 2, 1943]

PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER [1]

Sec.

[1] The interpretative opinions included herein are opinions issued in the past for the guidance of the public by members of the Commission's staff (or in a few instances by the Commission) and heretofore made public pursuant to Commission authorization. The opinions are to be read as of the date of original publication and in the context of the rules, statutes and circumstances then existing. However, opinions or portions of opinions which are clearly obsolete have been omitted. While it is not clear that publication of interpretative opinions of this kind in the FEDERAL REGISTER is required, it is believed that such publication may be helpful to the public and that it falls within the spirit of the Administrative Procedure Act.

Where rules referring to an opinion have been renumbered since the issuance of the opinion, the new designations are indicated in brackets.

§ 241.21 *Excerpt from letter relating to Section 16 (a).*

With regard to the monthly reports provided for in Section 16 (a), no reports are to be made except when there has been a change in ownership during a month subsequent to October, 1934. Every change of ownership must be reported even if, as a result of balancing purchases and sales, there has been no net change in holdings over the month. These reports of changes are to be filed on Form 4 directly by officers and directors and by any person who, at any time during such month, has been directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security (other than an exempted security) registered upon a national securities exchange, even though no such stock is held at the end of the month.

In addition to the monthly reports above discussed, a report must be made following the registration of a security, if such registration is not a temporary registration of a security already listed. In the case of securities temporarily registered, directors, officers, and principal security holders need make no report at the time of registration.

A third type of report required under section 16 is called for in the case where a person becomes a director, officer, or holder of more than 10% of an equity security on or after November 1, 1934, (or at any time on or after October 1, 1934, if the registration is not the temporary registration of a security already listed). In this third type of case, a report must be filed on Form 6, unless, by virtue of being already a member of the class of persons required to make reports with respect to the same security, the holder files a statement on Form 4 for the same month. * * *

The word "person" in the foregoing paragraphs should be construed to cover any individual or corporation, including any holding company, holding stock of the registered company.

If the company where stock is registered has a class of equity stock which is not listed or registered, officers and directors must report any changes of their holdings in the unregistered stock just as they would report such changes in the registered stock.

A person who is not an officer or director of a listed company need not report his holdings and transactions in any unregistered equity security unless he is the holder of more than 10 percent of a registered equity security (other than an exempted security), in which case his holdings and transactions in all of the equity securities of the listed company in which he is a principal stockholder are to be reported. If, however, such stockholder holds more than 10 percent in the unregistered equity security of a listed company and less than 10 percentum in the listed and registered security, no report is necessary.

All of these reports should be made by the director, officer, or stockholder and not by the corporation. They are to be made directly to the exchange and to the Commission.

Note that the definition of "equity security" contained in the Act is broader than that which is ordinarily attributed to the term. It means any stock or similar security, whether preferred or otherwise, or any security, even though it might be a first mortgage bond, which is convertible into an equity security, or which carries any warrant or right to subscribe to or purchase an equity security. It also includes any warrant or right which is detached from other securities, but which conveys the right to subscribe to or purchase an equity security. The Commission may make rules covering other securities which will define them as "equity securities."

To avoid confusion, it should be noted that, although the Act provides that, in applications for registration other than temporary registration of securities already listed the corporations should report each security holder of record holding more than 10 percent of any class of any equity security of the issuer (other than an exempted security); nevertheless the obligation to make individual reports by large stockholders, as distinguished from officers and directors, depends upon the beneficial ownership, directly or indirectly, of such equity stock, and not upon the matter of record.

If any equity security is listed upon more than one exchange, a separate report should be filed with each exchange and a duplicate original of each such separate report with the Commission.

[Securities Exchange Act Release No. 21, October 1, 1934]

§ 241.63 *Statement by Commission to correct the erroneous impression created by certain commercial institutions with respect to the necessity for filing reports with the Commission.*

Where no securities of a corporation are listed or admitted to unlisted trading privileges on any national securities exchange, such a corporation is under no duty to file reports under Section 12 or 13 of the Securities Exchange Act, nor is such a corporation subject to the requirements of Section 14 as to the solicitation of proxies for the voting of its stock. Furthermore, Section 16 does not require reports from such a corporation or from its officers, directors or stockholders as to holdings of or transactions in its stock. Although Section 15 of the Act authorizes the Commission to require registration of securities sold on over-the-counter markets, no such requirements have as yet been promulgated.

[Securities Exchange Act Release No. 68, July 22, 1934]

§ 241.116 *Letter of General Counsel relating to section 16 (a).*

One who is already a director or officer of a company having a class of equity securities registered as listed securities, and who is appointed or elected to the same or a different position, either as officer or director of the same company does not, in my opinion, at the time of such election or appointment, "become" a director or officer within the meaning of section 16 (a) of the Securities Exchange Act and Rule X-16A-1 (17 CFR 240.16a-1)[1] [formerly designated Rule NA1]. Accordingly, it is not necessary for such a director or officer to file a statement on Form 6 by reason of such election or appointment. Of course, this has no bearing on his duty to file Form 4 in case of a change of ownership, or Form 5 at the time of permanent registration, as specified in Rule X-16A-1 (17 CFR, 240.16a-1)[1] [formerly designated Rule NA1].

The Commission also made public the substance of another opinion rendered by its General Counsel, regarding the time at which changes in ownership are considered to occur for the purpose of reports required of directors, officers and principal stockholders under section 16 (a) of the Securities Exchange Act.

In my opinion an officer, director or stockholder is to be deemed to have acquired beneficial ownership of a security at the time when he takes a firm commitment for the purchase thereof, and to divest himself of such beneficial ownership at the time when he takes a firm commitment for the sale thereof. If it is necessary that certain conditions be satisfied prior to the consummation of the purchase or sale, and if it is uncertain whether such conditions will be satisfied, then it would appear that the officer, director or stockholder would not acquire beneficial ownership, or divest himself thereof, until such time as such conditions are satisfied and the undertaking to purchase or sell becomes a firm commitment.

[Securities Exchange Act Release No. 116, March 9, 1935]

§ 241.175 *Opinion of General Counsel relating to section 16 (a).*

There has been presented the question of whether a husband is the beneficial owner of securities held by his wife. The problem is significant in deciding whether such securities should be included by officers and directors in their reports under section 16 and by other persons in computing their ownership for purposes of deciding whether they are the beneficial owners of more than 10% of any class listed and registered equity security.

The mere fact that a wife, as a bookkeeping matter, keeps the securities in her separate estate is not conclusive in determining whether her husband is the beneficial owner of the securities so held, within the meaning of section 16 (a) of the Securities Exchange Act. Whether or not the husband is the beneficial owner of such securities depends upon whether by reason of any contract, understanding, relationship, agreement or other arrangement he has benefits substantially equivalent to those of ownership. The husband would also appear to be the beneficial owner of the securities held by his wife if he has the power to vest or revest in himself the full legal and equitable title at once, or at some future time, without payment of other than a nominal consideration. If the husband has no such benefits or powers, he would not appear to be the beneficial owner of the securities so held.

If securities are held by other members of the family, the same test seems to me appropriate. Attention is called to the fact that although a report includes the holdings of other members of the family of the person filing the report, he may avail himself of the privilege granted by Rule X-16A-3 (d)[1] [formerly designated Rule NA3 (d) (17 CFR, 240.16a-3)] and disclaim that such report is an admission that he is the owner of the securities held in the name of such other members.

[Securities Exchange Act Release No. 175, April 16, 1935]

§ 241.227 *Excerpt from a general letter relating to section 16 (a).*

The application for registration of certain equity securities of the _____ having become effective, it is required that a report be filed on Form 5 separately by each officer, director, and direct or indirect beneficial owner of more than 10 per cent of any listed equity security of such issuer.

Form 5 must be filed even though the securities, the registration of which has become effective, have been temporarily registered.

This report should disclose the beneficial ownership by the person filing the report, as of the effective date of the registration, of all equity securities of such issuer, whether or not they are listed and registered. In case any director or officer owns no such securities, he should nevertheless file a report on Form 5 expressly stating that he has no such ownership. In this connection your attention is directed to the provisions of Rule 1-16A-1 (c) (17 CFR, 240.16-1) as amended.

If a report is made on Form 4 with respect to equity securities of the same issuer for the month in which registration became effective, no report on Form 5 need be filed.

[Securities Exchange Act Release No. 227, May 14, 1935]

§ 241.1131 *Opinion of the Director of the Division of Forms and Regulations discussing the definition of "parent" as*

[1] Redesignation as of September 10, 1938.

used in various forms under the Securities Act of 1933 and the Securities Exchange Act of 1934. This is the same as Securities Act Release No. 1376 (17 CFR, 231.1376) [Securities Exchange Act Release No. 1131, April 7, 1937].

§ 241.1350 *Statement by Commission with respect to the purpose of the disclosure requirements of Section 14 and the rules adopted thereunder.*

NOTE: Because the names of the corporations involved are not deemed material at this time, they have been deleted from the statement.

The Commission's Proxy Rules under Section 14 of the Securities Exchange Act of 1934 compel the Commission to require that a certain minima of information must be given to security holders in connection with the solicitation of proxies by corporations, analogous to the disclosure requirements of the Securities Act of 1933. The purpose of these rules is to prevent the dissemination to the security holders and to the general public of untruths, hah-truths, and otherwise misleading information which would stand in the way of a fair appraisal of a plan upon its merits by the security holders. The Commission under the Securities Act of 1933 and under its Proxy Rules has no authority to pass upon the fairness or the merits or demerits of any such plan; nor to interfere in the consummation of any such plan where full and complete disclosure has been made. The Commission's authority here (unlike its authority under the Public Utility Holding Company Act of 1935) does not extend to the question of the fairness or equity of any such plan. However, we must insist upon an accurate presentation not only of the details of the plan but of the conditions surrounding the proposal. * * *"

[Securities Exchange Act Release No. 1350, August 13, 1937]

§ 241.1411 *Opinion of the Director of the Trading and Exchange Division relating to Rules X-15C1-6 (17 CFR 240.15C1-6) and X-10B-2 (17 CFR 240.10D-2).*

This will acknowledge receipt of your letter of September 13, 1937, in which, on behalf of several members of the Investment Bankers Conference, Inc., you request my opinion as to the interpretation of Rules MC6 [X-15C2-6] and GB2 [X-10B-2] [1] (17 CFR, 240.106-2).

In respect of Rule MC6 [X-15C1-6] you inquire: "What is 'secondary distribution'? Does this mean a secondary operation in the distribution of a new issue, or does it mean any operation, in a new or old issue, where the firm selling owns the security?"

Since the application of this rule is precisely the same whether a broker or dealer is participating or financially interested in a "primary distribution" or in a "secondary distribution," it does not appear necessary for the purpose of explaining the effect of the rule, to attempt a precise definition of a "secondary distribution" as distinguished from a "primary distribution." The crucial question appears rather to be: "Is the broker-dealer participating or financially interested in any type of distribution?" Clearly, a broker-dealer who is conducting "a secondary operation in the distribution of a new issue" would be participating in a distributing activity.

Whether "any operation, in a new or old issue, where the firm selling owns the security" is a distribution, within the intent of the rule, would depend on the facts in each individual case. Wherever the terms "primary distribution" and "secondary distribution" appear in these rules, the terms are used in the ordinary sense in which they are employed by those engaged in the securities business. These terms are intended to exclude the usual type of position trading as contrasted with the distribution of securities. I am further of the opinion that it is unimportant whether the firm effecting the distribution owns the security, has it under option, is acting as agent for some principal, or is merely a member of a selling group so long as financial interest exists on the part of such firm in effecting such distribution.

You next ask in connection with Rule MC-6, [X-15C1-6] (17 CFR, 240.15C1-6): "What is the meaning of the words 'otherwise financially interested'? If a partner of a house has 50,000 shares of XYZ stock listed on the New York Stock Exchange, is his house financially interested in this stock within the meaning of the rule? If a partner has 100 shares listed on the Stock Exchange, is his house financially interested? In other words, does the rule cover the personal ownership of partners as well as the holdings of the partnership?"

In my opinion there is a distinction between a financial interest in a distribution and a financial interest in a security which is the subject of a distribution. It seems to me, for example, quite possible for a member of a firm of brokers or dealers to be financially interested in a security for purposes of investment without either such partner or his firm being financially interested in any distribution which may be taking place in such security. Should, however, the financial interest of a partner or of his firm in such security, because of its extent or for any other reason, create a financial interest on the part of such partner or firm in the success of a distribution, it might well be that the requirements of Rule MC6 [X-15C1-6] (17 CFR 240.15C1-6) would apply. The rule, however, will be found more usually to apply to those situations in which the firm is directly or indirectly receiving a financial return arising from the sale of the security to the public.

In response to your request for an explanation of Rule GB2 [X-10B-2] (17 CFR 240.106-2), permit me to illustrate the application of this rule by suggesting a series of hypothetical situations. It is to be assumed that there is a concurrence of each of the other factors necessary for an application of the rules; hence, the firm designated A & Co. in each of the following illustrations is assumed to be participating or otherwise financially interested in the primary or secondary distribution of the security in question:

(1) A & Co., a securities firm in Chicago, offers to B, a customers' man employed by a San Francisco securities firm, a payment of 25¢ per share for each purchase of stock of the X corporation which B can cause to be effected on the Y exchange. In a typical case of this kind it is not necessary that the purchases be made through A & Co. or that they be filled from any particular block of stock. The payment of 25¢ per share is made, upon receipt of a copy of a confirmation evidencing purchase.

(2) A & Co. offers to C, one of its employees, a payment of 25¢ per share for each purchase of stock of the X corporation which C can cause to be effected on the Y exchange.

(3) A & Co. pays a regular salary to D, a customers' man employed by it, for devoting special attention to inducing the purchase of shares of the X corporation on the Y exchange.

(4) A & Co. offers to E & Co., another securities firm, a payment of 25¢ per share for purchasing on the Y exchange for the account of E & Co. as dealer shares of the X corporation, which would be the subject of subsequent resale by E & Co. to others.

(5) A & Co. offers to F & Co., another securities firm, a payment of 25¢ for each share of the X corporation purchased by F & Co. for the account of its customers on the Y exchange.

A & Co. in each of the above examples violates the rule in performing any of the foregoing acts. Moreover, after having performed any of such acts, A & Co. is restrained by the rule from effecting any sale or delivery after sale of the security of X corporation, in furtherance of the distribution in which A is interested. The foregoing examples are merely illustrative of some of the characteristic cases to which this rule is applicable and are not intended to set forth all possible applications of the rule.

I hope that this method of illustrating the application of Rule GB2 [X-10B-2] will prove of assistance to you.

[Securities Exchange Act Release No. 1411, October 7, 1937]

§ 241.1462 *Opinion of Director of Trading and Exchange Division relating to Rule X-15CI-1 (a) (17 CFR, 240.-15CI-1).*

This will acknowledge receipt of your letter of October 5, 1937, wherein you inquire whether, in respect of the over-the-counter rules which became effective as of October 1, 1937, a bank may be considered a "broker" or a "dealer" rather than a "customer".

Rule MCI (a) [X-15CI-1 (a)] (17 CFR, 240.15CI-1) states that the term "customer" shall not include a broker or dealer. Subsections 3 (a) (4) and 3 (a) (5) of the Securities Exchange Act of 1934 expressly state that the terms "broker" and "dealer" do not include a bank. Since, according to Rule AI (b) [X-1 (b)], the terms used in the Rules and Regulations promulgated under Title I of the Securities Exchange Act of 1934 shall, unless otherwise specifically state, have the meaning defined in the Act, it follows that Rule MCI (a) [X-15CI-1 (a)] does not exclude a bank from the term "customer".

In my opinion, therefore, a bank should be considered a customer rather than a broker or dealer for the purposes of the over-the-counter rules. (17 CFR, 240.15CI-1.

[Securities Exchange Act Release No. 1462, November 15, 1937]

§ 241.1571 *Partial text of letter of February 8, 1938, from the Secretary of the New York Stock Exchange to its members, relating to Rules X-3B-3 (17 CFR 240.36-3), X-10A-1 (17 CFR 240.-10a-1) and X-10A-2 (17 CFR 240.10a-2) (rules applicable to short-selling), together with a letter from director of the Trading and Exchange Division, concurring in the opinions expressed by the Exchange.*

FEBRUARY 4, 1938.

NEW YORK STOCK EXCHANGE,
11 Wall Street, New York City.

(Attention: Dean K. Worcester, Esq., Executive Vice-President)

GENTLEMEN: Representatives of your Exchange have discussed with me various problems concerning the operation of Rules X-3B-3 (17 CFR, 240.36-3), X-10A-1 (17 CFR, 240.10a-1), and X-10A-2 (17 CFR, 240.10a-2), relating to short-selling of securities, adopted by the Commission January 24, 1938. They have also submitted to me a draft of a circular proposed to be distributed among the membership of your Exchange, embodying comments and instructions regarding Exchange transactions under these rules, together with interpretations of certain provi-

[1] The Commission's present Rule X-15C1-6 is substantially identical to former Rule MC-6. Paragraphs (a) through (c) of the present Rule X-10B-2 are identical to Rule GB-2; however, a new paragraph (d) was added to the rule after the date of this opinion, exempting from its prohibitions certain transactions effected pursuant to an effective "special offering" plan filed with the Commission by a national securities exchange.

sions thereof. I understand that this circular is designed to facilitate operation under the rules.

The interpretations proposed to be included in this circular have been the subject of discussion between the Exchange representatives and the staff of the Trading and Exchange Division. As a result of these discussions a revised draft of the circular has been made. I have considered this revision, as it appears in the enclosed copy, and am of the opinion that the interpretative material contained therein is correct and in accordance with the underlying intent of the rules.

If at any time, you have any further questions with respect to the operation of these rules, I shall be glad to receive them and to discuss them with you.

Very truly yours,

GANSON PURCELL,
Director.

NEW YORK STOCK EXCHANGE,
OFFICE OF THE SECRETARY,
February 2, 1938.

To the Members of the Exchange:

Under date of January 24, 1938, the Securities and Exchange Commission promulgated rules X3B-3 (17 CFR, 240.36-3), X-10A-1 (17 CFR, § 240.10a-1) and X-10A-2 (17 CFR, § 240.10a-2) relative to short selling. These rules were sent to members of the Exchange by this office under date of January 26, 1938. They are reprinted on page H-135 of the Directory and Guide. The rules become effective on Tuesday morning, February 8, 1938.

The following comments and interpretations of these rules are intended for the guidance of members and their customers. The Director of the Trading and Exchange Division of the Securities and Exchange Commission has advised the Exchange that in his opinion these comments and interpretations are correct.

1. * * * A "short sale" is defined as (1) any sale of a security which the seller does not own; or (2) any sale which is consummated by the delivery of a security borrowed by or for the account of the seller. Thus, a sale of a security which is owned by the seller becomes a "short sale" if delivery to the purchaser is made by the use of borrowed securities. This may often be the case if the original security is not available in or near New York in negotiable form at the time of sale.

Although the term "short sale" may thus include many sales which would ordinarily be regarded as long sales, the prohibition of the general rule does not apply to (1) any person, whether a member or a non-member, selling a security which he owns and intends to deliver as soon as is possible without undue inconvenience or expense; or (2) any member executing for an account in which he has no interest a sell order marked "long" (see paragraph 4 below); or (3) any sale of an odd lot. Certain additional transactions * * * are exempted.

The general prohibition referred to above has the effect of a criminal law. Any person, including any member or any customer, who effects for his own account or for any other account any "short sale" in violation of the rule, may be guilty of a criminal offense.

2. *Securities subject to the rule.* The rule applies, generally speaking, to all securities dealt in upon any national securities exchange, other than government or municipal securities.

3. *Place of transaction.* The rule applies to any short sale effected by the use of any facility of a national securities exchange. In consequence, it covers all short sales (other than odd lots and other sales exempted by the rule itself) made upon the Exchange, of any security subject to the rule. The rule does not apply, however to sales not made on any national securities exchange.

4. *Marking of orders.* Every sell order (including odd-lots) in a security subject to the rule, which is executed on the Exchange whether originated or handled by a member, must be marked to indicate whether it is "long" or "short". The abbreviations "L" or "S" may be used. A member, (including any floor broker) or any employee may mark an order "long" only if (1) the customer's account is "long" the security involved; or (2) the member or employee is informed that the seller owns the security and will deliver it as soon as is possible without undue inconvenience or expense. To obviate the necessity of hurriedly obtaining the information specified in rule X-10A-2, (17 CFR, 240.10a-2), it is advisable for the member when he receives the order also to obtain information from the seller as to the practicability of then delivering the security. As a method of obtaining such information with respect to an order to sell, a member (including any floor broker) may enter into any bona fide written agreement with his customer that the customer, when placing "short" sell orders, will designate them as such, and that the designation of a sell order as "long" is a representation by the customer to the member that the customer owns the security, that it is then impracticable to deliver the security to such member and that the customer will deliver it as soon as is possible without undue inconvenience or expense.

5. *Ownership of securities.* A person is deemed to own a security if (1) he or his agent has title to it; or (2) he has purchased or has entered into an unconditional contract, binding on both parties, to purchase it but has not yet received it; or (3) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) he has an option to purchase or acquire it and has exercised such option; or (5) he has rights or warrants to subscribe to it and has exercised such rights or warrants. He is not deemed to own a security if he owns securities convertible into or exchangeable for it but has not tendered such securities for conversion or exchange, or if he has an option or owns rights or warrants entitling him to such security, but has not exercised them.

Within the meaning of the rules a person "owns" securities only to the extent that he has a net long position in such securities. Thus, if a person maintains two accounts and is short 1000 shares of a security in one and long 1000 shares of the same security in another, any sales of such security by such person are "short sales" and are subject to the provisions of the rules.

6. *Price at which short sales may be made.* [See amended paragraph (a) of Rule X-10A-1 (17 CFR, 240.10a-1)] * * *

When a security is dealt in on two or more national securities exchanges, the last regular way sale price on the particular exchange involved is controlling. * * *

The price which governs the making of short sales is the last regular way sale price regardless of the indentity of the participants therein and regardless of whether it was itself a short sale. * * * Of course, no member may sell short for his own account at any price at which he could not sell short for a customer.

* * * * *

7. *When issued transactions.* The rules apply to the sale of "when issued" securities in the same manner as issued securities. In the case of a sale of a "when issued" security, the last "regular way" sale price means the last price at which the "when issued" security has sold on the Exchange. A person is deemed to be the owner of a "when issued" security if he has entered into a contract to purchase the same binding on both parties and subject only to the condition of issuance or, by virtue of his ownership of an issued security, will be entitled to receive, without the payment of consideration, the "when issued" security, to the extent that he has not already disposed of such "when issued" security.

8. *Covering transactions.* If on the due date of delivery of a security sold pursuant to an order marked "long", the member has not received the security from the customer, he must cover the open position unless he knows or has been informed by the seller either (1) that the security is in transit to him; or (2) that the seller owns the security, that it is then impracticable to deliver it and that it will be delivered as soon as is possible without undue inconvenience or expense. If the member has received the security at his main or branch office, or if he knows or has been informed by the seller that either (1) or (2) is the case, he may at his option either fail to deliver or make delivery with borrowed securities. If, however, he neither knows nor is informed by the seller that either of these situations exists, and has not received the security, he must cover the transaction by buying in, for "cash", for the account of the customer, the security sold. Such buy-ins are not to be given to the Secretary of the Exchange for execution, but are to be effected by the member directly or through an agent of his own choosing. If on the date when delivery upon the original contract is due, the member receives the security so bought in, or knows that it is in transit to him, he may make delivery upon the original contract with the security so received, or with borrowed securities, or may fail to make delivery thereon.

The provisions of this paragraph apply to odd lots as well as to full lots. [Paragraph (b) (2) of Amended Rule X-10A-2 (17 CFR, 240.10a-2) now permits exceptions from these covering requirements in certain cases of bona fide mistake.]

9. *Loans of securities between members.* A member may, without regard to the restrictions imposed by Rule X-10A-2 and without inquiry as to the purpose of the loan, lend a security to another member. The lending member may nonetheless be criminally liable for a violation of the short selling rules if he knows that the borrower intends to violate such rules.

ROBERT L. FISHER,
Secretary.

[Securities Exchange Act Release No. 1571, February 5, 1938]

§ 241.1965 *Opinion of General Counsel relating to section 16 (a).*

Beneficial ownership of securities held by holding companies, partnerships and trusts. In order to show the recent redesignation of the rules referred to therein and a supplemental opinion of its General Counsel with regard to indirect beneficial ownership through holding companies, the Securities and Exchange Commission today reprinted the opinions of its General Counsel heretofore published in Release No. 79 dated January 13, 1935, as follows: [1]

Holding companies. I understand that you represent a director of the B. M. Company whose stock is listed on the New York and Detroit Stock Exchanges and registered pursuant to Rule JE1.[2] I further understand that your client owns approximately two-thirds of the stock of the B. C. Company, a business corporation whose stock is rather closely held and is not registered on any national securities exchange. The B. C.

[1] While these opinions were prepared in response to questions presented under Section 16 (a) of the Securities Exchange Act of 1934, they would seem to be equally applicable to corresponding situations arising under section 17 (a) of the Public Utility Holding Company Act of 1935.

[2] While the rule cited had to do with temporary registration of securities, the opinions apparently apply equally to cases arising out of permanent registration of securities.

Company owns over ten percent of the listed stock of the B. M. Company, and during the month of November, 1934, purchased a few hundred additional shares of that stock in the market. You ask whether your client is required to file reports pursuant to Rule X-16A-1 [2] (formerly designated Rule NA1), as amended, in respect to the November purchases by the B. C. Company.

The question whether the holder of stock in a holding company should file reports in respect of securities owned by the holding company, is a question of fact to be determined in the light of all the circumstances involved. In my opinion, no consideration need be given by the owner of stock in a holding company to the holdings of that company, except in a case where the holding merely provides a medium through which one person, or several persons in a small group, invest or trade in securities, and where such company has no other substantial business. In such a case, a person in control of the holding company who is an officer or director of the issuer of a listed equity security owned by the holding company, or whose interest in such security through the holding company (together with the amount of such security of which he is otherwise directly or indirectly the beneficial owner) aggregates more than ten percent of such security, should file a report in accordance with Rule X-16A-1 (17 CFR, 240.16a) [3] (formerly designated Rule NA1). This report should include the holding company's ownership of such security, and transactions by it therein, to the extent of such person's interest. Such control might in fact be joint, and in such a case all persons sharing such control, regardless of whether one of such persons holds a majority of the voting stock of the holding company, would, to the extent of their respective interests, be under a similar duty to report in respect of securities owned by the holding company. The filing of reports by such controlling person or persons would not, in my opinion, relieve the holding company from itself filing reports pursuant to Rule X-16A-1 (17 CFR, 240.16a-1) [1] (formerly designated Rule NA1) if the holding company were the owner of more than ten percent of the equity security in question.

The existence of other substantial business is merely of evidentiary value on the question whether the corporation is actually used by one person or a small group as a medium for investing or trading in securities. The basic question is whether the stockholders of the corporation are using it as a personal trading or investment medium, and to the extent that it is so used the stockholders are properly to be regarded as the beneficial owners, to the extent of their respective interests, of the stock thus invested or traded in.

Whether or not the circumstances in the case which you present are such that your client should file a report covering the transactions by the B. C. Company in stock of the B. M. Company is a matter for your determination, but I trust that the opinion expressed above will be helpful in this connection. I call your attention to Rule X-16A-3 (d) (17 CFR 240.16a-3) [2] (formerly designated Rule NA3 (d)) of this Commission which will permit your client, in case of doubt, to file reports covering the ownership of and transactions by the B. C. Company while at the same time disclaiming beneficial ownership of the securities so reported. Your client should of course include in his reports information as to the ownership of and/or transactions in equity securities of the B. M. Company of which he is in any other manner the beneficial owner.

Partnerships. You present the case of a partnership, one partner of which is a director of a company, at least one class of whose equity securities is listed on a national securities exchange. If the partnership holds any equity securities of that company, the director should file reports in respect of the holdings of the partnership in such equity securities, to the extent of his pro-rata interest in the partnership. However, if the partner desires, he may exercise the option granted by Rule X16A-3 (b) (17 CFR, 240.16a-3) [2] (formerly designated Rule NA3 (b)) and report as to all such equity securities held by the partnership, with a notation that he owns only a partial interest in those shares.

You also present a case involving a partnership of three partners each of whom has an equal interest in the partnership, where the partnership holds 29 percent of a class of equity securities listed on a national securities exchange. In this case no reports would be required as to partnership holdings of such class of equity securities on the part of any individual partner who is not a director or an officer of the issuer, unless such partner's indirect interest in such security through the partnership (together with the amount of such security of which he is otherwise directly or indirectly the beneficial owner) were to amount to more than ten percent thereof, or unless such partner were the beneficial owner of more than ten percent of some other class of equity security of such issuer listed on a national securities exchange. Such partner could, of course, take advantage of Rule X-16A-3 (b) (17 CFR, 240.16a-3) [2] (formerly designated Rule NA3 (b)) for the purpose of filing reports as to his ownership of equity securities through his interest in the partnership.

In any case where a partnership holds for its own account more than ten percent of a class of any equity security listed on a national securities exchange, it should file reports as to such holdings in accordance with the requirements of Rule X-16A-1 (17 CFR, 240.16a-1) [2] (formerly designated Rule NA1), regardless of whether reports are filed by the partners, since the partnership would be the direct beneficial owner of more than ten percent of such class.

TRUSTS—I

You put a case of an irrevocable personal trust of which A is trustee and under which B is entitled to the income for life with the principal payable to C upon the death of B. The trust holds an equity security of Corporation X which has been temporarily registered under the Securities Exchange Act pursuant to Rule JE1.[4] You state that the trust has made purchases and sales of this equity security during the month of November and, on the basis of further facts indicated below, you ask various questions in regard to the filing of reports of such changes of ownership under Section 16 (a) of the Securities Exchange Act and Rule X-16A-1 (17 CFR, 240.16a-1) [2] formerly designated Rule NA1), as amended, of the Commission.

I beg to express the following opinions in regard to your various questions:

1. If, at the time of the transactions in question, the trust held 12% of the registered equity security of Corporation X, a report as to such transactions should be filed by A as trustee not later than January 30, 1935. Such report should contain a general designation of the beneficiaries of the trust. It would not seem necessary that the report include any amount of such equity security held by or for A in his own right, nor would it seem necessary that B or C file additional reports with respect to changes in the holdings of the trust.

2. If at the time of the transactions in question, the trust held 5% of the registered equity security of Corporation X, and A, B and C were at the time directors of Corporation X, no reports with respect to the transactions of the trust are required from A, B or C individually or from A as trustee. If B or C were the settler of the trust and/or were to exercise any power of control over A's administration of the trust, a case would be presented, the particular circumstances of which might well be such as to require the filing of reports by B or C.

3. If, at the time of the transactions in question, the trust held 5% of the registered equity security of Corporation X, and A, B and C each individually owned 7% of such registered equity security, no reports with respect to the transactions of the trust are required from A, B and C individually or from A as trustee. Here again I wish to call your attention to the fact that no opinion is expressed concerning the situation mentioned in the last sentence of the preceding paragraph.

4. If the trust were subject to revocation, the person who possesses the power to revoke the trust for his own benefit either alone or in conjunction with someone not having a substantial interest adverse to such person in the disposition of the securities held in the trust would appear to be the beneficial owner of the registered equity security of X held in the trust. However, if the trust held more than 10% of such security, the fact that a power of revocation existed would not relieve A as trustee from his duty to file reports concerning transactions of the trust in that security.

TRUSTS—II

You put the case of an irrevocable personal trust, which holds an equity security listed on a national securities exchange and which from time to time has transactions in such security. The trustee of this trust is a director of the issuer of such equity security. The daughter of the trustee is entitled to the income of the trust until reaching a specified age and is then entitled to the corpus. The trust deed provides that if the daughter dies before reaching the specified age, the trustee is to become entitled to the corpus of the trust.

You inquire whether the trustee, under section 16 (a) of the Securities Exchange Act and Rule X-16A-1 (17 CFR, 240.16a-1), [3] (formerly designated Rule NA1) of the Commission, must file reports in regard to the above mentioned equity security held in the trust. Under these circumstances the trustee should in my opinion report the holdings and transactions of the trust as his own, indicating the nature of his interest.

[Securities Exchange Act Release No. 1965, December 21, 1938]

§ 241.2066 *Letter of General Counsel concerning the services of former employees of the Commission in connection with matters with which such employees become familiar during their course of employment with the Commission.* This is the same as Securities Act Release No. 1934. [Securities Exchange Act Release No. 2066, May 5, 1939]

§ 241.2446 *Statement of the Commission and separate statement by Commissioner Healy on the problem of regulating the "pegging, fixing and stabilizing" of security prices under sections 9 (a) (2), 9 (a) (6) and 15 (c) (1) of the Securities Exchange Act.*

A. *The problem.* Although the Securities Exchange Act contains a general prohibition against manipulating security prices up or down, it does not prohibit certain kinds of manipulation. Thus, section 9 (a) (6) permits the "pegging, fixing or stabilizing" of security prices, except to the extent that it may be "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." The Report of the Senate Committee on Banking and Currency in discussing the regulatory powers conferred on the Commission stated: "Practices such as pegging, fixing or stabilizing the price of a security are subjected to *regulation* by the Commission, which is authorized to prescribe such rules as may be necessary or appropriate to protect

[2] See footnote 2 on preceding page.
[3] Redesignation as of September 10, 1938.

investors and the public *from the vicious and unsocial aspects of these practices.*" [Italics added.]

The questions of policy involved in *any* regulation of stabilizing are of such fundamental significance as to require a discussion of the considerations which have led to the Commission's conclusion to attempt to embark upon a broad program of regulation. These questions of policy, although they apply to Regulation X-9A6-1 (17 CFR, 240.9a6-1), recently adopted to deal with only a limited type of stabilizing, are primarily relevant to any general program for the regulation of stabilizing in other and more important situations. They must therefore be analyzed in their relation to the whole problem.

There are many who feel that stabilizing, since it is a form of manipulation, is inherently fraudulent and hence should be wholly prohibited under all circumstances. The Commission is unanimous in recognizing that stabilizing is a form of manipulation. The statute itself so recognizes. The Commission also agrees that stabilizing in many respects is undesirable. That, too, is implicit in the statute. Nevertheless, the majority of the Commission considers that merely to point to the evils attendant upon stabilizing poses the problem but does not answer it. The question of how to deal with stabilizing as it exists today cannot be answered by theory alone. It is an intensely practical problem which, for the present, must be solved in terms of the existing financial machinery.

The Commission faces three choices. (1) It can permit stabilization to continue unregulated; (2) it can adopt a program for the regulation of stabilization in an effort to eliminate particular abuses which, in the absence of regulation, are being lawfully employed today; or (3) it can decide that stabilization is inherently so detrimental to the interest of investors that the Commission should recommend to Congress that all stabilization be prohibited.

For reasons discussed hereafter the majority of the Commission is not now prepared to say that, under existing conditions, all stabilizing should be wholly prohibited. Nor is the majority of the Commission content to allow stabilizing to continue unregulated. It remains to determine whether a workable program for the regulation of stabilizing can be developed.

It seems clear that the only course open to the Commission is to adopt regulations which can be revised from time to time as we see how they actually work. Such regulations must reconcile, as far as possible, the often conflicting objectives of protecting purchasers of securities, on the one hand, and of preserving the ready flow of capital into industry, on the other. Here, as in most other fields of human activity, perfection is an unattainable ideal. Compromise and adjustment are inescapable. A closer approach to the ideal than is now achievable may in the future be found in the development of investment banking or other underwriting institutions with sufficient resources so that the need for stabilizing can be substantially reduced, even entirely eliminated. But the growth of American industry cannot wait upon such a development. Consequently, the Commission has concluded that its immediate duty under the statute is to meet the situation through regulated stabilizing, frankly recognizing the experimental character of its approach to the problem.

Preliminary studies by the Commission's staff led to the adoption on March 15, 1939, of rules and regulations of the Commission requiring the filing of detailed reports respecting all stabilizing operations conducted to facilitate the distribution of security offerings in respect of which a registration statement has been filed under the Securities Act of 1933. By the end of 1939 the Commission had been able to review case histories covering the distribution and accompanying stabilization of over 50 bond and stock issues. This knowledge should now enable it to make at least an initial inroad into one of the most technical and controversial problems which Congress left to it under the Securities Exchange Act of 1934.

(B) *Description of the Fundamentals of Market Stabilization in Aid of Security Distributions.* Stabilization is a generic term. For our present purposes it may be broadly defined as the buying of a security for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public. Stabilizing, in the sense that we are here concerned with it, is closely related to the financing of industry, much of which is achieved through the offering and sale of securities to the public. Because of the closeness of this relationship the practice of stabilizing must be appraised in the light not only of the needs of industry for capital but of the prevailing methods of security distribution.

Let us suppose that a corporation desires to expand its plant and needs to obtain funds for that purpose. The corporation could, theoretically, dispense with an underwriter and content itself with hiring an investment house, as a mere selling agent, to sell its securities on the market, for a selling commission, at the best prices obtainable and at as early a date as possible. But then the corporation would not know, in advance, how much the funds would cost it, for it would not know at what price its securities would sell on the market and therefore would not know whether a given quantity of its securities would yield a given sum; nor would it know when it would receive the necessary funds, for they might be obtained only in dribs and drabs.

That would make plant construction difficult and often impossible. For the corporation needs to know, before letting its construction contracts, that it will have a certain sum in hand, at a certain date and at not more than a certain cost.

If the corporation could, directly or through an agent, sell its securities by a few simultaneous sales to a few large investing institutions—to which many individuals have entrusted their savings for investment—there might well be no problem of stabilizing. But that is not possible as to many types of corporate securities. They must be sold in the open market to a large multitude of direct individual investors. That fact creates factors of uncertainty which make it necessary that the corporation do something more than sell its securities through a mere selling agent.

These elements of uncertainty are removed by the firm commitment underwriting agreement which the underwriter normally makes with the corporation: The underwriting investment banker agrees that on a fixed date the corporation will receive a fixed sum for a fixed amount of its securities.

But how can the underwriter afford to make that contract unless he has a sufficient amount of capital of his own to invest in those securities? If he had that much capital as is frequently the case with underwriters in some other countries—then stabilizing would be of little or no importance. But American underwriters do not have sufficient capital to perform that function. They dare not, therefore, take the risk of being obliged to carry out their underwriting agreements by themselves investing their own resources in the underwritten securities. They can afford to make such agreements only on the supposition that they will, with great speed, be able to sell the securities to the multitude of direct individual investors. If they knew that they were unable to do so, they could not afford to—and therefore would not—enter into firm commitment underwriting contracts. And if they did not, then many a corporation desiring to expand its plant, would find it difficult or impossible to do so—and thus the flow of individual savings into industrial expansion would be seriously impeded.

For the purposes of this discussion the underwriter, realistically regarded, is a salesman who hopes that he will sell the underwritten securities at a fixed price in a very short period. His ability to fulfill his underwriting contract with the corporation turns, then, on his ability to sell the securities promptly on the market at or near the fixed price which he pays to the corporation for the issue. Analysis of the present methods of distributing securities indicates, we are told, that the underwriter's ability to resell the issue, in certain conditions of the market, in turn, depends on his ability to stabilize.

Most formal offerings of new security issues of significant size are today brought out by an investment banking syndicate and sold to the public at a fixed price. This underwriting syndicate, consisting of from a few to well over one hundred underwritten houses, buys the entire new issue of securities from the issuing corporation at a predetermined fixed price and immediately reoffers it to the public at a slightly higher price which is also a predetermined fixed price (the "offering" or "issue" price). The issue is usually resold to the public both by the underwriters and by a so-called "selling group" composed of selected security dealers who act as retailers for the underwriting syndicate.

The most important attributes of present-day syndicate distribution of securities are probably (1) the element of certainty to the issuing corporation, which for all practical purposes is assured of payment on a day certain of the agreed price for the issue regardless of its reception by the public and of subsequent market fluctuations, and (2) the element of speed, reflected both in the rapid sale of the issue to the public and in the consequent promptness of payment by the underwriters to the issuer.

It is because of these attributes that it is important to note the alleged necessity for preventing the market price of a new issue from dropping below its offering price during the period of distribution. Some proportion of an issue, even though initially it may be completely sold by the underwriters to the selling group dealers, will finds its way back into the open market. This selling pressure results from the fact that some purchasers change their minds and almost immediately resell. In part, this selling comes from so-called "free riders" or speculators who purchase with the hope of quickly selling out and taking a profit from an early rise. If these reofferings are not absorbed by public buying in the open market, their pressure will tend to force the market price below the original offering price.

In order to absorb this open market selling and to prevent the consequent drop in market prices which might impede, if not preclude, the success of the financing, the manager of the underwriting syndicate, upon making the offering, usually enters a "syndicate bid" to buy such securities as may be offered in the open market. Normally the syndicate bid is placed at the issue price. If the selling pressure grows too heavy to permit the constant "pegging" of the market at the original offering price, the syndicate bid will usually be dropped to successively lower levels. The stabilizing purchasing by the underwriting syndicate may range, depending upon the success of the particular offering, anywhere from 1% to as high, occasionally, as 15% or 20% of the issue.

Stabilizing a market as described above is normally employed to facilitate formal public offerings of bonds. Comparable procedure is also followed in connection with most new stock offerings made at a fixed price.

Another type of stabilization is designed to facilitate additional issues offered by a corporation to its stockholders, usually at prices below prevailing market levels. A similar type of stabilizing is also commonly used

to facilitate both primary and secondary distributions in which the offering price is represented to be "at the market" or at a price based on the market. In both of these latter situations it is not customary for the syndicate to maintain a rigid "peg" in the market by bidding steadily at one price. However, any downward trend in the market price of the security is usually retarded by the underwriters' purchases of stock at successively lower levels.

It should be further noted that stabilizing is regarded as necessary only in the case of issues which are neither notable successes nor notable failures. In the former case the market for the issue usually takes care of itself. In the latter, where the selling pressure in the open market is too great, the underwriters cannot afford to support the market at or near the issue's original offering price. For the same reason, stabilizing cannot as a practical matter be used to stem a market or economic trend of any real significance.

The mechanics of stabilizing as described here are by no means universally followed. However, whatever techniques are followed, and whether the underwriters be successful or unsuccessful, their stabilizing represents a form of manipulation which interferes with free and open markets. It is, of course, a negative type of manipulation since it seeks to retard and not to create affirmative market movements. Nevertheless, this ability so to interfere with our markets has been abused in the past. That it remains susceptible to future abuse is common knowledge. In determining whether the solution to the problem lies in prohibiting stabilizing, in subjecting it to regulation or in continued nonaction, the Commission has sought to weigh the relative advantages and disadvantages to the investor and to the national economy which may attend each of these alternatives.

(C) *Disadvantages of stabilizing.* The legislative hearings which preceded the adoption of the Securities Exchange Act of 1934 showed that abuses by underwriters of the stabilizing process were so prevalent as to require governmental action of some kind. The oft-repeated and, in our opinion, wholly justified complaint against security stabilizing is that when the operation is ended and the "peg is pulled", the market price of the security frequently drops with ensuing loss to all who purchased it on the basis of an artificial, "pegged" market price. Insofar as stabilization prevents falling market prices and thus permits the issuance of securities at unjustifiably high prices, the practice must be regarded as an evil. Similarly, the active trading which frequently results from the very fact of the distribution and the accompanying stabilizing at the offering price may also serve to invite other buyers into the market.

Statistically, it seems beyond dispute that, in the past at least, unregulated stabilization has in fact facilitated the distribution of over-priced securities to the detriment of the investing public. Chart I, attached in the appendix hereto, in which adjustments have been made designed to eliminate the effect of general market fluctuations, illustrates the average market history, for a period of sixteen weeks after offering, of 203 bond issues brought out between 1921 and 1931 most of which, so far as could be determined, were stabilized to a greater or lesser extent. The story shown is one of price stability during the first few weeks of the offering, followed by a drop, on the average, of about a half point. Chart II in the appendix indicates, furthermore, that this was more than a temporary, technical decline, since, during the second year of their existence, these new issues still sold off about a point and a half as compared to the market.

Examination of the stabilizing of 19 new bond issues, publicly offered during the period from March 15 to August 31, 1939, as to which reports were filed with the Commission pursuant to Rule A-17A-2 (17 CFR, 240.17a-2), shows in Chart III that the average drop from original offering prices (after adjustment for market changes) was about 1.4% during the third month following their offering dates. Of these 19 issues, the average open market prices of 12, or approximately 63%, during the first twelve weeks after their offering dates were below their original offering prices after adjusting for general market trends.

On the other hand, examination of the price levels for a period subsequent to the period covered in the chart shows a marked improvement in these stabilized issues when compared with general market trends. Thus, on January 31, 1940, after eliminating the bonds of a Canadian corporation (because the drop in their price is primarily attributable to the war and the threat of Canadian foreign exchange control) the average open market price of the remaining 18 issues was *above* their average original offering price, after adjusting for general market trends.

The vice inherent in stabilizing has been pointed up by the absence of publicity with respect to such an operation. Investors have true. Since March 1939 the Commission's are purchasing at prices in line with market prices fixed by the normal forces of supply and demand when, in fact, the contrary is true. Since March, 1939 the Commission's rules have required that all prospectuses under the Securities Act unequivocally state in simple language, where such is the case, that it is the intention of the underwriters to stabilize the market in aid of the offering. Nevertheless, in many instances the significance even of this statement probably cannot be grasped by all purchasers.

The effect which the requirement of adequate notice of a proposed stabilization had in one particular instance may be worth citing. A corporation proposed to offer a new preferred stock in exchange for an outstanding issue at a predetermined price ratio. The corporation was advised of the necessity of fully and adequately disclosing that the exchange offering was to be facilitated by a market stabilizing operation. It may have been only a coincidence that thereafter it not only refrained from interfering with the market but actually changed the basis of the exchange offering so as to make it substantially more favorable to the stockholders to whom the new issue was to be offered. This again suggests, as do the statistical data and charts described above, that at least in the past the practice of stabilization, inadequately publicized, has facilitated the overpricing of security issues and consequent loss to the investing public.

Finally, it should be noted that many people feel that stabilizing not only is fraudulent, but that its attendant evil of the overpricing of security issues is inherent. They believe that no regulation short of complete prohibition can protect buyers against these dangers which arise from a deceptive and an artificial market. And they conclude that buyers should receive the ultimate protection of complete prohibition, regardless of the adverse effects which prohibition might have on the needs of industry for capital.

(D) *The Underwriter's Arguments in Justification of Stabilization.* Without adopting the reasons frequently advanced to justify the widespread use of stabilizing in aid of security distributions we may restate the arguments as follows:

One argument runs that stabilization is warranted in order to offset the market "abnormalities" which result from the very fact of the offering. When a new or an additional issue of significant size is offered to the public a temporary glut of the market may often be the immediate result. At the same time the demand for the offered security is diverted by the underwriters and the selling group dealers away from the open market and into the channels of the distribution itself. The selling efforts of dealers necessarily attendant upon the making of the offering thus result in taking away from the open market the demand for the offered security which might otherwise there exist. As noted, "free riders", as well as other buyers who change their minds, will sell, and at a time when there is a temporary unbalance between supply and demand created by the offering. These scattered open market sales, taken in conjunction with the sudden influx of supply and the accompanying withdrawal of normal open market demand into the channels of direct distribution, unless counteracted, will exert a market influence which, according to the underwriters, is out of all proportion to their real significance. The sound market value of millions of dollars of new securities, unseasoned and not yet digested by the investing public, should not, they say, be predicated upon a handful of resales the market effect of which is unduly magnified by the present day publicity given to market quotations. Therefore, the underwriters urge that stabilizing, although admittedly an artificial influence, is justified to neutralize a temporary condition of oversupply which itself may likewise be regarded as abnormal, and that temporary stabilizing controls, commensurate with the degree of the temporary abnormal disparity between supply and demand, are warranted to offset that unbalanced condition of the market.

Another argument is based upon the underwriter's view that it is appropriate and desirable for a seller to permit a buyer to return his securities if he so desires. This applies not only to the investing public but to the members of the underwriting syndicate and the selling group as well. Dealers or underwriters in one section of the country may overestimate local demand just as investors may overestimate their own ability to carry a security. At the same time others may have been unable to fill their demand. It is consequently desirable, say the underwriters, that they should be permitted to repurchase and reallocate to others the securities of those who bought more than they can handle. Another variation of the same general contention is that the underwriters have an obligation to the purchasers of the issue to afford a market place where those purchasers who wish to sell may be able to do so at a fair price. On this basis the industry urges that it is in the interest of the investing public itself for the underwriters to provide the advantages of such a market place by placing their syndicate bid at or near the offering price.

The third argument is based upon the necessities of the situation. Under the existing system, which today revolves around firm commitments and fixed price offerings of securities to a relatively speculative public, some degree of stabilization, according to the underwriters, is necessary to the successful flotation of new security issues on anything other than a continued "bull" market. Since underwriters today are primarily salesmen having only the limited capital of distributors, they claim that they cannot undertake long or even medium term commitments in order to insure the success of billions of dollars of security offerings. If an entire issue of securities is to be bought by such underwriters at a fixed price, it is said to be vitally necessary that those underwriters be able to protect themselves as well as the selling group dealers, against a "disorderly" open market during the resale of the issue to the public. This is said to follow because if the market price of a new issue sags even fractionally below the offering price, it cannot be sold at the offering price which was determined when the issuing corporation received its price for the issue. This in turn is assigned to the fact that the American public follows daily price quotations closely and is as much concerned with immediate paper profits or losses, as well as with liquidity, as it is with the ultimate fate of the security if held on a long term basis. Stabilization is therefore said to be an unfortunate, but nevertheless an unavoidable concomitant of modern security distribution, of present day

public markets and of the existing public emphasis upon widely published daily market quotations.

The underwriting industry further claims after the necessary "mopping up" of loose ends resulting from the inevitable resales, a properly distributed issue should find its natural and ultimate market level in line with and not significantly below the prices of comparable securities or market averages. Indeed, issues for which stabilizing operations have been necessary during the first crucial days after the offering frequently *rise* in relation to general market levels. Of 19 bond issues which were offered between March 15 and August 31, 1939, and as to which the Commission has received detailed stabilizing reports, 7, or 37%, sold during the first twelve weeks after their offering dates at an average price in the open market above their original offering prices after adjustment for general fluctuations in the bond market. In the case of 11, or slightly over 59%, of these issues their average open market prices during the twelve weeks following their offering dates were above or within one point of their original offering prices after adjusting for general market trends. Chart IV also shows that this was the general pattern of new issues brought out during the year of 1935, a period of active refunding and rising market prices.

These same considerations are said to apply, although in perhaps a lesser degree, to stabilizing to facilitate "secondary distributions"; that is, public offerings of outstanding securities where the proceeds of the distribution go to liquidating security holders rather than to the issuing corporation. If secondary distributions could not be thus facilitated, it is argued that the original distribution of those securities (and the consequent financing of the issuing corporation) would be made the more difficult because of the reluctance of substantial investors to make large and commensurately illiquid commitments.

Accordingly, the underwriters emphasize that where an issue is not overpriced in relation to comparable outstanding securities, and where the extent and intensity of stabilization, attended by the fullest possible publicity, is appropriately limited in relation to the size of the issue, the stabilizing device may be employed without inflicting any appreciable damage upon investors. At the same time, they assert that the desirable attributes of certainty, speed and economy of industrial financing could be retained.

(E) *The economic problem presented by the practice of stabilization.* Stabilization, it must be recognized, is now an integral part of the American system of fixed price security distribution. From the point of view of industry, any practice which assists security distribution under firm commitment underwriting contracts is obviously desirable. From the parallel point of view of the underwriter, stabilization is regarded as perhaps an unhappy, but a necessary choice if industry is to obtain its capital funds "cash-on-the-barrel-head" and if the underwriter is not to be exposed to market risks which he claims his present underwriting capital will not permit him to assume. From the point of view of the investor, on the other hand, it is clear that the process of stabilizing permits the underwriter to induce his purchase of securities on the basis of what he believes is a "natural" market price established by "natural" trading activity but which, in fact, are both, to a greater or lesser extent, artificial.

This brings us to the crux of the problem viewed in its larger aspects; namely, the conflicting interests of two segments of the public as a whole. One part of the public, consisting of existing security holders, employees and others dependent upon the turning wheels of industry, has a direct interest in securing the financing of industry as cheaply and as effectively as possible. The other segment of the public, made up of purchasing investors, has an equally direct interest in obtaining appropriate investments at the cheapest possible prices. To both of these divisions of the investing public this Commission owes a duty. Furthermore, the Securities Exchange Act, while primarily directed towards the protection of investors, is also concerned with the protection of the Nation's credit and banking structure and the health of its capital markets. Congress recognized the need for an adjustment between the interests of purchasing investors on the one hand and the needs of industry for capital funds on the other. Therefore, by section 9 (a) (6) of the Securities Exchange Act, it assigned to this Commission the duty of finding a reasonable middle ground between these two objectives which are by no means always easy to reconcile: (1) To guard the welfare of the multitude of direct individual investors against injury from stabilizing. (2) To guard against impeding the flow of individual savings into industrial expansion.

The damage to investors results ultimately from the over-pricing of security issues. Stabilizing, of course, aids the distribution not only of properly priced issues but of the over-priced issues. Unfortunately, the correct pricing of new issues is not, and can never become, an exact science. Hence, any regulation of stabilizing, while it may seek to put a premium on correct pricing and to penalize over-pricing of securities, cannot be expected wholly to eliminate the risk of over-pricing. Yet, as against the Commission's duty to minimize this danger to security buyers, we cannot overlook our duty in the interests of the Nation as a whole not to jeopardize the ready access of industry to an adequate and efficient capital market. Finally, the Commission recognizes that in the field of stabilizing it is faced with an existing condition, not a theory.

(F) *Alternative courses of possible commission action*—(1) *Prohibition.* Stabilization is regarded by many experts as a necessary adjunct to our present capital markets. Neither the investment banking industry nor the Commission has as yet found any immediate practicable substitute for the present system. Furthermore, the alleged necessity of stabilizing under certain conditions of the market has not yet been disproved. Therefore, lacking proof that the underwriters' arguments as summarized above are unsound, it would seem premature for the Commission now to recommend, or take other steps towards, the outright abolition of stabilizing. It must be remembered that the constituency of our capital market does not include, as does that of some other countries, a substantial number of "investment underwriters" such as institutional investors, including investment trusts, which underwrite the unsold portion of an issue with the intention of holding for investment the securities which they must take up under their underwriting agreement. Nor is the development of a substantial amount of such "investment underwriting" capital in any immediate prospect. Although the recent avid buying by banks and insurance companies of prime grade investment bonds makes up to some extent for the absence of any real "investment underwriting" in our present day market, it must be remembered that this source of capital is available only for this limited type of security.

Our conclusion seems obviously to have been contemplated by Congress. Some of those whose deep-seated objections to stabilizing have resulted in their recommendations that stabilizing should be prohibited or that it should not in any wise be countenanced by this Commission have implied that either the Congress or its committees contemplated its abolition. Any such implication is not warranted by the legislative history of the Securities Exchange Act of 1934. Neither the Senate Committee on Banking and Currency nor the House Committee on Interstate and Foreign Commerce, both of which considered the bill, recommended in their reports on the legislation that stabilizing should be prohibited in its entirety. On the contrary, the mandate to the Commission, as explained by the Committees of Congress, was to guard investors and the public "from the vicious and unsocial aspects of these practices" by "regulation", not prohibition. Congress through its committees, as well as through the Act itself, thus recognized that not all the aspects of stabilizing are necessarily so deleterious as to justify, on a balance of interests, complete prohibition of all stabilizing.

Many of those who object to the Commission's adoption of a program of regulation of stabilizing do so on the further ground that any stabilizing, no matter how regulated, constitutes an interference with the free forces of supply and demand. The Commission cannot regard that, in and of itself, as a cogent objection. It must be recognized that there are times when the "free play" of the "forces" of supply and demand may, if unrestricted, produce socially or economically undesirable consequences.

A method of security distribution has not yet developed under which slight day-to-day fluctuations in market price will not play so preponderant a role as they now appear to do. A workable alternative for the present distributing mechanisms has not yet been devised which we can be sure will dispense with the alleged necessity of stabilization. It is by no means certain that the costs to investors and industry of prohibiting stabilizing would not outweigh the damage which might result from its use under appropriate restrictions.

Those who oppose rules which would permit stabilization say that against the duty of this Commission to protect the interest of investors, no considerations of the needs of industry for capital should be permitted to prevail. They thus depict a sharp antithesis between the needs of the investor and the needs of industry. The antithesis is by no means so sharp. In the first place, the needs of a corporation for capital and the welfare of those who are already investors in that corporation are often identical. Moreover, the welfare of even the purchasing or new investor is by no means certain to be served by hampering the present mechanisms of distribution if the interference, while safeguarding him from all possible injury due to stabilizing, will substantially contract industrial expansion. Such contraction spells industrial depression, and industrial depression is no boon to purchasing investors. To buy securities cheap is folly if they continue to grow cheaper.

Until the foregoing questions can be answered, the Commission does not feel that the facts now warrant it in recommending the more drastic step of prohibiting all stabilization of security prices. While the solution may ultimately be found in sweeping changes of the entire structure of the capital market, neither our underwriting industry nor our national economy now seems ripe for such a step.

Our conclusion is reached not at all by giving a controlling consideration to the interests of underwriters. It is reached because of the needs of industry for capital—needs which it has not been demonstrated can be served without stabilizing. We cannot accept the suggestion that such industrial needs must not be allowed to play any part in the actions of this Commission when they run contrary, to any extent, to the interests of purchasing investors. Such was not the intention of Congress.

(2) *Inaction vs. Regulation.* Whatever the vices of unregulated stabilizing, it would seem to be beyond question that the public interest, as well as the interest of investors, will be better served by regulating stabilizing than by leaving it unregulated.

One of the major factors which led to the Commission's inaction in the past has been the opposition to the adoption of rules pred-

icated on the following reasoning: All stabilizing unquestionably involves potential dangers to the great mass of direct individual investors. If the Commission adopts any stabilizing rules it would mean that it was recognizing and thereby, to that extent, legitimatizing stabilizing. The proponents of this view believe that the Commission must not, by any action on its part, make itself responsible for stabilizing.

When first encountered, these views were appealing to the Commission which recognizes, as any intelligent observer must, the potential dangers involved in stabilizing. Those views give every member of this Commission a feeling of anxiety when considering the issuance of any stabilizing rules. But on careful analysis those views are fallacious.

In the first place, Congress did not abolish stabilizing. It authorized this Commission, by regulation, to eliminate only "the vicious and unsocial aspects of those practices." It will not do for this Commission to proceed on the basis of a viewpoint which Congress, in its wisdom, did not find acceptable.

Those who dwell on the virtues of complete abolution of stabilizing have, nonetheless, always been unwilling to urge that the Commission adopt rules prohibiting the practice in its entirety. Nor have they suggested that the Commission urge Congress to amend the Act so as to abolish stabilizing. They seemed tacitly to recognize that the Commission would be in a poor position to follow either of these courses unless and until it issued some regulations, observed them in operation, and then reported on their consequences because, absent such study and report, we could supply Congress with no new evidence, gathered since Congress rejected recommendations for the prohibition of stabilizing. Yet, paradoxically, those theoretically opposed to stabilizing have objected to having the Commission adopt any rules the operation of which can be studied.

The position of those who urge continuance of a policy of nonaction is untenable for a further reason. Under the Securities Exchange Act as it now stands, many forms of stabilizing, no matter how vicious, are lawful except to the extent that they may violate rules of the Commission or other provisions of law. For instance, with the exception of Regulation X–9A6–1 which became effective February 15, 1940, the character and extent of stabilizing purchasing is wholly unregulated. Market prices in some situations may even be "pegged" above the public offering price. In the absence of regulation, stabilizing may be lawfully employed under many other circumstances where it is both ethically and economically indefensible. And it would seem futile to hope that, absent regulation, so temperate a use of stabilizing will be made as to render governmental regulation unnecessary. Under a program of regulation, however, the flagrant abuses of stabilizing which are cited, curiously enough, both by those who advocate prohibition and by those who favor continued nonaction would no longer be lawful.

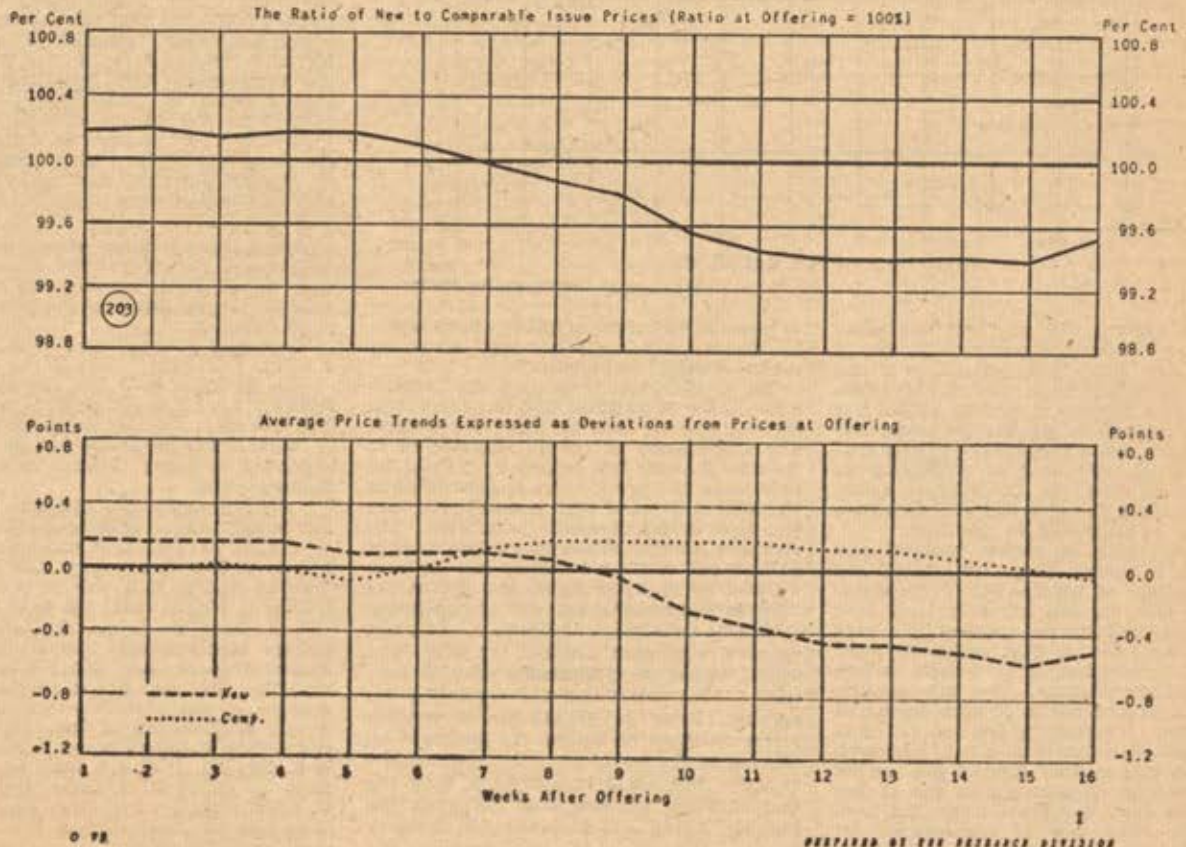
There is no denying the fact that to allow any stabilizing, in order to achieve the Congressional objective of not seriously interfering with the needs of industry for capital, may to some extent block the other Congressional objective of protecting the individual, direct investors who buy securities. The possibilities of injury to such buyers, resulting from stabilizing, can be reduced—although perhaps they cannot be wholly eliminated—by careful regulation of stabilizing. To that limited extent the one objective of Congress must give way to the other. With study and care we may be able, by regulation, to reduce to a very narrow compass the area of conflict between those objectives. Or we may witness such changes in our investment machinery as to make stabilizing of relatively little importance. It is not inconceivable that through the development of new types of investment companies, we shall some day have true underwriters with ample capital (representing the savings of a large number of individual investors) who will not need to rush to the market, and who will not feel it necessary to restrict their investments to bonds, as do most institutional investors today.

If no such or similar development occurs and if, after a period of working with regulated stabilizing, we find that the injury to purchasing investors is uncontrollably too great, then, *but not before*, we should request Congress to determine which of these two objectives is to be paramount.

G. *The advantages of piecemeal regulation.* Enough has been said to indicate the scope of the difficulties which stabilization presents from the point of view of industry, the underwriter and the investor. The technical problems incident to regulation of different types of stabilizing are varied and intricate. One of the major deterrents to earlier action on stabilizing rules has been the Commission's reluctance to adopt any program of comprehensive regulation upon the workability of which competent representatives of the industry could not reach substantial agreement. These considerations, coupled with its own awareness of the economic potentialities of its actions, resulted in the Commission's decision to attack the problem piecemeal, step by step. Segments of the larger problem may be isolated and an approach to its ultimate solution may be made through the regulation of those segments.

The area in which abuses have been and can again become most prevalent is stabilizing in connection with so-called "market offerings" where the price is represented to be at, or based upon, open market prices established by the ebb and flow of supply and demand. Before the act, operations to facilitate this type of offering often constituted

THE BEHAVIOR OF NEW ISSUE PRICES DURING DISTRIBUTION
(1921 - 1931)



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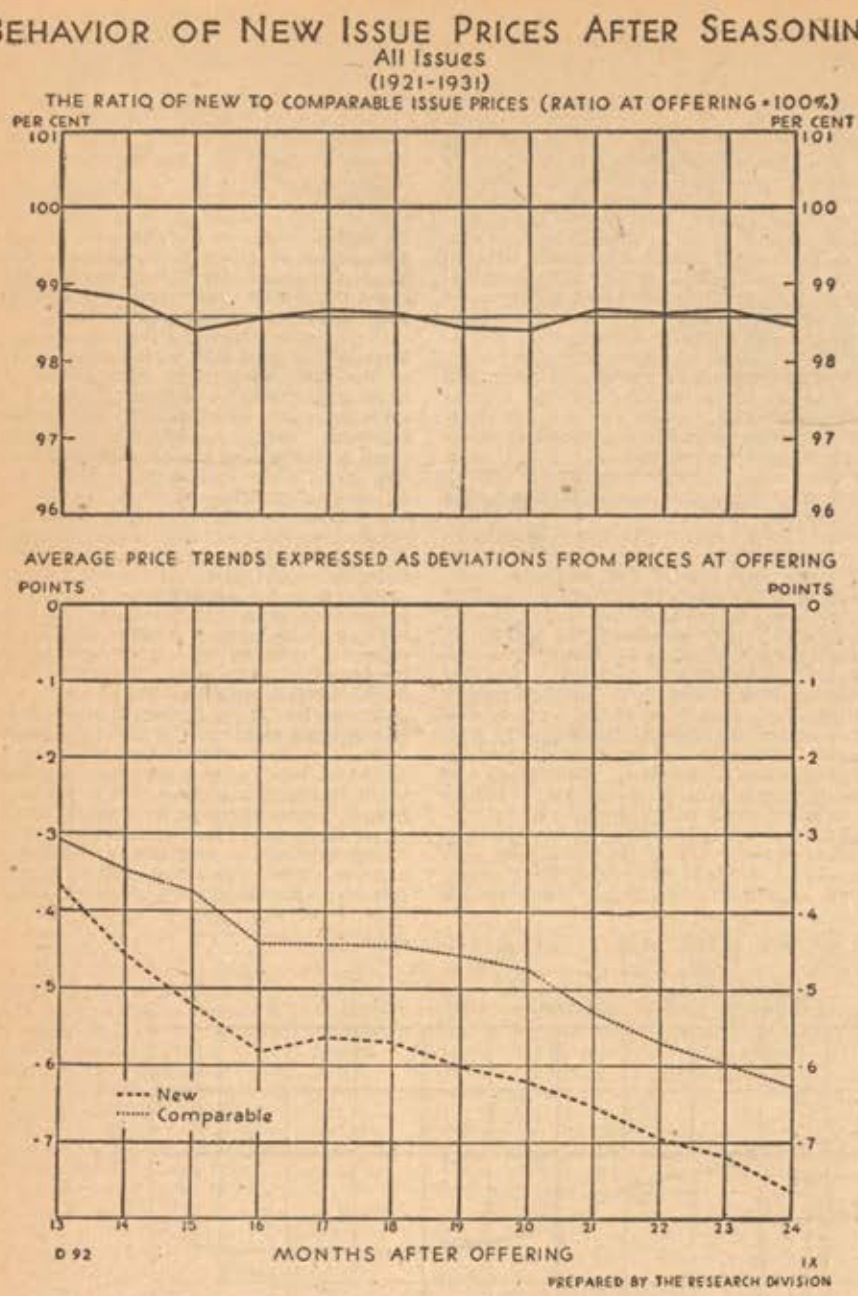
PREPARED BY THE RESEARCH DIVISION



the most flagrant type of "pool manipulations" now outlawed by section 9 (a) (2) of the statute. Since 1934, stabilizing of the type now covered by Regulation X-9A6–1 continued to be subject to various abuses not otherwise prohibited by the Securities Exchange Act. It was because of the very susceptability of this kind of stabilizing to grave abuses that the Commission determined to apply the first test of substantive regulation of stabilizing to this field.

The new rules, of course, prohibit any "mark up" of prices. They also prohibit any rigid "pegging" of the market. Since stabilizers on each day can buy only on a scale down until the price has dropped by a fixed amount, the rules in effect permit no more than the maintenance of an orderly market during the distribution. The rules require stabilizers to give notice of their intention to stabilize. If stabilizing has actually been commenced, that fact must also be disclosed. Stabilizers may neither support the market nor profit from its independent rise at any price more than one point above the level at which stabilizing is commenced. Of course, the rules also prohibit any stabilizing at prices to which the stabilizers have reason to believe the security has been previously raised by illegal manipulation.

The Commission recognizes that experience under Regulation X-9A6–1 may well demonstrate the need for its future revision. The Commission is not so sanguine as to consider that the rule is perfect. Indeed, we may reach the point where operation under the rule will prove that stabilizing within this area should be wholly prohibited. The rule does, however, represent the first attempt to find out whether investors can be safeguarded by workable regulation against the "vicious and unsocial aspects" of stabilizing.

Separate statement of Healy, C. I do not approve Regulation X-9A6–1 (17 CFR, 240.-9a6–1) which the Commission adopted January 3, 1940, permitting and regulating the pegging, fixing or stabilizing of security prices on stock exchanges "to facilitate an offering at the market of any registered security". Nor am I in sympathy with the Commission's "Statement of Policy on the Pegging, Fixing and Stabilizing of Security Prices". Because of the importance of the problem, I think it best to record the reasons for my dissent.[1]

I. *The statute.* One of the causes leading to the enactment of the Securities Exchange Act of 1934 was the fact—sought to be corrected by the Act—that frequently the prices of securities on securities exchanges and over-the-counter markets had been manipulated and controlled with resulting harm to investors and to our national economy generally.[2] To banish such evil practices Congress enacted certain provisions. These provisions are contained in section 9 of the Act.

Only two of the subsections of section 9 are pertinent here; one prohibits manipulation and the other outlaws "pegging, fixing, or stabilizing" to the extent provided by the rules and regulations of the Commission. The provisions are as follows:

"Section 9. (a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange:

* * * * *

"(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

* * * * *

"(6) To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

The differences between "manipulation" and "stabilizing" are often difficult of perception.[3] It is not surprising, therefore, that in almost every "manipulation" case the claim is advanced that the activities of the respondent were "stabilizing" activities.[3a] But under section 9 (a) (2) the Commission has consistently held, speaking generally, that a series of transactions in a stock effected for the purpose of maintaining its price at or about the level to which respondent previously had artificially raised it so as to induce purchase and sale by others violated the provisions of section 9 (a) (2).[4]

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[1] When the regulation was adopted by the majority of the Commission I reserved the right to set forth my views in connection with the regulation and the related statement of policy.

[2] Securities Exchange Act of 1934, section 2 (3).

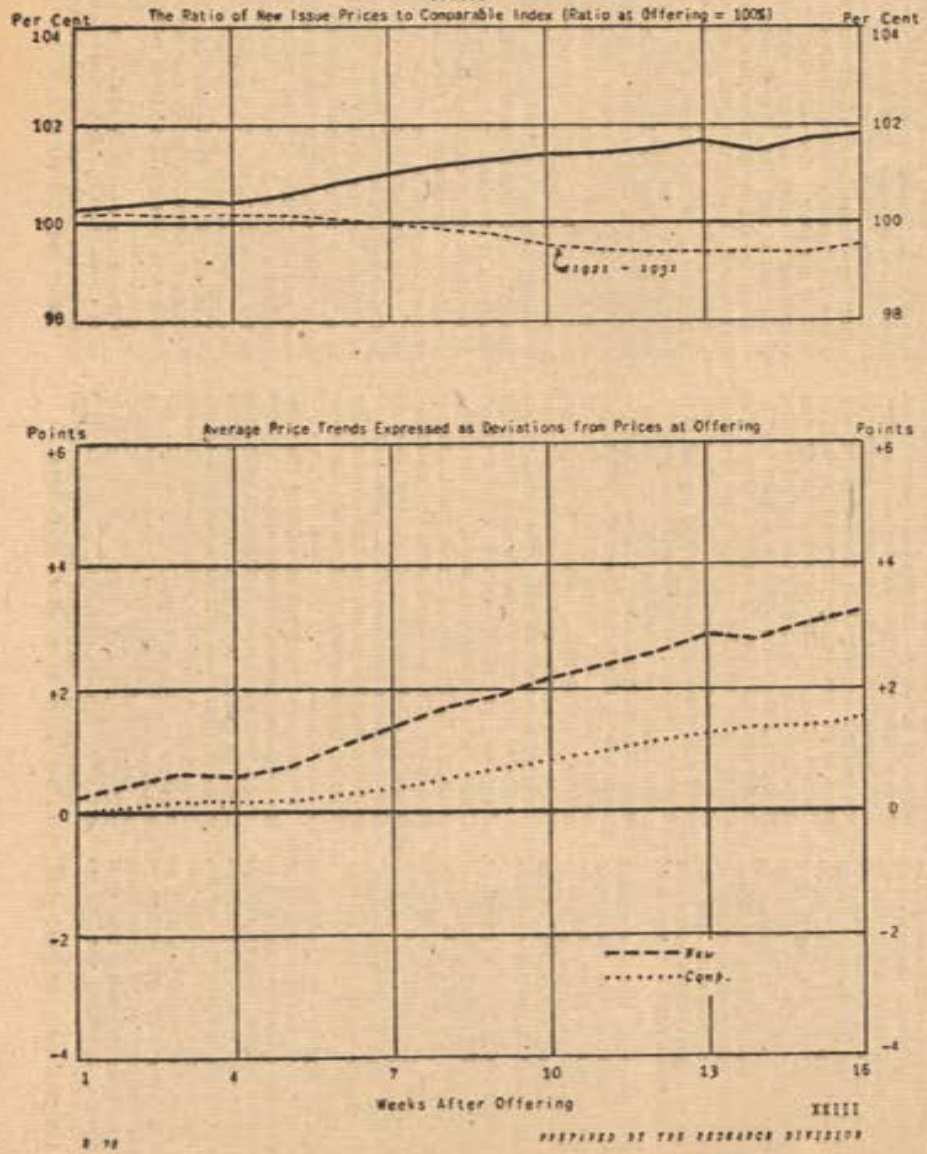
[3] See Woolsey, D. J., in United States v. Brown et al., 5 F. Supp. 81 (S. D. N. Y. 1933). The opinion in this case is invaluable because of its collection and analysis of the important pertinent decisions of both American and English courts.

[3a] For comments of a historian, see Beard and Beard, America in Midpassage (1939) 162.

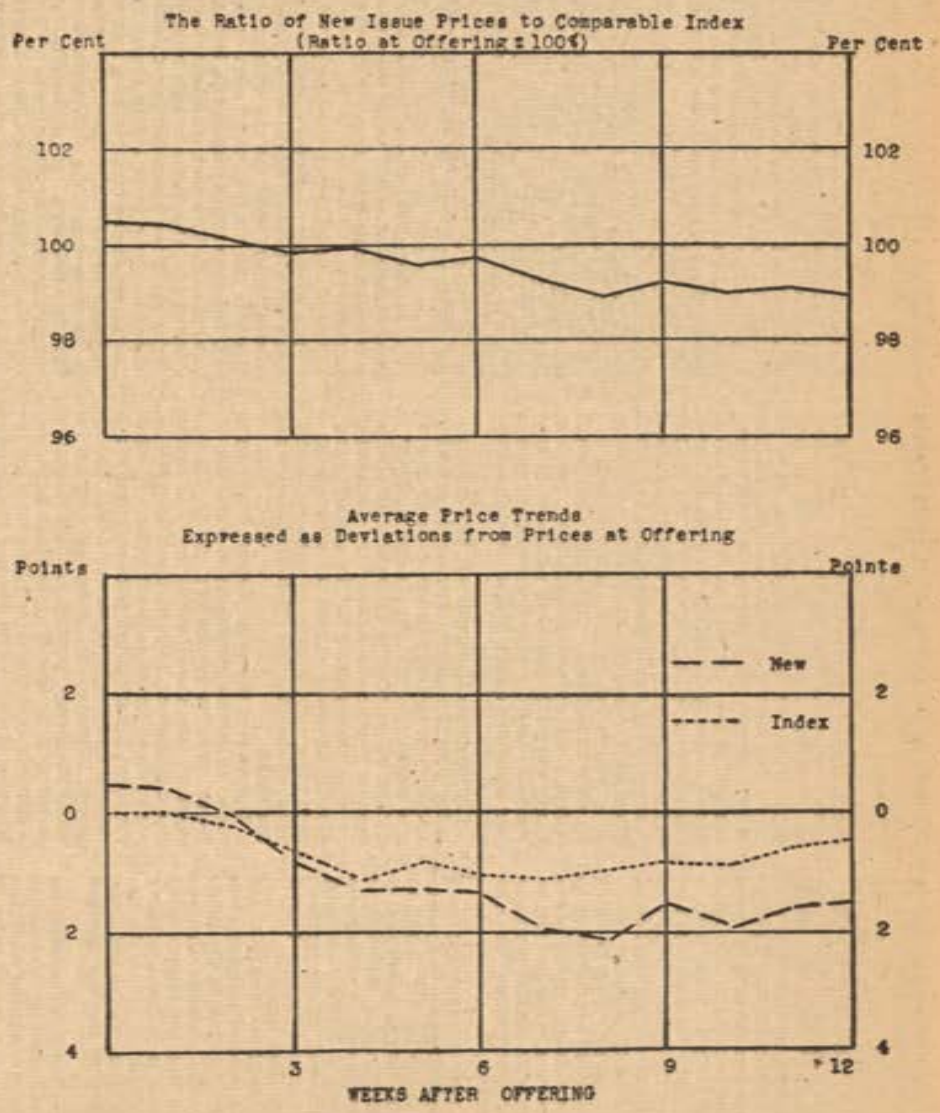
[4] E. g., In the Matter of Michael J. Meehan, 2 S. E. C. 588; In the Matter of White and Weld et al., 3 S. E. C. 486; In the Matter of Charles C. Wright et al., 3 S. E. C. 190.

A. A. Berle, Jr. in an article on "Stock Market Manipulation" (38 Columbia Law Review 393) advances the theory that the Securities Exchange Act of 1934 and certain sections of the Securities Act of 1933 are merely codifications of the law previously established in United States v. Brown et al., 79 F. (2d) 321 (C. C. A. 2, 1935) affirming 5 F. Supp. 81 (S. D. N. Y. 1933), cert. den. 296 U. S. 650 (1935). For other cases prior to Securities Exchange Act of 1934, see cases cited in note 17, *infra*.

THE BEHAVIOR OF RECENT NEW ISSUES DURING DISTRIBUTION
All Issues
(1935)



THE BEHAVIOR OF 23 STABILIZED BONDS DURING DISTRIBUTION
March 15 --- August 30,1939



The Commission has brought a number of suits for injunction and has developed and helped to prosecute a number of criminal cases in which the offense charged was that the defendants established artificial market prices and solicited orders for the stock at such prices without disclosing that the price on the exchange was an artificial one resulting from the sellers' activities on the exchange.[3]

[3] See Securities and Exchange Commission v. Torr, 15 F. Supp. 315 (D. C. 1936); S. C. 87 F. (2d) 446 (C. C. A. 2, 1937); S. C. 22 F. Supp. 602 (D. C. 1938); Koeppe & Co. v. Securities and Exchange Commission, 95 F. (2d) 550 (C. C. A. 7, 1938); Securities and Exchange Commission v. Saphier, unreported (D. C. 1936).

Though the statute outlawed "manipula-

Proceedings have been successfully prose-

tion", stabilizing activities were subjected to such treatment as this Commission found to be necessary in the public interest or the interest of investors. The claim has been made that Section 9 (a) (6) leaves the Commission with no authority to outlaw "pegging, fixing and stabilizing". With this claim, I do not agree. The truth, as I see it, is that Congress was intent upon outlawing stabilizing but because of the strenuous fight made against such a course, determined to leave the problem with the Commission with a mandate to solve it. This conclusion is fortified by a statement of the Senate Committee on Banking and Currency which considered the matter. That committee stated:

"Practices such as pegging, fixing or stabilizing the price of a security are subjected to regulation by the Commission, which is authorized to prescribe such rules as may be necessary or appropriate to protect investors and the public from the vicious and unsocial aspects of these practices." [8]

If this Commission took the view which I take, that so-called stabilization in connection with offerings "at the market" is not in the public interest and that prohibiting it is necessary for the protection of investors, it would be at liberty to say so and to make its view effective by enacting a rule forbidding it when the distribution is "at the market". My adherence to this position has been known to the Commission for some time.

II. *Analysis of Regulation X-9A6-1* (17 CFR, 240.9A6-1). The regulation became effective February 15, 1940. What is the stabilizing that the regulation permits? In general, it permits those who are selling listed securities to the public in either a primary or secondary distribution on or off the exchange to stabilize the price on the exchange, provided that they do so in the way specified in the regulation.

Speaking generally, the regulation provides that no person shall stabilize a security registered on a national securities exchange to facilitate an offering "at the market" of any registered security unless a notice of intention to stabilize has been sent to this Commission. The stabilizing need not be done by the persons making the offering nor need it be confined to the security being offered, but it may include any other registered security. Thus, if the offering is of a security of a holding company, the stabilizing could, in theory at least, be applied to every other registered security of that corporation and to every registered security of every subsidiary of the corporation. For example, in the case of Electric Bond and Share Company about ninety-six securities could be affected.

The regulation provides that purchases made during the course of the stabilizing operations may not be at a price above the price of the last sale on the exchange and at such price only when the highest price of the security on the date of such purchase exceeds the last sale price by ½ of 1% of the highest price or ¼ point, whichever is greater. Thus, purchases may not be designed to raise the price, but only to retard a decline. In no event may purchases above a "maximum price" be made. The "maximum price" may be as much as 102½% of (but in no case more than one point above) the price at which any stabilizer effects his first purchase of the security after the notice of intention to stabilize has been sent to the Commission. That price establishes the level above which the stabilizer can neither support the market nor profit from its rise. It must be admitted that these provisions are intended to prevent prices being run up and to prevent stabilizing at a level to which the price has been run up by manipulation. But stabilizing is admittedly a form of manipulation. There is, to my way of thinking, no difference in substance between raising a price by manipulation and maintaining a price through manipulation.

It is important to point out that the regulation does not apply to securities offered at a fixed price but only to securities offered "at the market". "Offering at the market" is defined as an offering in which the offering price is represented to be "'at the market' or at a price related to the market price". Stabilizing when related to offerings at a fixed price, not represented to be at the market or related thereto, is left unregulated and undefined.

I think that the worst possible situation in which to permit stabilizing is when the offering price is represented to be "at the market". Even when stabilizing is permitted in connection with an offering at a fixed price, the harm to investors is not to be overlooked for there the stabilized price may frequently mislead and injure those who buy. The investor, observing the exchange price or (as often happens) having had his attention called to it by salesmen, believes, as he has a right to, that the price is one made by the free play of supply and demand in a fair and unmanipulated market.[9] But when the offering price is "at the market" the possibilities of deception and injury to investors are immeasurably increased. Securities issued "at the market" are issued on the theory that the price is set not by the underwriter but by the interplay of the forces of supply and demand. Yet the regulation by permitting stabilizing of such securities permits an interference with the free forces of supply and demand and thereby tolerates the creation of a price mirage and the distortion of the price which would be set by the market if it were to function without artificial support.

The process of distributing "at the market" where the market is controlled by the distributors has in the past caused the public investors losses amounting to many tens of millions of dollars. These losses—losses which are actual and not theoretical—are mirrored in case histories. The practice was employed by the Cities Service Securities Company (a wholly-owned subsidiary of Cities Service Company) when the securities company in the period from April 1927 to December 1930 collected from the American investors $1,146,518,779 from the sale of Cities Service common stock. Its peculiar vice was that the money used to build up the price of the common stock on the Curb Exchange was obtained from the public to whom the stock was being sold on the over-the-counter market at constantly rising prices; prices made by purchases with money which the public itself was providing.[9a] Control of exchange prices was employed in connection with the distribution of securities of Associated Gas and Electric Company, United Founders Corporation, Corporation Securities Company of Chicago and the Insull interests in distributing common stock of Middle West Corporation, to name only a few significant examples.

For some years I have had a conviction which deepens with the reading of the Commission's Reports on Investment Trusts and Investment Companies, especially those dealing with United Founders Corporation and United States Electric Power Corporation, that the greatest injury done the investing public through the manipulation or control of stock exchange prices, was the pervasive, destructive and seemingly irresistible power of the print on the ticker tape to promote the distribution and sale of securities over-the-counter and by off-the-exchange solicitations—securities many of which were overpriced, some of which were worthless, and others of which were issued from unworthy motives.

That an offering "at the market" implies a price fixed by the forces of supply and demand free from artificial stimulation was recently made clear by the unanimous decision of the Sixth Circuit Court of Appeals in Otis & Co. v. Securities and Exchange Commission.[9] In that case the Commission had asserted that Otis & Co. had violated Section 17 (a) (2) of the Securities Act of 1933 which makes it unlawful to obtain money by any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the circumstances, not misleading. A secondary distribution of the stock of the Murray Ohio Company was involved. Representatives of Otis & Co. approached certain large stockholders some of whom agreed to sell Otis & Co. a number of shares at the current exchange quotation. They and certain other stockholders agreed not to sell any of their remaining shares for a period during which Otis & Co. was redistributing (reselling) the stock to the public over-the-counter. It was alleged that during the period of resale, Otis & Co. dominated the buying side of this stock on the Cleveland Stock Exchange where it was listed. During this period the exchange quotation rose from 4½ to 19. Otis & Co. offered the stock "at the market", and there was evidence that its salesmen called the market quotations to the attention of customers. Otis & Co. resorted to the claim of stabilization—a claim which has been made in practically every manipulation case the Commission has ever instituted—and asserted that the withholding agreement was beneficial to both distributor and purchaser. The trial court found that Otis & Co. made no disclosure of its withholding agreements or of its extensive stock exchange purchases while its salesmen pursuant to instructions were offering the stock to the public "at the market". Our counsel claimed and both the trial and the appellate courts agreed with him that an offering "at the market" could refer only to a "price standard which normally reflects the operation of a free and open market in the sale and purchase of" the security. The appellate court was somewhat more emphatic in its views than the trial court and said: "We have held that the appellant's (Otis & Co.) offering to sell 'at the market' must have been understood to imply a price fixed by supply and demand free from artificial re-

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cuted against persons who have engaged in activities resulting in the establishment of artificial market prices but which, in violation of Section 17 (a) (2) of the Securities Act of 1933, were not disclosed. See Coplin et al. v. United States, 88 F. (2d) 652 (C. C. A. 9, 1937), cert. den. 301 U. S. 703 (1937); Kopald-Quinn v. United States, 101 F. (2d) 628 (C. C. A. 5, 1938).

It is to be pointed out that in these cases the defendants in the injunction cases and the respondents in the criminal cases and in our cases suspending brokers from exchanges were found guilty of *raising* prices by manipulation to assist them in distributing securities; whereas the present rule permits not the raising of prices but the preventing of price declines. I can see no differences in substance between manipulation that causes a rise in price and a manipulation that prevents a fall in price. I believe there is no difference.

[8] S. Rep. No. 1455, 73d Cong., 2d Sess., p. 55.

[9] "When an outsider, a member of the public, reads the price quotations of a stock listed on an exchange, he is justified in supposing that the quoted price is an appraisal of the value of that stock due to a series of actual sales between various persons dealing at arm's length in a free and open market on the exchange, and so represents a true chancering of the market value of that stock thereon under the process of attrition due to supply operating against demand. (Citing cases)." Woolsey, D. J., in United States v. Brown et al., 5 F. Supp. 81, 85 (S. D. N. Y. 1933).

[9a] The price at which the stock was sold on the over-the-counter market was the previous day's closing price on the exchange.

[9] 106 F. (2d) 579 (C. C. A. 6, 1939).

straints and intentional stimulation, at least so far as appellant was concerned."[9]

The regulation permits stabilizing in the cases of both primary and secondary distributions. A primary distribution is, speaking generally, the first or original distribution of a security. The proceeds thereof usually go to the issuer. The secondary is, speaking similarly, a distribution or sale of a security by an individual owner who has owned it for some time. The avails of such distribution usually go to the owner of the security. Many secondary distributions are made by investors who, for reasons of their own (sometimes a poor opinion of the security or special knowledge of its weaknesses), wish to shift their investment or who are obliged to obtain cash for one reason or another. Many other secondary distributions have their origins in other motives. Many of them are generated by brokers or dealers who seek out owners of good sized blocks of shares, persuade them to execute an option or equivalent contract and then sell the securities either over-the-counter or on the exchange at a profit or for a commission.

The regulation specifies nothing as to the size of the offering involved. It follows that the secondary offering involved may be a very small one. It may be said that in such a case it will not pay the distributor to stabilize or that he will not have the necessary resources. That will be true in many cases; but there will be a residue of cases where it will not be true. They will consist principally of low-priced, low-grade securities whose intrinsic worth is open to the gravest doubt.

The regulation provides that no person subject to it shall stabilize unless he sends a notice of intention to stabilize to this Commission and to the exchange where stabilizing is to be effected. It is to be pointed out, however, that the person who gives the notice may or may not stabilize. Having given notice of his intention to stabilize, he may or may not do so; or he may stabilize on one day and not on another. He is required to make reports to the Commission (not to the exchange) describing his operations. These reports are to be made to the Commission on the first business day following the day on which the stabilizing occurs. Thus, reports of Monday's activities will reach the Commission the following Wednesday, and the reports of Saturday's deals will reach the Commission the following Tuesday. No provision has been made for making these reports public. The Commission has been urged to keep them secret. If they are not made public, the investor, at the most, will know no more than that a notice of intention to stabilize has been filed; he will not know whether the price of the designated security is actually being artificially maintained. No one will know, except some officers and employees of this Commission, the members and employees of the syndicate group and the brokers doing the stabilizing. It may be that a new and very undesirable type of speculation will develop, in which the real subject of the speculation will be not the merits of the security nor even the market trend, but whether the stabilizers are stabilizing!

Even if the reports are made public, they will be of limited usefulness to the investing public, for their contents will not be known at the best until several days after the stabilizing activities have occurred. Even this is premised on the unwarranted assumption that the contents of the reports filter through the country within a reasonable time after the reports are filed in Washington. It is true that those who make the offering in the over-the-counter market, through the mails or by office-to-office canvassing must state in the prospectus that notice of intention to stabilize has been filed, but they must immediately add, "This statement is not an assurance that the price(s) of the above security(ies) will be stabilized or that the stabilizing, if commenced, may not be discontinued at any time." If the distributor sells to any person otherwise than on an exchange, he must make written disclosure that stabilizing transactions have been effected, if that is the fact. However, this notice need not be given until the completion of the transaction. This, according to the current view, need not occur when the buyer contracts to buy or even when he pays his money, but only when the security is delivered. Assume that a buyer pays his money, receives his security, then learns for the first time that the market price on which he relied had been artificially maintained by the man who sold the security to him. Assume further that he is dissatisfied and wants his money back. Is he entitled to it? The regulation, of course, does not attempt to say. And I am unwilling to hazard an expression on what his rights may be. I am convinced that in the absence of this regulation and on the basis of common law cases, he would have the right to rescind the contract for purchase and recoup his money or sue for damages in an action at law.

However, such a buyer is the only one who gets such notice. The security being stabilized will carry no distinguishing symbol on the ticker tape. The ordinary investor or speculator who buys and sells on the stock exchange will have no knowledge as to whether the stock is subject to such a notice of intention or whether it is in fact being stabilized. The short seller will not know that the stock he is selling short is being stabilized, and that, therefore, although the trend of the market may be downward, the price of his stock may not go down and that he may not be able to cover at a lower price.[9a] Likewise, those associated with the persons engaged in stabilizing can play the long side of the market with at least the assurance that a strong group is stabilizing the stock and that the chances of the price dropping are decreased.

The ordinary buyer and seller in the over-the-counter market (not referring now to the distributor and stabilizer) will likewise have no notice of the stabilizing. Relatively few persons throughout the country will see in the press a statement that a notice of intention to stabilize has been filed; fewer persons will understand what it means.

Furthermore, the person engaged in stabilizing is not forbidden to enter into "stand-off" agreements. Indeed, that one engaged in stabilizing may negotiate such an agreement is recognized by Form X-9A6-1 (17 CFR § 240.9a6-1), which is the form to be used to notify this Commission of an intention to stabilize.[10] This means that the distributor who artificially maintains the price or retards a price decline during the period of distribution may obtain options from all the principal holders of the security (even though he has not the slightest intention of exercising any or all of them) or obtain their agreement that during the period of distribution they will not offer their securities for sale. The effect is, of course, to diminish the supply while the distributor is artificially increasing the demand (referring here, of course, to secondary distributions). Such a practice is strikingly similar to that which this Commission and the United States District Court and the Sixth Circuit Court of Appeals regarded as unlawful in the Otis & Co. case, discussed above.[11]

III. *The Commission's statement of policy.* The Commission's statement of policy is not coextensive with the regulation to which it is addressed. The statement is addressed to the general problem of stabilization and not alone to that restricted phase with which the regulation is concerned. The statement of policy states that stabilization may be "broadly defined as the buying of a security for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public." Implicit in this definition is the admission, which the Commission's statement elsewhere expressly makes, that stabilization is one form of manipulation.[12] Defined with less euphemism it is a manipulation designed to help induce the public to exchange its money for a security which the underwriter is selling at a market price the decline of which, through his own acts, he is preventing or retarding.[13]

The statement agrees that "whatever techniques are followed * * * stabilizing represents a form of manipulation which interferes with free and open markets" but accepts the practice as "an integral part of the American system of fixed price security distribution". That a practice which enables an underwriter to shift the results of his mistakes (such as incorrect pricing and poor distribution) to the public is accepted by the majority as "an integral part" of our system of security distribution is discouraging.

The philosophy of the Commission's statement is much the same as that of the Dickinson Committee whose report to the Sen-

[9] For cases where the Commission has held registration statements defective for failure to amplify the statement that securities are to be offered "at the market" by disclosing past or proposed manipulation of the market and other factors affecting it, see: Rickard Ramore Gold Mines, Ltd., 2 S. E. C. 377; Canusa Gold Mines, Ltd., 2 S. E. C. 548; Old Diamond Gold Mines, Ltd., 2 S. E. C. 786; Queensboro Gold Mines, Ltd., 2 S. E. C. 860; Ypres Cadillac Mines, Ltd., 3 S. E. C. 41; Thomas Bond, Inc., Securities Act Release No. 1980; Potrero Sugar Co., Securities Act Release No. 2054; Austin Silver Mining Co., Securities Act Release No. 1774; and Unity Gold Corporation, Securities Act Release No. 1776.

[9a] The Act does not outlaw short selling. It provides (Section 10) that it shall be unlawful to effect a short sale of any registered security in contravention of such rules and regulations as the Commission may prescribe. The Commission has adopted one rule limiting and regulating but not forbidding short sales. See Rule X-10A-1.

[10] Item 4 of Form X-9A6-1 reads: State which of the persons named in Item 1 has made or caused to be made any contract or arrangement which is in effect whereby the right of any person to sell any securities of the issuer of the securities involved in the stabilization (other than the securities which are or were comprised within the offering) was in any manner limited or restricted, and attach as Exhibit A a copy of each such contract and arrangement or, if oral, outline briefly the provisions thereof.

[11] Otis & Co. v. Securities and Exchange Commission, 106 F. (2d) 579 (C. C. A. 6, 1939).

[12] Clearly defined, "manipulation" is "a planned effort by an individual or group of individuals to make the market price of a security behave in some manner in which it would not behave if left to adjust itself to uncontrolled or uninspired supply and demand". Twentieth Century Fund, Inc., The Security Markets (1935) 444.

[13] A series of transactions raising the price for the purpose of inducing buying by others violates Section 9 (a) (2) of the Act and results in jail sentences, injunctions and disbarment of brokers from exchanges. A series of transactions designed to prevent or retard a decline in the price of a security in order to facilitate its distribution to the public is quite permissible!

ate[14] spoke of legitimate and illegitimate pools. That report said:

"* * * the underwriters support the market by trading in the securities on the exchange until the distribution is completed. This has been criticized on the ground that the public could have bought at a lower level if the underwriters did not support the market. If the security is properly priced, however, this transaction is not properly subject to criticism, since otherwise no undewriter could distribute at the public offering price, and if he could not, he could not have afforded to enter into a firm commitment to pay to the corporation the money and the latter, if it had no underwriting and had not completed its sales or securities before its maturity, might default. Naturally, such transactions may be perverted from their normal uses by 'rigged' quotations on the exchange so that when the syndicate stops trading, that is 'pulls the plug', the price sags and the public has a security which is selling several points below the public offering price. Such a sag in price, however, may in some cases be due to poor distribution of the security, i. e., it was sold to too many market traders rather than investors, so that the sales exceed the demand rather than to any intrinsic defect in the security."[15]

I find myself in accord with but little of this reasoning. The report says for example, "If the security is properly priced * * * this transaction is not properly subject to criticism". If this statement is sound the converse thereof should be equally sound, i. e., if the security is not properly priced, the transaction is properly subject to criticism. When is a security properly priced? What is a proper price if it is not one established by market based on supply and demand unaffected by unnatural restraints and stimulation? The stabilizing rule puts a premium on improper pricing in that the burden thereof may be passed to the public. It removes the one standard by which some sort of intelligent judgment can be formed as to whether the security was properly priced. It will make for a poor and inexpert corps of underwriters. But the Dickinson Report continues as an answer to possible criticism, "otherwise no distributor could distribute at the offering price". This is about equivalent to saying the distributor cannot induce the public to buy unless he is allowed to fool the public. The reasoning employed would almost justify taking the public's money by force if the corporation needing it had a maturity to meet. If an underwriter cannot distribute at the offering price without resort to artificially maintaining the price, he should not distribute at that price.

The Dickinson Report speaks of the possibility of the price sagging when the "plug is pulled" (i. e., where the stabilizing activities end) and ascribes this to rigging. There is no doubt that when the "plug is pulled" the price usually sags. It is a form of rigging, albeit a mild form. The price has often sagged when "the plug was pulled" merely because the supply has been increased at a rate out of proportion to the existing demand for the security. In such cases the price ought to sag. However, the report says: "Such a sag in price * * * may be due to poor distribution". There is no doubt that many sags have been due to poor distribution, but under this rule a premium is put on poor distribution. The distribution may be poor but if the stabilizing is effective the natural results of poor distribution will be postponed until after the distributor had made his profit.

In striking contrast to the Dickinson Report is the Pecora Report.[16] This report, happily, recognizes that there is no litmus to test the "good" and "bad" practices; it acknowledges the evils inherent in stabilization and does not seek to apologize for its conclusions.

In Section 3 of Chapter II of the latter report, investment banking methods are discussed. It is recognized that little true underwriting goes on (p. 93). With respect to pegging and stabilizing, it is said (p. 95):

"Obviously, the primary motive for artificially supporting the retail price is to afford the members of the selling group a period of time within which to induce the investing public to absorb the issue. Were the price to drop before all the bonds were sold, the bankers might be unsuccessful in disposing of the entire issue. The investor, relying upon the artificial price, is influenced to purchase the bonds by the apparent stability of the issue."

Instances are cited where the motive behind the pegging was merely to protect the interests of an individual who dominated the affairs of the corporation.

The report states further (p. 97):

"The pegging process operates to deceive the prospective investor. There is an artificial manipulation of price with a consequent misrepresentaton of the true market for the securities offered."

The conclusion supported by recitals of concrete instances, is "as soon as the bankers 'pull the plug', i. e., withdraw their support at the expiration of the period of primary distribution, there is a concomitant decline in the price of the bonds". Again the report:

"Thus the benefits accruing to the ultimate investor from this artificial price maintenance are negligible. Hence, the long term investor receives no lasting benefit from the stabilizing process."

Again (p. 99):

"No matter how the operation is characterized, its effect is the same—it creates the appearance of a stable market where public demand is maintaining the price, whereas in fact the stability is an illusion created by the manipulative practices of the bankers."

The history of "stabilizing" is accompanied by an impressive line of case-law holding that practice and substantially similar practices to be in effect "manipulation" and against the public policy and denying recovery under so-called stabilization agreements.[17] And this Commission has recognized that stabilizing possesses elements of harm against which the public was to be protected. In the promulgation of rules with respect to over-the-counter transactions the Commission promulgated a rule—Rule X–15C1–8 (17 CFR, 240, 15C1–8)—which provides:

"The term 'manipulative, deceptive, or other fraudulent device or contrivance', as used in section 15 (c) (1) of the Act, is hereby defined to include any representation made to a customer by a broker or dealer who is participating or otherwise financialy interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange that such security is being offered to such customer 'at the market' or at a price related to the market price unless such broker or dealer knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by him, or by any person for whom he is acting or with whom he is associated in such distribution, or by any person controlled by, controlling or under common control with him."

A practice which is deleterious on the over-the-counter market does not acquire propriety when practiced on an exchange!

The Commission's statement states that the "stabilizing can be apprized in the light not only of the needs of industry for capital, but of the prevailing methods of security distribution". What need be pointed out is that stabilizing operations are not necessary in the marketing of good issues properly priced and well distributed. Stabilizing becomes necessary only where the security is such that the underwriter must "make a market". In such a case it becomes the underwriter's weapon to defy normal market trends and to enable him to dispose of the securities at a price which he determines. At the same time it will give a fictitious appearance of strength to issues and attract investor's funds.

It is sometimes sought to justify stabilizing by pointing out that the process maintains a market for those investors who want to sell before completiton of the distribution. This claim is not to be denied, nor need it be, for the real question is whether the process of maintaining the market for the benefit of a few who decide to sell encourages others to buy at prices which cannot be maintained once the support is withdrawn. If the answer is yes, the few who sell during such period and the distributor are benefitting at the expense of the many who sell after the break. As between the two groups, our duty is to protect the genuine investor.

There is unanimity of agreement that stabilizing encourages the overpricing of securities.[18] By giving a pretense of trading activity and stability of price it invites buyers into the market. Thus the demand for the security is increased although the price is "out of line".

The Commission's statement states: "Some proportion of an issue offered to the public, even though it may be initially sold out by the underwriters to the selling group dealers, will find its way back into the open market. * * *" If these reofferings are not absorbed by public buying in the open market, their pressure will tend to force the market price below the original offering price." At another place in the statement reference is made to the argument that "stabilization is warranted in order to offset the market 'abnormalities' which result from the very fact of offering." I do not believe that an "abnormality" exists where supply exceeds demand. If supply is out of line with demand the price ought to fall and the underwriter ought not to be permitted, for the sake of his own purse, through the process of stabilizing to stop the fall long enough to permit him to pass the loss to the public. If the condition posed in the statement quoted above exists and if stabilizing is permitted the public will take the loss as soon as the "plug is pulled" and pay for the underwriter's error of judgment. The underwriter and not the public should pay for the former's mistakes. However, if the force of the argument be recognized, then those advancing it should also recognize that the permission to stabilize is not confined to cases where the threat to prices is due to the offering itself. The permission in fact takes no account of the cause of the decline. It may be due to a dozen other causes, such as gen-

[14] Stock Market Regulation, 73d Cong., 2d Sess. (1934).

[15] At pp. 13–14.

[16] Report of the Senate Committee on Banking and Currency pursuant to S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.), S. Rep. No. 1455, 73d Cong., 2d Sess. (1934). For a historian's comment on this report see, Beard and Beard, America in Midpassage (1939) 162–5.

[17] Harper v. Crenshaw, 82 F. (2d) 845 (D. C. App. 1936), cert. den. 298 U. S. 685. See also United States v. Brown, 5 F. Supp. 81 (S. D. N. Y. 1933), aff'd. 79 F. (2d) 321 (C. C. A. 2, 1935), cert. den. 296 U. S. 250; *Sanderson & Levi* v. British Westralian Mines and Shares Corporation, Ltd., Queens Bench Division, cited in United States v. Brown, supra; Scott v. Brown, L. R. (1892) 2 Q. B. D. 724; Berle, Liability for Stock Market Manipulation, 31 Col. L. Rev. 264 (1931).

[18] This fact is also acknowledged in the Commission's statement.

eral trends, disaster, et cetera. Still the stabilizing may continue—to the profit of the underwriter and to the detriment of the investor.

The Commission's statement frankly acknowledges that "stabilizing cannot as a practical matter be used to stem a market or economic trend of any real significance." This is certainly true. What need be added is that those who are induced to purchase securities during that brief period when the stabilizers are attempting to prevent the application to these normal trends and before their inability to do so for a substantial period is realized by them, will bear the burden of the attempt.

The Commission's statement makes reference to the results of an examination of stabilizing operations undertaken to facilitate the distribution of nineteen new bond issues. It appears that the average drop from original offering prices (after adjustment for market changes) was about 1.4% during the third month following their offering dates. These figures are of telling importance; particularly so when it is recalled that these nineteen issues were high-grade bonds and that they were offered during what was for the most part a "seller's market." These figures—taken from actual and not hypothetical experiences—make it abundantly clear that the genuine market begins when stabilization ends.[19]

The Commission's statement accepts the premise advanced by underwriters that they must always dispose of an issue within a few hours after the offering. That a speedy distribution is of value to the underwriter is not to be questioned in view of the restricted amounts of capital which the underwriters have and the very large amounts of participations which they accept.

I do not for one moment question the value of stabilizing to the underwriter. Some of them distribute nothing but high-grade first mortgage bonds where the underwriter's risk is at a minimum. Even in these cases the underwriting contract is completed by filling in the price and spread and amending the registration statement just a few hours before the public offering. In these cases the so-called underwriter often has informal assurance that every dollar of the issue will be sold almost at once. The underwriter naturally desires to eliminate from his undertaking every risk that he can eliminate. The fewer risks, the fewer his losses and the greater his profits. This is especially understandable in an underwriting system where the underwriter has little capital and accepts participations every year which exceed his total capital many times over. The tabulation set forth below is most revealing.[20] In such a system of underwriting the so-called underwriter tends to become a mere distributing agent or merchant.

In England, unlike the practice in the United States, the underwriters who take up an unsubscribed portion of an issue generally feel no haste in disposing of those securities. They realize that eventually a buyer will be found at the issue price or at a slight concession.[21] The haste of the American underwriters—admittedly a haste made necessary by their lack of capital—has often given rise to unnecessary losses. Underwriters have complained about the "failures" of certain issues. Though the claim is made that the underwriters were required to take substantial losses on such issues, the fact is that in some, though not all instances, if the underwriters had held the securities for a period they would have been able to sell the securities at a price above the original offering price and in the interim would have received the interest or dividends. The tabulation below is revealing.[22]

The self-interest of underwriters is human. We must not forget, however, that it is other people's money which they are seeking and that the savings of the public must not be taken from it by any method which is not strictly honest.[23] He who solicits from the owner of a large number of shares an option from which he then distributes over-the-counter with the aid of the tape print which he maintains through stabilizing operations, does not deserve to be called "underwriter." Such a course does not conform to the best standards of the market place.

Against the principle that underwriters should not be permitted to take the public's money by any means other than those strictly honest, no considerations of the paucity of underwriting capital or the needs of industry for capital should be permitted to prevail. I for one am convinced that all the needs of legitimate industry for capital can be met without resort to deception. To contend otherwise is no compliment to our industries.

I think our primary consideration must be the interests of investors for if the investor is driven from the market by unethical practices our whole system will collapse. Moreover, the investor is not the only one who is immediately affected by stabilizing. During the stabilizing period bank loans which are collateralled by the securities being stabilized will be effected,[24] and margin calculations will be based upon artificial prices. So too, the proper appraisal of the value of securities necessary for a fair calculation of taxes owed federal and state governments will be hindered.[25]

Only by giving controlling consideration to the interests of underwriters can it be said that stabilizing is in the public interest. The statute throughout speaks of public interest and the protection of investors as one and the same thing and I am convinced they are. In my opinion stabilizing is not in the interest of investors and thereby is against the public interest.

IV. The Commission's statement, using as an example an instance where an underwriter has entered into a firm commitment to distribute securities at a fixed price, refers to stabilizing as a practice which enables the issuing corporation to obtain from the underwriter a fixed sum of money at a fixed date. This example has little application to Regulation X-9A6-1 which has been adopted. This regulation is concerned with stabilizing only where the distribution is "at the market." In such case the market price is the offering price and there is no assurance to the issuing corporation that it will receive a fixed sum or a fixed price. Furthermore, the regulation is not limited to instances where firm commitments by underwriters have been executed. It applies equally to instances where the underwriter's obligation is that of merely exercising his best efforts to dispose of the securities. Here again the issuing corporation has no assurance of receiving a certain sum for there is no assurance that the entire issue will be sold.

[Securities Exchange Act Release No. 2446, March 18, 1940]

§ 241.2687 *Statement of the Commission respecting distinctions between the reporting requirements of Section 16 (a) of the Securities Exchange Act of 1934 and Section 30 (f) of the Investment Company Act of 1940.*

It should be noted that two marked differences exist between the requirements of Section 30 (f) of the Investment Company Act and Section 16 (a) of the Securities Exchange Act:

(1) The Investment Company Act requires reports not only from those classes of persons who are required to report under the Securities Exchange Act, but also from certain additional classes of persons. The classes of persons who must file on Forms N-30F-1 (17 CFR, 274.202) and N-30F-2 (17 CFR, 274.203) are the following: officers, directors members of advisory boards, investments advisers and their affiliates, and persons who own beneficially more than 10% of any class of outstanding securities (other than short-term paper). Those who are affiliates of investment advisers solely because they are employees are not required to report.

(2) Under the Investment Company Act, the reports relate to all classes of securities other than short-term paper. The reports under the Securities Exchange Act relate only to equity securities.

In regard to the classes of persons required to report on the new forms, definitions of all the classes named except "officers" may be found in section 2 (a) of the Investment Company Act. "Officer" is defined in the

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[19] Steiner and Lasdon, The Market Action of New Issues—A Test of Syndicate Price Pegging, 12 Harv. Bus. Rev. 339 (1934). This article reports the results of a study of 288 issues and concludes that, "Of the 288 issues studied, 227, or 78.7% broke their offering prices within the six-month period. * * * Deducting convertible obligations * * * it was found that 203 out of 256 nonconvertible obligations, or 79.3%, broke their offering prices within the stipulated period. Considering amounts instead of number of issues, $6,327,700,000, or 75.1%, of the sum total of $8,427,900,000 worth of issues studied broke their offering prices. When the adjustment was made for convertible obligations, $5,467,600,000, or 77.5%, out of a total of $7,057,000,000 declined below the original price.

[20] Ratio of average participations to average capital, 1934-39:

[In millions of dollars]

Company	Average capital employed	Average yearly participations*	Ratio average yearly participations to average capital
Morgan Stanley & Co., Inc.	8	147	17.51
Smith Barney & Co.	10	127	12.57
Kuhn, Loeb & Co.	16	142	8.99
First Boston Corporation	11	142	12.84
Dillon, Read & Co.	6	52	9.18
Blyth & Co.	4	93	23.83
Harriman, Ripley & Co.	7	141	19.58
Mellon Securities Corp.	12	50	4.11

*Excludes municipal securities.

[21] Twentieth Century Fund, Inc., The Security Markets (1935) pp. 79-84.

[22] The table below does not purport to include all issues since 1936 which were not successful. Complete information is not available to the writer.

	Date of issue	Price to underwriter	Date on which issue first went above price to underwriter	Price 12/31/39
Shell Union Oil 3¼s 1951	3/10/36	97	7/9/36	102 3/32
Northern States Power $5 p'fd.	2/11/37	100¼	11/19/38	111
Pure Oil 5% cum. p'fd.	8/23/37	97½	.....	78¼
Bethlehem Steel 3½s 1952	8/30/37	98	week of 11/5/38	107¼
Central Illinois Public Service 3¼s 1968	12/8/38	98¼	1/5/39	103
Shell Union 2½s 1954	7/19/39	96¾	.....	95¾
Southern Bell 3s 1979	7/20/39	106	.....	105
Ohio Public Service 4s 1962	8/26/39	100¾	2/23/39	109

[23] Cf. Brandeis, Other People's Money (1914).

[24] Securities Exchange Act, sections 2 (2) and 2 (3); American Sumatra Tobacco Corp. v. Securities and Exchange Commission, decided January 2, 1940, Court of Appeals for the District of Columbia.

[25] This point is recognized in the Act. See section 2 (3).

instructions to the forms to mean president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers. It is the opinion of the General Counsel of the Commission that an assistant would be an "officer" if his chief is so inactive that the assistant is really performing his chief's functions. However, an assistant, although performing some functions which might be those of his chief, would not be an "officer" so long as these duties were under the supervision of his chief. Temporary absence or brief vacation of an officer during which an assistant performs the officer's duties would not constitute the assistant an "officer." Subject to the foregoing, assistant treasurers, assistant secretaries, and assistant comptrollers, for example, are not to be considered "officers" for the purposes of this definition.

[Securities Exchange Act Release No. 2687. November 16, 1940]

§ 241.2690 *Statement of the Commission issued in connection with the adoption of Rules X-8C-1 (17 CFR, 240.8C-1) and X-15C2-1 (17 CFR, 240.15C2-1) under the Securities Exchange Act of 1934 relating to the hypothecation of customers' securities by members of national securities exchanges and other brokers and dealers.*

Application of rules—(a) *Rule X-8C-1* (17 CFR, 240.8C-1). This rule applies to all members of national securities exchanges, and to all brokers and dealers who transact a business in securities through the medium of any such member.

(b) *Rule X-15C2-1* (17 CFR, 240.15C2-1). This rule applies to all brokers or dealers regardless of whether they are members of a national securities exchange or do a business in securities through the medium of such a member. The rule defines as a "manipulative, deceptive or other fraudulent device or contrivance" any hypothecation of customers' securities except under the same circumstances as are specified by Rule X-8C-1.

Prohibitions of the rules. Since the two rules, in effect, are identical in scope and text they will be discussed and explained together. Throughout this summary the term "broker" will be used to mean a member, broker or dealer. The rules contain three simple prohibitions which, generally speaking, coincide with the three clauses of Section 8 (c) of the Securities Exchange Act of 1934.

In effect, paragraph (a) of the rules provides that:

(1) A broker may not hypothecate securities carried for the account of his customers in such a way as a permit such securities to be commingled with securities of other customers unless he first obtains the written consent of each such customer;

(2) A broker may not hypothecate securities carried for the account of his customers under a lien for a loan made to the broker in such a way as will permit such securities to be commingled with securities of any person other than a bona fide customer; and

(3) A broker may not hypothecate securities carried for the account of his customers in such a way as to permit the liens of pledgees thereon to exceed the aggregate indebtedness of all of such broker's customers in respect of securities carried for their accounts.

Definitions. For the purposes of these rules the term "customer" does not include general or special partners or directors or officers of the broker, as the case may be, but does include other members, brokers or dealers. By excluding from the term "customer" any participant as such in any joint, group or syndicate account with a broker or any partner, officer or director of the broker, the rule permits the broker or any partner, director or officer thereof to participate with others in such accounts.

The term "securities carried for the account of customers" is defined by the rules to mean (1) securities received for the account of a customer; (2) securities sold, and earmarked or otherwise appropriated, to a customer; and (3) securities sold, but not appropriated, by a dealer to a customer who has made any payment on account, to the extent that the dealer owns and has received like securities. However, where securities are sold to a customer on a dealer basis, and where the securities are subject to a lien, they do not become "securities carried for the account of a customer" pending their release from such lien as promptly as practicable. Securities which are not "carried for the account of customers", of course, are not subject to the rules.

The rules provide that "aggregate indebtedness" of a broker's customers shall not be deemed to be reduced by reason of uncollected items. Thus, if the broker receives a check, part or all of the proceeds of which are to be credited to a customer, the "aggregate indebtedness" of customers is not reduced by the amount of the check until it has cleared. In the usual case, customers' debits are reduced or paid off by checks. Consequently, before such reductions in the "aggregate indebtedness" of customers actually occur, the broker will normally have a reasonable period of time between receipt of checks and their clearance in which he can reduce loans collateralized by customers' securities in order to prevent a violation of paragraph (a) (3) of the rules.

In computing the "aggregate indebtedness" of two accounts, one of which guarantees the other, they are to be treated as a single account and are to be considered on a consolidated basis. Furthermore, in the case of accounts in which both long and short positions are carried, the "aggregate indebtedness" of customers includes an amount equal to the market value of securities short in such accounts.

The rules also provide that in computing the total amount of the liens to which customers' securities are subject, a broker or dealer may disregard any rehypothecation thereof by another broker who is also subject either to Rule X-8C-1 (17 CFR, 240.8C-1) or Rule X-15C2-1 (17 CFR, 240.15C2-1).

Exemptions. Generally speaking, brokers should have no difficulty in complying with the requirement of paragraph (a) (3) that a broker must not pledge his customers' securities for a sum which, in the aggregate, is greater than the total amount that his customers owe to him on securities carried for their accounts. Good brokerage practice alone would make it desirable for a broker to borrow substantially less on customers' securities than customers owe him. There should thus be a "cushion" of his own capital between the amount of customers' debits and the amount of the broker's bank loans on customers' securities. This "cushion" should be sufficient in size to absorb any reasonably anticipated reductions in customers' indebtedness.

Nevertheless, in order to take care of the exceptional situation where customers' indebtedness is paid off in so great an amount as to use up this "cushion" and thus to reduce the total of customers' debit balances below the broker's current borrowings on customers' securities, this paragraph contains an exemption. The exemption provides that paragraph (a) (3) shall not be deemed to be violated if, as a result of reductions in the aggregate indebtedness of customers on any day, the amount of the liens to which customers' securities are subject during that day exceeds the total indebtedness of customers in respect of securities carried for their accounts. A payment by a customer on any day which reduces the amount which the customer would owe the broker on that day had the payment not been made is regarded as a reduction of indebtedness on that day within the meaning of the rules.

This exception is a limited one and is applicable only if funds [or securities][1] sufficient to reduce the liens to which customers' securities are subject are paid or placed in transfer to pledgees so as to eliminate any temporarily exempted excess as promptly as practicable after the reduction occurs. The phrase "as promptly as practicable", as used in this exemption and in paragraph (b) (2) of the rules, means as soon as possible in the light of all the surrounding facts and circumstances, such as the size of the firm and its staff, the scope of its operations, the volume of business and the physical, practical and geographical limitations.

However, if it is not practicable to eliminate such an excess of liens over customers' indebtedness on the day upon which it arises, the rules require that funds sufficient to eliminate the excess must be paid or placed in transfer to pledgees either before one half hour after the commencement of banking hours on the next banking day at the place where the broker carries his largest principal amount of loans or before the broker obtains or increases any bank loan collateralized by customers' securities, whichever is earlier.

Exemption for cash accounts. Paragraph (c) of the rules affords a limited exemption from the requirement of paragraph (a) (1) that customers' securities may not be commingled under a loan unless all of the customers concerned have consented to such commingling. This exemption is applicable only to securities which are carried for a customer in a special cash account within the meaning of Section 4 (c) of Regulation T of the Board of Governors of the Federal Reserve System.

Generally speaking, such a special cash account is one in which the member, broker or dealer purchases securities for, or sells securities to, a customer only if funds sufficient for the purpose are already held in the customer's account or if the purchase or sale is effected in reliance upon an agreement, accepted in good faith, that the customer will promptly make full cash payment for the securities.

The exemption afforded by the rules for the commingling of customers' securities without their consent, where the securities are carried in such a special cash account, is subject to the condition that at or before the completion of the transaction of purchase of such securities for, or of sale of such securities to, the customer written notice is given or sent to him disclosing that the securities are or may be hypothecated under circumstances that will permit the commingling thereof with securities of other customers. The term "the completion of the transaction" has the same meaning as is given to that term by Rule X-15C1-1 (b) (17 CFR, 240.15C1-1).

Exemption for clearing house liens. Paragraph (d) of the rules exempts from the operation of paragraphs (a) (2), (a) (3) and certain other provisions any lien of a clearing corporation or similar department or association of a national securities exchange for a loan made and to be repaid on the same calendar day, if it is incidental to the clearing either of securities or of loans through the clearing house. Thus, for all practical purposes, the broker, in operating under paragraphs (a) (2) and (a) (3) of the rules, can disregard his pledges of customers' securities under clearing house liens. However, in computing "aggregate indebtedness" the broker must also disregard any indebtedness in respect of any securities which are subject to a clearing house lien exempted by this paragraph.

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[1] The phrase "or securities" was added to the text here summarized by an amendment of the rules effective March 28, 1941.

Exemption for certain liens on securities of noncustomers. Paragraph (e) permits pledgees, whether banks or others, to have what may be referred to as a "one-way lien" against the broker's own securities. In discussing this exemption, brief reference must first be made to existing banking practices in the handling of brokers' loans. The usual type of loan agreement entered into between banks and borrowing brokers is designed to give the pledgee bank a lien upon all securities which the broker may place in the possession of the bank, for the full amount of all credit extended to the broker, even though some of such securities may be securities which the borrowing broker is carrying for the account of his customers. A broker's pledge of customers' securities under such circumstances to a bank, broker or other lender from which he is also borrowing funds collateralized by his own securities would, of course, violate paragraph (a) (2) because securities of customers would thus be commingled under a common lien with securities of persons other than bona fide customers. Paragraph (a) (3) might also be violated because customers' securities would thus be subjected to liens for a total amount equal to the sum of the broker's borrowings on customers' securities and his borrowings on his own securities, which total might, of course, exceed the aggregate indebtedness of all customers to the broker.

The type of loan agreement heretofore in force between banks and borrowing brokers in some cases also provides that the bank may rehypothecate any collateral deposited by the broker, alone or with other property, for an amount greater than the broker's borrowings from the bank. The bank's right to effect such a rehypothecation would, of course, also involve a breach of paragraph (a) (2) and paragraph (a) (3) of the rules. Furthermore, any right of rehypothecation by a bank which would permit the commingling of the broker's own securities with those of his customers would, in any event, violate paragraph (a) (2).

Similarly, under the "day loan" agreements which have been in general use, the lending banks have obtained a lien upon all securities bought or otherwise acquired with the proceeds of the day loan. Under such an agreement, where a firm uses the proceeds of a day loan to take up securities for its own account as well as for the account of customers, it would be hypothecating their securities and his own securities under a single lien.

The same situation normally exists where a broker is carrying an account of his own and an omnibus account for his customers with a second broker. Any lien which the second broker carrying the accounts may have against customers' securities in the omnibus account to secure the first broker's debit balance in his own account would likewise involve a violation by the first broker of paragraph (a) (2) and, in some cases, of paragraph (a) (3) of the rules.

In order to avoid such violations of Rules X-8C-1 (17 CFR, 240.8c-1) and X-15C2-1 (17 CFR, 240.15c2-1), brokers who pledge customers' securities with any pledgee from whom they are also borrowing on their own securities must see to it that the pledgee, whether it be a bank, another broker or any other lender, does not obtain a general or so-called "cross-lien" on customers' securities as additional collateral for other loans which it has made to the broker on his own securities or those of his partners on other non-customers. In other words, where a broker pledges customers' securities as well as his own securities with a single pledgee to secure several loans, one or more of which are made against the broker's own securities, it will be necessary that the pledgee does not have a lien upon customers' securities for any loan except other loans also made against securities carried for the account of customers of the same broker.

It will also be necessary to see that the pledgee, unless he is a broker or dealer subject to Rule X-8C-1 (17 CFR, 240.8C-1) or Rule X-15C2-1 (17 CFR, 240.15C2-1), does not have a right to rehypothecate customers' securities commingled with those of the broker or to rehypothecate customers' securities for a sum greater than the loans against those securities.

Furthermore, in situations where the broker will use the proceeds of a "day loan" to take up or otherwise acquire securities for his own account as well as for the account of customers, it will be necessary that, at any particular time, the lien of the pledgee under "day loans" upon securities of customers shall be no greater than that amount of the proceeds of the "day loans" as is then actually in use to acquire customers' securities, plus the amount of other loans (i. e., not "day loans") collateralized in whole or in part by customers' securities. Such a limitation on the lien of the "day loan" would prevent not only the violation of paragraph (a) (2) which would otherwise result from commingling customers' securities with the firm's own securities under such a loan, but also possible violations of paragraph (a) (3) which might so result.

The Commission understands that a substantial time before the rules become effective, banks which customarily do a loan business with brokers and dealers will have made appropriate revisions in their general loan agreements as well as in their "day loan" agreements designed to permit brokers to meet the requirements of paragraphs (a) (2) and (a) (3) of the rules.

Although paragraph (a) (3) of the rules does prevent a pledgee from having a lien on customers' securities for loans made against the brokers' own securities, paragraph (e) of the rules permits the converse. That is, it permits what might be called a "one-way lien" against the broker's own securities as additional collateral for loans made against customers' securities. To this end the rules provide that the broker may use his own securities as additional collateral for day loans and for loans which are "made against securities carried for the account of customers." For the purposes of this exemption, such a loan is defined as a loan which is obtained or increased only on the basis of securities carried for the account of customers. * * *[1] The exception does not permit the broker to deposit his own securities as collateral in substitution for customers' securities.

Notice requirements. Finally, paragraph (f) of Rule X-8C-1 (17 CFR, 240.8C-1) provides that no person subject to its provisions shall hypothecate any securities of a customer unless at or prior to the hypothecation he gives written notice to the pledgee that the security pledged is carried for the account of a customer and that the hypothecation does not contravene the rule. However, in the case of an omnibus account, where written notice to the broker carrying the account may not be practicable before each transaction which results in a pledging of the securities bought for the account, the member, broker or dealer for whom the account is carried need only furnish a signed statement to the broker carrying the omnibus account that all securities in such account will be customers' securities and that the hypothecations will not contravene the rule. Day loans which are made and to be repaid on the same calendar day are exempted from these requirements for the giving of notice to pledgee.

[Securities Exchange Act Release No. 2690, November 15, 1940]

[1] The deleted material was rendered inapplicable by subsequent amendment of the rules.

§ 241.2822 *Opinion of General Counsel, relating to paragraph (b) (2) (ii) of Rules X-8C-1 (17 CFR, § 240.8C-1) and X-15C2-1 (17 CFR, § 240.15C2-1) under the Securities Act, concerning the hypothecation of customers' securities.*

Your first question assumes a situation in which a dealer sells securities to an out-of-town customer. The customer instructs the dealer to deliver the securities to the X National Bank for his account against full payment of the purchase price to be made by the X National Bank. As soon as the dealer is in a position to make delivery he puts the securities into an envelope addressed to the X National Bank for the account of the out-of-town customer. At the same time, a bookkeeping entry is made showing the certificate numbers of the certificates which are to be delivered to the X National Bank in accordance with the customer's instructions. The dealer's messenger tenders the security to the X National Bank. However, the X National Bank for some reason refuses to accept delivery and to pay the purchase price. You ask whether such securities by reason of this act of identification have become "securities carried for the account of" the out-of-town customer under paragraph (b) (2) (ii) of Rules X-8C-1 (17 CFR, 240.8C-1) and X-15C2-1 (17 CFR, 240.15C2-1).

It is my opinion that under these circumstances the securities in question have not been "appropriated" by the dealer to the customer within the meaning of that paragraph of the Rules and therefore are not "securities carried for the account" of the customer. Such identification as has been made by the dealer is merely incidental to the mechanics of the delivery which is required to fulfill the sale. In my opinion, in situations where the terms of the sale call for delivery to the buyer or to an agent of the buyer against full payment of the purchase price, "appropriation" within the meaning of the Rules normally would occur only when delivery is made to the purchaser or the purchaser's agent and accepted by him.

As a second question, you ask when "appropriation" occurs if the out-of-town buyer instructs the dealer to ship the securities to him under a sight draft to which the securities are attached. I understand that in such a case the dealer gives the draft and the securities to a bank for transmittal and collection and that ordinarily such bank is considered the sole agent of the forwarding dealer for the purposes of transmission and collection. Here again, it is my view that the securities are not "appropriated" to the customer under the rules until they are delivered to the buyer or the buyer's agent and the draft has been honored. Whether the dealer gives the securities and the draft to the bank for "collection only" or obtains immediate credit from the bank on the draft by discounting it or otherwise is in my opinion immaterial.

Of course, this opinion as to when "appropriation" occurs in such a case is predicated upon what I understand to be the customary practice in the business. It is possible that special arrangements may be made between the parties as a result of which "appropriation" may take place before the delivery of the securities and the honoring of the draft. This opinion does not purport to pass upon such special cases.

Finally, you inquire when "appropriation" under the Rules takes place in dealers' transactions in which there is no agreement as to the time, method and place of delivery, or in which for other reasons prompt delivery of the securities sold is not contemplated. In those situations the securities would be considered to have been "appropriated" when the dealer segregates, identifies or otherwise earmarks the securities sold either by tagging them, by placing them in an envelope for the

customer or by identifying them by some other means, such as a bookkeeping entry, in the customer's account, of the certificate numbers of the securities sold to him. From that time on the securities are "securities carried for the account of" customers and, subject to the temporary exception for existing liens which paragraph (b) (2) (ii) of the Rules itself provides, any pledge of the securities would have to meet the requirements of the Rules.

[Securities Exchange Act Release No. 2822, March 17, 1941]

§ 241.3040 *Partial text of letter sent by the Director of the Trading and Exchange Division to certain securities dealers who had failed to keep records of the times of their securities transactions, as required by Rules X–17A–3 (17 CFR, 240.17a–3) and X–17A–4 (17 CFR, 240.17a–4) under the Securities Exchange Act.*

I wish to emphasize that paragraph (a) (7) of Rule X–17A–3 (17 CFR, 240.17a–3) specifically requires that "a memorandum of each purchase and sale of securities" for the account of your firm be kept which must show "the price and, to the extent feasible, the time of execution" of each transaction. The phrase "to the extent feasible" was intended to be applicable only in exceptional circumstances where it might be actually impossible to determine the exact time of execution. In this connection, I wish to point out that our experience has demonstrated that it is in fact feasible to keep the times of so-called "trading transactions". I might also add that a transaction is "executed" within the meaning of the rule when the contract to sell or purchase, as the case may be, is entered into by the trader or other person authorized to effect transactions for the account of the firm.

I therefore suggest that your firm take prompt steps to insure the recording of the times of all transactions executed by your trading department as well as of all other transactions. Even in unusual situations where it may be physically impossible to determine the precise time when the transaction was executed, the rule requires that at least the approximate time be noted.

[Securities Exchange Act Release No. 3040, October 13, 1941]

§ 241.3056 *Opinion of General Counsel, relating to the anti-manipulation provisions of section 9 (a) (2), 10 (b) and 15 (c) (1) of the Securities Exchange Act of 1934, as well as section 17 (a) of the Securities Act of 1933.*

You have asked me for my opinion as to the legality of certain transactions which you propose to effect in stock of the X Corporation, a security listed on a national securities exchange and registered under the Securities Exchange Act of 1934. As I understand the situation from your letter, you have made a study of the condition of the X Corporation, and have satisfied yourself that, at the current market quotation, the stock is underpriced. You have recently acquired a substantial block of the stock in a privately negotiated transaction, and contemplate making a public distribution of the block so acquired. In order to increase the size of the proposed redistribution you wish to purchase additional shares in the open market. Your letter indicates that you expect that your purchases of additional shares will have the effect of raising the market price of the stock to a figure somewhat closer to what you consider to be its true value. Your proposed redistribution would be at that increased figure.

In entering upon any such program, it is essential to keep in mind the provisions of section 9 (a) (2) of the Securities Exchange Act, which makes it unlawful, directly or indirectly, "to effect * * * a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or *raising* or depressing *the price* of such security, *for the purpose of inducing the purchase* or sale *of such security by others.* [The italics are mine.]

Your letter shows that a vital part of your program will be the expected rise in price which will enable you to make the profit without which you would naturally be unwilling to go into the operation. As you point out, any substantial buying on your part would naturally advance the price. Bringing about a price rise by extensive purchases is not unlawful in itself; this was recognized by the Senate Committee on Banking and Currency, which, in its report on the Act prior to its passage, said:

"To manipulate the price of a security by any series of transactions with the specific intent of raising or depressing the price, is prohibited by paragraph (3) [the present paragraph (2)]. Any extensive purchases or sales are bound to cause changes in the market price of the security, but mere knowledge on the part of the purchaser or seller that his transactions will have this effect is not sufficient to bring him within the scope of this provision. Thus, if a person is merely trying to acquire a large block of stock for investment, or desires to dispose of a big holding, his knowledge that in doing so he will affect the market price does not suffice to make his actions unlawful." Sen. Rep. No. 792, p. 17, 73d Cong., 2d sess.

The purpose of Section 9 (a) (2) is thus not to prohibit purchasing which may advance the market, or selling which may depres it. However, when purchasing is done under such circumstances that it must be expected to, and does, raise the price, and where the purpose of such purchasing is to induce others to purchase—presumably at the higher levels thus created—the statutory elements are present, and a violation of the Act is involved. The Act makes unlawful any series of purchases made for such a purpose, whether or not the purpose is achieved, i. e., whether or not any other persons do in fact purchase at the higher levels. And furthermore, it is immaterial that the program is undertaken in a bona fide belief that the security ought for some reason to be selling at the higher level.

As the existence of a violation of Section 9 (a) (2) is dependent upon the precise acts engaged in during the course of an operation and the purpose with which they are entered into, I am naturally reluctant to attempt any expression of opinion in advance as to whether any proposed operation will be in violation of the law. Only an analysis of the precise activities conducted can justify an opinion on such a question. And, of course, questions of purpose and motive can ordinarily be best determined by the observer on the basis of the evidentiary weight to which concrete facts and actions are reasonably entitled. It is in this sense that the timing of any selling in which you may engage becomes important. Let me illustrate this by two hypothetical cases:

On the one hand, let us suppose that a broker, believing a stock to be underpriced, enters into a buying program which, in view of the condition of the market, he knows will have the result of raising the price. From time to time he disposes of part of his purchases, either over the exchange or over-the-counter, to customers attracted either by the rising price or the increased activity, at the levels which his buying has thus created. Or, to vary the case, he makes no sales until his purchases have carried the price to what he considers proper levels, and then disposes of the stock at those levels, either over-the-counter to his customers, or, if he believes the market by reason of the increased activity he has generated will take the selling without breaking, by means of sales over the exchange.

In either case, the broker will have effected a series of purchases creating active trading and raising the price of the security, and it will be difficult to avoid the inference that his transactions were effected for the illegal purpose of inducing others to buy. The fact that the broker may have believed bona fide that the stock at higher levels would still be a good buy for his customers is immaterial; tampering with a market, manipulating it, cannot be excused even by an honest belief that it would be of benefit to others to have it tampered with. And in the picture I have drawn, the relevance of the sales is not that they are an indispensable element of the offense, but that they are of great evidentiary weight in determining the purpose with which the buying was undertaken. Consequently, under the circumstances stated, I should be of the opinion that the broker in question was guilty not only of violating section 9 (a) (2) of the Securities Exchange Act, but also of violating the general fraud provisions of the Securities Act and the Securities Exchange Act. In this connection I direct your attention to the Commission's opinion In the Matter of Barrett & Co., Securities Exchange Act Release No. 2901.

On the other hand, let us suppose the case of a broker who enters into a similar buying program with the same faith in the value of a stock, and the same belief that at higher levels it will still be a good buy for his customers. This broker likewise knows that his buying will affect the price of the stock, either through increased activity or rising prices. He does not buy, however, for the purpose of inducing others to purchase, but rather for the purpose of acquiring a supply which he can dispose of at a profit if an expected increase in market price does materialize from other causes than his buying activity. Consequently, this broker, before making any sales, whether on the exchange or over-the-counter, takes care to permit a sufficient period of time to elapse from time of his last purchase to make sure that the effect of his purchases on the market will have been dissipated, and the market will have found a level (whether above, below, or at, his last purchase price) which is its own independent level, created by outside factors of supply and demand and unaffected by his own activities. The length of time he waits will be dependent upon the character of the market, and the length of time which the market takes to lose the effect of his buying.

Of course, other factors discernible in connection with the operation might be of evidentiary value in establishing the existence of a manipulative purpose even though resales were not undertaken in proximity to the purchasing. Such factors might include the pattern of the broker's purchasing—that is, whether his purchases were made in a manner particularly calculated to raise market prices, whether he accompanied his buying by efforts to induce others to buy in the market at the same time, whether he was being pressed to repay or reduce bank loans for which securities of the same issues were held as collateral. The presence of these or other similar factors might well lead, as a matter of evidence, to the conclusion that the broker was motivated by a manipulative purpose.

However, in the absence of such other complicating factors, it would seem that in the case I have last described any inference of illegality which might have arisen merely from the fact that the broker's buying had raised the market price would be rebutted by the fact that he had avoided resales until the effect of his buying on the market had been dissipated and the market price had become a price uninfluenced by his buying program.

I appreciate that in the two cases I have described the brokers may claim to have been

motivated by equally genuine desires to assist their customers into good and fairly priced investments. But the facts of the second case, as I have stated them, do not seem to me to raise any inference of manipulation, whereas I believe that from the facts of the first case a manipulation may fairly be inferred. And the program presented by your letter seems to me to fall within the first rather than the second of my two hypothetical cases. The act is designed to prevent manipulative activities, and does not excuse them merely because they may be in part benevolently inspired.

[Securities Exchange Act Release No. 3056, October 27, 1941]

§ 241.3069 *Opinion of the Chief Counsel to the Corporation Finance Division relating to when-issued trading of securities the issuance of which has already been approved by a federal district court under Chapter X of the Bankruptcy Act.* This is the same as Trust Indenture Act Release No. 31 (17 CFR 261.31). [Securities Exchange Act Release No. 3069, January 4, 1945]

§ 241.3085 *Statement of Commission policy with respect to the acceleration of the effective date of a registration statement.*

Section 12 (d) of the Securities Exchange Act of 1934 confers upon the Securities and Exchange Commission discretionary authority to accelerate the effective date of registration of securities for which applications for registration are filed under Section 12 (b) and (c). The Commission's general policy regarding requests for acceleration will be as follows:

The Commission will consider requests for acceleration of the effective date of registration of securities in cases where, in its opinion, adequate and reasonably current information concerning the issuer has previously been filed and made available to the general public under any Act administered by the Commission. However, in passing upon requests for acceleration the Commission will also consider the following additional factors:

(a) The adequacy of disclosure in the application for registration and its general compliance with the requirements of the Act and the rules and regulations thereunder;

(b) The distribution of the securities being registered or the distribution of other securities related thereto;

(c) The operation of the exchange's trading mechanism in relation to the date on which effective registration is requested;

(d) Compliance with the registration requirements of the Securities Act of 1933;

(e) Any other factors pertinent to the particular case, such as required stockholder approval; qualification under applicable State "Blue-sky" laws; authorization by appropriate State and Federal Agencies having jurisdiction; Court proceedings; and similar matters connected with the securities being registered or with other securities related thereto.

Requests for acceleration of the effective date of registration of securities may be made either by the registrant or its authorized representatives or by the exchange on which registration is sought. Every request should be in writing and should state the grounds upon which it is based and the approximate date on which effective registration is desired.

While the Commission will cooperate with registrants and with exchanges by acting upon requests for acceleration as promptly as possible, consistent with the public interest and the protection of investors, applications for registration should be filed early enough to allow at least ten days for examination of the application and consideration of the request for acceleration by the Commission.

Wherever applications can be filed sufficiently in advance to permit registration to become effective in the ordinary course, requests for acceleration should not be made.

[Securities Exchange Act Release No. 3085, December 6, 1941]

§ 241.3380 *Letter of the Director of the Corporation Finance Division relating to sections 14 and 18.*

The rules in Regulation X-14 (17 CFR, 240.14) provide in effect that no proxy solicitation relating to a meeting of security holders at which the election of directors is an item of business shall be made by the management of the issuer unless each person solicited is concurrently furnished or has previously been furnished with an annual report to security holders containing such financial statements for the last fiscal year as will, in the opinion of the management, adequately reflect the position and operations of the issuer. The rules further require that copies of the annual report to stockholders must be mailed to the Commission in order that it may check compliance with the rule. You inquire whether the reports thus mailed are considered by the Commission to be material "filed" with the Commission within the meaning of Section 18 of the Act and therefore to be subject to the liabilities imposed by that section.

We do not regard the copies of annual reports so mailed to the Commission to be proxy solicitation material "filed" with the Commission or subject to the proxy rules or to the liabilities of Section 18 of the Act except in cases in which the issuer specifically requests that it be treated as part of the proxy soliciting material or in cases in which it is incorporated in the proxy statement by reference. This is so whether the annual report is sent to the persons solicited and to the Commission in advance of the proxy statement or concurrently with it.

[Securities Exchange Act Release No. 3380, February 2, 1943]

§ 241.3385 *Excerpts from letters of the Director of the Corporation Finance Division relating to section 14 and Schedule 14A under Regulation X-14 (17 CFR, 240.14).* The first excerpt refers to paragraph (H) of item 5 of Schedule 14A which reads as follows:

Describe briefly any interest, direct or indirect, of each person who has acted as a director of the issuer during the past year and each person nominated for election as a director and any associates of such director or nominee in any transaction during the past year or in any proposed transaction to which the issuer or any subsidiary was or is to be a party. No reference need be made to immaterial and insignificant transactions. If the interest was or is to be in the purchase or sale, other than in the ordinary course of business, of property by the issuer or a subsidiary, include a statement of the cost of the property to the issuer or subsidiary and a statement of the cost to the purchaser or vendor.

The definition of the term "associate" in Rule X-14A-9 (17 CFR, 240.14A-9), which is referred to in the Director's letter, reads as follows:

The term "associate", used to indicate a relationship with any persons, means (1) any corporation or organization (other than the issuer or a majority owned subsidiary of the issuer) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10% or more of any class of equity securities, (2) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity, and (3) any relative or spouse of such person having the same home as such person.

The Director's comment on this item follows:

In general, the following principles should be observed in preparing the information called for by paragraph (H) of item 5.

The word "interest" means a material interest. In determining the materiality of a person's interest, the scope of the definition of the word "associate" in Rule X-14A-9 (17 CFR, 240.14a-9) may be considered as indicating the type of interest in respect of which information should be furnished. For example, the fact that a director of the issuer is also a director of another company is not enough of itself to establish the materiality of his interest in transactions between the two companies. On the other hand, if the director of the issuer were an officer or holder of 10% or more of the stock of the other company, his interest in transactions between the two companies should be disclosed unless the transactions were immaterial and insignificant.

Your letter sets out a list of transactions between your company and other companies or firms in which a director of your company is a director or partner of the other party to the transaction. If the director's interest in the transaction arises merely from the fact that he is a director of the other company, it appears in the light of the principles stated above that no mention of the transaction need be made. However, in commenting on your questions I shall assume that your director is an officer, partner or 10% stockholder of the other party to the transaction.

Your list is as follows:

1. A bank which makes commercial loans to the company at the going rate of interest and also issues Letters of Credit, etc. at the going rate.
2. An insurance company which issues policies of Marine Insurance in the usual form and at the usual rates.
3. An industrial company from which the Company makes purchases of machinery, equipment or supplies.
4. A law firm which is employed on an annual basis to handle various legal matters.
5. A tenant at a substantial rent of part of an office building owned by a subsidiary of this company.
6. A railroad over which this Company ships most of its products.
7. A telegraph company.
8. A telephone company.
9. An electric light company.
10. A sales agent for one particular line of fabrics in one city.

I believe that a director's interest in transactions with the companies referred to in 7, 8 and 9 need not be referred to under paragraph H if the transactions involved the ordinary services rendered by such companies and the services were rendered at the usual and regular rates. If the transactions involved extraordinary, unusual or special services and were not immaterial and insignificant, the interest of directors in them should be disclosed.

Directors' or their associates' interest in transactions with the companies referred to in 1 to 5, inclusive, and in 10 should be disclosed unless the transactions were immaterial and insignificant.

If a choice between two or more carriers is available to the company in determining the route over which its products should be shipped, I should consider that the director's interest in the transactions referred to in 6 should be disclosed unless the transactions were immaterial and insignificant.

The description of the transaction and of the director's interest in it should be brief.

Details such as the dollar amount involved and the precise terms of the arrangements need not be stated.

To another inquiry regarding the same provision of the rule, the Director wrote as follows:

You state that a director of the issuer is an officer of a banking institution with which the company may have funds on deposit, or which may act as trustee under a mortgage or other indenture, or as transfer agent of stock, or as registrar with respect to outstanding stocks or bonds. You ask whether the director's interest in these transactions should be disclosed under item 5 (B).

Where a director of the issuer is an officer of a banking institution which during the period covered by the statement has rendered services as trustee under a mortgage or other indenture, the existence of such relationship should be disclosed unless the whole matter is immaterial and insignificant. Directors' interests in the other transactions mentioned in this item need not be disclosed.

Another excerpt refers to the paragraph (I) (3) of item 5 which requires in respect of each director, nominee, or person who has acted as an officer but not as a director and who has received remuneration in excess of $20,000 during the fiscal year, a statement of:

The amount paid or set aside by the issuer and its subsidiaries primarily for the benefit of such director, officer or nominee, pursuant to each pension or retirement plan of the issuer and its subsidiaries or other similar arrangement, and the amount of the annual benefits estimated to be payable to such director, officer or nominee in the event of retirement.

The Director's comment on this paragraph follows:

You state that your employees' retirement plant provides for contributions to the retirement fund both by the employees and by the company. The amount of retirement benefits, if any, which a particular officer or director will receive will depend upon his continuance in the company's employ until he reaches retirement age and upon the amount of his salary in future as well as past years. In view of these uncertainties and of the fact that his retirement benefits will result in part from his own contributions, you suggest that you should not include in the tabulation called for by item 5 (I) the estimate of annual retirement benefits specified in paragraph (3) thereof.

I think you should include the required estimate in the tabulation, computing it upon the assumption that an employee will continue in the employ until normal retirement age at his present salary and explain in a footnote the assumptions upon which the estimate is based. The footnote may also include a statement to the effect that part of the sum is attributable to the employee's own contributions.

The following excerpt refers to paragraph (L) of item 5 which calls for the name of each person other than a director, officer or employee of the issuer whose aggregate remuneration from the issuer exceeded $20,000, the amount received by each such person and the capacity in which it was received.

You point out that paragraph 5 (L) of item 5 of Schedule 14A is substantially the same as item 11 of Form 10-K, the form on which the company files its annual report with the Exchange and with the Commission under the Securities Exchange Act of 1934. You ask whether the instructions as to item 11 of the Instruction Book for Form 10-K may be used as a guide in determining what disclosure should be made in the proxy statement under item 5 (L).

Item 5 (L) is intended to elicit information similar to that required to be given under item 11 of Form 10-K and the instructions as to that item may properly be used as a guide in the preparation of that part of the proxy statement.

[Securities Exchange Act Release No. 3385, February 17, 1943]

§ 241.3505 *Opinion of the Director of the Trading and Exchange Division relating to the anti-manipulation provisions of sections 9 (a) (2), 10 (b), 15 (c) (1) of the Securities Exchnge Act of 1934, and 17 (a) of the Securities Act of 1933.*

You have asked me for an opinion as to the legality of certain transactions you propose to effect in the debentures of "X" Corporation which are being publicly offered at a fixed price by an underwriting group of which you are a member.

I understand that the debentures became effectively registered under the Securities Act of 1933 several days ago, and that the offering was made on the day following the effective date. I also understand that since the commencement of the offering one of the underwriters, acting as manager of the group and as the agent for all of the underwriters, has been effecting purchases of the debentures for the purpose of facilitating the distribution. You have not yet disposed of some of the debentures which, as an underwriter, you purchased from the issuer, and as a member of the selling group have purchased additional debentures from the manager. You have been selling the debentures at retail at the fixed public offering price.

You state that, in addition to distributing the debentures through your retail department at the fixed public offering price, you would like to buy and sell the debentures, through your trading department, at prices which may exceed the price at which your retail department has been making sales. You ask whether such "trading" transactions, if effected prior to the completion of the distribution, would violate any of the anti-manipulative provisions of law.

I believe that discussion of the problems will be facilitated by considering initially the legality of purchases made at prices varying from the offering price when such purchases are made by the manager.

Since the debentures are not registered on a national securities exchange, Section 9 (a) (2) of the Securities Exchange Act of 1934 is not by its terms directly applicable. However, the Commission has consistently expressed the view that transactions which would violate Section 9 (a) (2), if effected in a registered security, would be in violation of Section 15 of the Securities Exchange Act and Section 17 (a) of the Securities Act of 1933, if effected in a security which is not so registered. In this connection, I refer you to In the Matter of Barrett & Company (Providence, Rhode Island) *et al.*, 9 S. E. C. 319 (1941), Securities Exchange Act Release No. 2901, p. 9, *et. seq.* Therefore, the provisions of Section 9 (a) (2) are pertinent in determining whether the general fraud provisions of Section 15 of the Securities Exchange Act and of Section 17 of the Securities Act have been violated.

Section 9 (a) (2) of the Exchange Act makes it unlawful, directly or indirectly, "to effect, *alone or with one or more other persons*, a series of transactions in any security registered on a national securities exchange *creating actual or apparent active trading* in such security or *raising* or depressing *the price* of such security, *for the purpose of inducing the purchase* or sale *of such security by others.*" [The italics are mine.]

In determining the application of these provisions to purchases made by the manager, consideration must also be given to whether they constitute lawful "stabilizing" transactions, in which event they would not be subject to the anti-manipulative provisions of the type described in Section 9 (a) (2). The Commission has stated that it considers "stabilization" to facilitate the distribution of a security to be "the buying of a security for the limited purpose of preventing or retarding a decline in its open market price * * *" Securities Exchange Act Release No. 2446, March 16, 1940, p. 3. (17 CFR § 241.2446)

Obviously, lawful "stabilization" does not encompass transactions which raise the price of the security or which create actual or apparent trading greater than that necessary to prevent or retard a decline in the price. When a block of an unregistered security is being publicly offered and transactions in that security admittedly are being effected for the purpose of facilitating the distribution, it is clear that the distributors have the purpose of inducing the purchase of the offered security by others. It also follows, in my opinion, that under such circumstances transactions by the stabilizers raising the price of the security or creating greater trading activity than is necessary to prevent or retard a decline in such price clearly would be in violation of the general fraud provisions of the two Acts.

Thus, in the situation described in your letter, if the manager effected transactions in the debentures which raised their price or created more trading therein than was necessary to stabilize effectively the price of the debentures, in my opinion such transactions would be in violation of Section 15 of the Securities Exchange Act and Section 17 of the Securities Act. In this connection, I would like to point out that purchases above the offering price, while the distribution is going on, would be unlawful, in my opinion, even though independent quotations and transactions at a higher price may be found. Such transactions are obviously not necessary to facilitate the distribution and would be considered as creating excessive trading.

Moreover, if the manager of an underwriting group who has authority to purchase securities on behalf of the syndicate effects unlawful transactions, the individual members of the underwriting group are, as a matter of law, likewise responsible for the unlawful acts, since the manager of a syndicate is no more than an agent for the members of the group. The individual members of the group are liable as principals for such unlawful transactions.

Since the members of the group would be liable if the manager effected the transactions, it appears obvious that any member would be in violation of Sections 15 and 17 were he to effect similar transactions directly. When an underwriter is engaged in the distribution of a security he obviously has the purpose of inducing the purchase of that security by others, with the result that when he concurrently effects trading transactions which raise the price of the security, or create trading activity beyond that necessary for stabilizing, it is difficult, if not impossible, to give credence to the view that the trading transactions were not also conducted, at least in part, for the purpose of inducing the purchase of the security by others.

The foregoing is true, in my opinion, even though the underwriter may have sold all of the securities retained by or allotted to him in the distribution, as long as the manager is still stabilizing to facilitate the offering. While this situation prevails, the manager is still inducing the purchase of the security by others, and the underwriter, as one of the manager's principals, is to be presumed to have the same purpose. In general, as long as the syndicate agreement is in existence and the manager is vested with the power of acquisition and resale of securities customarily conferred upon him

by such agreements, all members of the syndicate, whatever their individual positions may be, should be on notice that the distribution is or may be in process and that they are or may still be participants therein.

The fact that the transactions effected by the trading department of the underwriter are labelled as "trading" transactions and that it may be asserted that they are effected without knowledge by, or consultation with, its retail distributing organization, does not affect my conclusion. Although the argument has frequently been made that the trading department of a firm which is a member of an underwriting group operates independently of the retail division of the same firm, the fact remains that the firm is a single business organization and that the act of the trading department is legally the act of the distributor.

Accordingly, I am of the opinion that purchases effected under such circumstances by any department of your firm raising the price of the security or creating excessive trading therein would violate Section 15 of the Securities Exchange Act and Section 17 (a) of the Securities Act.

Thus far this discussion has been confined to the situation in which the manager of an underwriting group is stabilizing, on behalf of the members of that group, to facilitate an offering. However, my conclusion that so-called trading transactions which raise prices or which create excessive trading activity during the course of the distribution are in violation of law does not depend upon the existence of a stabilizing operation. When an underwriter or selling-group member is still engaged in offering the security he is inducing the purchase of that security by others. Transactions by the underwriter at that time which create excessive trading activities in the security or which raise the price thereof, are illegal, regardless of whether they are characterized as "trading" or "stabilizing" transactions.

[Securities Exchange Act Release No. 3505, November 16, 1943]

§ 241.3506 *Opinion of the Director of the Trading and Exchange Division relating to the anti-manipulation provisions of sections 9 (a) (2), 10 (b), 15 (c) (1) of the Securities Exchange Act of 1934, and 17 (a) of the Securities Act of 1933.*

You have inquired whether transactions effected by the manager of an underwriting syndicate to cover an overallotment short position of the syndicate are subject to the anti-manipulative provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933.

As I understand it, you are the manager of a syndicate which is underwriting an issue of shares of stock of "X Y Z" Corporation. The issue is being publicly offered at a fixed price, having recently become effectively registered under the Securities Act of 1933. I also understand that the syndicate account is "short" shares in the amount of approximately 8% of the amount originally offered, resulting from overallotment. It also appears that the individual members of the underwriting group are "long", in the aggregate, approximately 17% of the amount originally offered, representing the unsold portion of the original offering. Moreover, the members of the selling group who are not underwriters have an aggregate long position amounting to approximately 12% of the original offering.

In considering the question which you have raised, we may start with the premise that a syndicate overallotment is customarily made for the purpose of facilitating the orderly distribution of the offered securities by creating buying power which can be used for the purpose of supporting the market price. Thus, it would appear, in the absence of circumstances indicating the contrary, that purchases made for the purpose of covering the "short position" of the syndicate are effected for the purpose of facilitating the distribution. Moreover, if such purchases are effected to facilitate the offering, it is obvious that there exists the intention or purpose of inducing the purchase of the offered security by others.

Under these circumstances, all purchases which raise the market price of the offered security or create excessive trading activity would appear to contravene the anti-manipulative provisions of law. In this connection, you may be interested in examining Securities Exchange Act Release No. 3505 issued by the Commission under date of November 16, 1943.

However, not all purchases for the purpose of covering a short position impel the conclusion that the underwriters still have the purpose of facilitating a distribution. There are a number of factors which must be considered in determining whether that purpose is still present. Some of the external factors indicating that the manager no longer has the intention of facilitating an offering, but has only the purpose of covering the syndicate short position, are as follows:

1. Neither the underwriters nor the selling-group members have remaining unsold any shares of the offered security, and hence are no longer engaged in soliciting purchases thereof;

2. reasonable efforts have been made by the manager to acquire securities away from the market, i. e., in privately negotiated transactions, for the purpose of covering the syndicate short position;

3. the independently established market price of the offered security is above the fixed offering price;

4. the manager has not, while covering the syndicate short position, made additional short sales of the offered security;

5. a reasonable period of time has elapsed between the termination of distributive efforts on the part of participants in the distribution and commencement of covering of the syndicate short position;

6. the underwriting group holds no options on securities of the same class as those being offered; and

7. all agreements with the syndicate manager or underwriters restricting the right of any person to sell the securities of the same class as the offered security have been terminated.

It should be noted that the factors mentioned above do not necessarily include all of the factors to be taken into consideration, nor is it necessary for all of the factors to be present before the conclusion can be reached that in a given setting the purpose of facilitating an offering no longer exists.

Applying these principles to the facts which have been presented by you, it is obvious that the position of the underwriting group is only technically short, the underwriters as a group actually having a net long position amounting in the aggregate to 9% of the amount of the securities originally offered. Moreover, the selling group members have securities remaining unsold in the additional amount of 12%. It is obvious that participants in the distribution are still engaged in inducing the purchase of the offered security by others. Under these circumstances, purchases of the stock effected by the syndicate manager as agent for the underwriting group which raise the price of the stock or which create excessive trading activity, would clearly be unlawful, even though one of the purposes of the manager in effecting such purchases is that of extinguishing the technical short position of the syndicate account.

The statement has frequently been made by managers of syndicates that they are not in a position to know whether the individual underwriters or selling-group members have securities remaining unsold, and that managers have no means of requiring members of underwriting or selling groups to supply them with the offered securities to permit the extinguishment or reduction of the short position.

Considering these contentions first with respect to the individual underwriters, it should be noted that the manager of a syndicate is an agent for the members of the underwriting group and that the individual members of the group are principals in any transaction effected by the manager as such. The failure of an agent of an underwriting group to inform himself with respect to the status of the distribution cannot, in my opinion, grant immunity to any such agent or to his principals from the anti-manipulative provisions of law. On the contrary, no such agent should permit his principal's act or refusal to act, to force him, the agent, to violate the law in attempting to protect such principal's interests.

In view of the foregoing, it would seem incumbent upon the manager to insure his ability to obtain all necessary information concerning the status of the distribution. In this connection, it would seem appropriate for the agreement between underwriters to contain provisions stating, in effect, that the manager, upon request, shall be informed of the amount of the offered securities which the individual underwriters have remaining unsold. Moreover, it would also seem appropriate for the agreement between underwriters to contain provisions requiring the individual underwriters, upon request of the manager, to deliver to him unsold securities, at or below the offering price, for the purpose of reducing the syndicate short position.

While an agency relationship may not exist between the manager of the syndicate and members of the selling group, there is a community of interest between them and the manager's purchases redound to the benefit of the members of the selling group. And since the relationship between the selling group and the syndicate is customarily determined by contract between the two, and since, in effect, the members of the selling group are selling securities for the manager and the syndicate which he represents, it would likewise seem appropriate for the contract between the underwriting syndicate and the selling group to contain provisions analogous to those mentioned above.

[Securities Exchange Act Release No. 3506, November 16, 1943.]

§ 241.3572 *Statement of the Commission relating to the anti-fraud provisions of section 17 (a) of the Securities Act of 1933 and sections 10 (b) and 15 (c) (1) of the Securities Exchange Act of 1934.*

On May 31, 1944, the Commission rendered its findings and opinion on a voluntary plan submitted by Standard Gas and Electric Company under Section 11 (e) of the Public Utility Holding Company Act of 1935 (Holding Company Act Release No. 5070). Although the Commission did not approve the plan under Section 11 (e) in its present form, it stated with respect to the fact that the plan as submitted by the management excluded the outstanding common stock of Standard from participation in the recapitalized company: "We are clear that there is no possibility that Standard's common stock has any interest in the company, either on a comparison of the liquidation preferences of the securities senior to it with the value of the enterprise or on an analysis of the foreseeable income to be available to the different classes of securities in the enterprise. The plan should, therefore, exclude Standard's common stock from participation."

The Commission is informed that the New York Stock Exchange suspended trading in the common stock on May 31, 1944, and that similar action has been or is about to

be taken by the Chicago Stock Exchange, on which the common stock has likewise been registered, and by the Boston and Philadelphia Stock Exchanges, on which it has been admitted to unlisted trading privileges.

It is the view of the Commission that any broker or dealer who sells or executes a purchase order for Standard common will violate the fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 (where use is made of the mails or an instrumentality of interstate commerce) unless prior to the completion of the transaction he informs the purchaser of the exclusion of the common stock from participation under the plan and the Commission's finding that the common stock has no interest in the company and should be excluded from participation. This applies to any sale of Standard common, whether on an agency or on a principal basis.

[Securities Exchange Act Release No. 3572, June 1, 1944]

§ 241.3638 *Letter of the Director of the Corporation Finance Division relating to section 20 and to Rule X-14A-7 (17 CFR, 240.14a-7) under the Securities Exchange Act of 1934.* This release is the same as Investment Company Act Release No. 735 (17 CFR, 271.735). [Securities Exchange Act Release No. 3638, January 3, 1945]

§ 241.3639 *Statement by Commission relating to section 3 (a) (1).* This is the same as Securities Act Release No. 3038 (17 CFR, 231.3088). [Securities Exchange Act Release No. 3639, January 4, 1945]

§ 241.3674 *Statement of the Commission in connection with the adoption of certain amendments to Form 3-M, one of the forms for registration of over-the-counter brokers or dealers under section 15 (b) of the Securities Exchange Act of 1934, and to Rule X-15B-2 (17 CFR, 240.15b-2), the rule governing the filing of supplemental statements to such applications.*

Form 3-M has in the past required each registrant to disclose whether the registrant or any partner, officer, director, trustee, or branch office manager of the registrant is a member of any exchange or securities association, or has ever used or been known by any other name, or has a business history which includes a finding of certain types of illegal or unethical conduct by a court, a state agency, or a securities exchange. The effect of most of the amendments to the form is to extend this requirement to cover the business history of any salesman or other employee of the registrant. The term "employee" as used in these amendments is not necessarily limited to persons who are deemed employes for other purposes, such as social security or workmen's compensation legislation; it may include so-called "free lance salesmen" or other persons whether or not they are deemed employees in some other statutory context.

The remaining amendments to Form 3-M require information regarding certain arrangements with respect to the profits of the registrant (exclusive of profit-sharing or bonus arrangements with employees).

The amendment to Rule X-15B-2 (17 CFR, 240.15b-2) provides that, whenever the Commission amends Form 3-M to require the filing of additional information, each registered broker or dealer shall supply such information within 90 days by filing a supplemental statement on Form 6-M. Accordingly, copies of this release (containing the amended items of Form 3-M) and of Form 6-M are being sent to every registered broker or dealer, together with a letter stating that the answers to the amended items on Form 3-M must be supplied by filing a supplemental statement on Form 6-M not later than July 9, 1945, even though the answers are all in the negative. The broker or dealer should have reasonable ground to believe, after making a reasonable investigation, that such answers are correct.

The amended Form 3-M does not require a listing of *all* salesmen or other employees, but only an enumeration of those who are members of a securities exchange or association, or who have ever changed their names, or who have business histories which include a conviction, an injunction, a refusal or revocation of registration, a finding of violation of the Securities Act of 1933 or the Securities Exchange Act of 1934, an expulsion or suspension from or denial of membership in a securities exchange or a registered securities association, or a past connection in some managerial or controlling capacity with some other broker or dealer who has been the subject of such a conviction, injunction, refusal, revocation, expulsion or suspension.

Section 15 (b) of the Securities Exchange Act of 1934 requires the Commission to deny or revoke the registration of any broker or dealer if it finds (1) that such action is in the public interest and (2) that such broker or dealer, or any partner, officer, director or branch manager, or any person controlling or controlled by such broker or dealer, has been convicted within ten years or is enjoined in connection with activity in securities, or has willfully violated any provision of the Securities Act of 1933 or the Securities Exchange Act of 1934 or any rule thereunder. Since a salesman or other employee of a broker or dealer is a person "controlled by" him within the meaning of this section, the Commission has held that, when a broker or dealer employs a salesman who has been so convicted or enjoined or who has committed such a violation, the broker or dealer is subject to denial or revocation of his registration if the Commission finds that such action is in the public interest. See In the Matter of Bond & Goodwin, Incorporated, — S. E. C. —, Securities Exchange Act Release No. 3543, p. 21 (March 17, 1944); In the Matter of E. H. Rollins & Sons, Inc., — S. E. C. —, Securities Exchange Act Release No. 3661), p. 21 (Feb. 22, 1945). Form 3-M as it has read heretofore, however, has not required a broker or dealer to disclose whether or not any of his salesmen or other employees has been so convicted or enjoined or has been found to have committed such a violation.

The present amendments to Form 3-M, insofar as they relate to past business histories, are designed both to give investors the benefit of such disclosure and to facilitate enforcement of section 15 (b). Their adoption does not mark any departure from the Commission's policy of permitting persons who have been convicted or enjoined, or who have violated one of the Acts, or who have had their own registrations revoked, from acting as salesmen for other registered brokers or dealers in certain cases. The Commission will continue to act on a case-by-case basis, as it has in the past, in determining whether or not denial or revocation of the registration of a broker or dealer who retains such an employee would be in the public interest. The Commission recognizes also that there may be cases where it will not be necessary in the public interest to require a registrant to disclose publicly that a salesman or other employee has a business record of the specified types. In such cases a registrant may apply to the Commission, under section 24 (b) of the Securities Exchange Act of 1934 and the Commission's rules thereunder, for confidential treatment of the required information.

[Securities Exchange Act Release No. 3674, April 9, 1945]

§ 241.3803 *Statement by Commission relating to the adoption of Rule X-13A-6B (17 CFR, 240.13a-6b).* Prior to adoption, comments upon drafts of the proposed new rule and of the amended Item 11 of Form 8-K (17 CFR, 249.308) were obtained from technical and professional associations, governmental agencies, national securities exchanges, individual companies, attorneys, and many other interested persons. Effect has been given in the new rules to a number of the suggestions received. A minority of those commenting on the proposed rule, however, expressed varying degrees of doubt as to the desirability and feasibility of the proposed reporting program. For this reason it has been decided to make public the following statement by the Commission outlining briefly the more important objections raised by those opposed to the program and the reasons for adopting the new rule:

Section 13 (a) (2) of the Securities Exchange Act of 1934 requires every issuer of a security registered on a national securities exchange to file "such annual reports, * * * and such quarterly reports, as the Commission may prescribe." Pursuant to this subsection rules calling for the filing of annual reports were adopted shortly after the effective date of the Act. Rules were later adopted calling for current reports on Form 8-K whenever any of certain special events occurred during the year. Since that time the problems involved in the requiring of regular quarterly operating reports have been under study from the point of view of both the usefulness of such reports to investors and their feasibility in the light of contemporary business and accounting practices.

We have now concluded to initiate a regular quarterly reporting program applicable to most issuers having securities listed on a national securities exchange. Under the new rule, a company is required to furnish quarterly information as to the sales or other gross revenues derived from its operations. However, companies which regularly publish or distribute to stockholders quarterly financial statements or reports containing at least the above information may comply with the rule merely by filing copies of such published reports as an exhibit to Form 8-K. The information called for is not required to be certified by independent public accountants.

As a result of extended study of the problem and of the comments received from those to whom preliminary drafts of the program were sent, we are of the opinion that companies should furnish investors and the public with regular interim information as to their operations. We are inclined to believe, moreover, that it would be desirable to obtain at quarterly intervals a condensed income statement showing not only gross revenues but also net income before and after Federal income taxes together with any non-recurring items of income or costs and losses of an unusual size even though certain of the items could only be arrived at by the use of reasonable estimates or on the basis of certain assumptions. It appears, however, that a substantial number of listed companies do not now have their accounting and reporting practices so organized as to be in a position to make the determinations necessary to furnish reasonably reliable data of this character on a quarterly basis. Accordingly, we have determined for the present merely to require

information as to sales or other gross revenues. On the other hand, companies customarily preparing more detailed information will be able to satisfy the requirements of the rule by filing copies of their regular quarterly statements or reports.

Objection to the program has been made on the ground that the required information as to sales or other gross revenues may be uninformative or misleading due to the seasonal nature of a business or to unusual events of the quarter. Somewhat similarly it is claimed that the information called for is useless since changes in sales volume may not be accompanied by a comparable change in gross or net profits, particularly for short periods or during periods when business conditions are unsettled. Although such difficulties clearly exist in varying degrees depending upon the type of company, we feel, to the contrary, that reports of sales volume when taken in conjunction with other known information as to the business and as to business generally will be of substantial usefulness. Among other things, for example, the information being required should at the present time provide an index of the extent to which a company has been able to reenter civilian markets or to maintain in the postwar period its wartime volume of civilian business. It is also our view that such information will aid in the formation and exercise of an informed investment judgment based on other available information as to the general nature of the operations of the company, its plans and prospects for the future, its position with respect to other companies in the same industry, and many other factors which affect the financial success of a business.

Where in a particular case an issuer feels that its report as to sales or other gross revenues may not be representative because of the seasonal nature of the business or for other reasons, there are, of course, a number of possible procedures that may be utilized. In the case of a seasonal business, an appropriate statement of the nature of the business could be given. In addition, it would be appropriate and desirable to furnish along with the report for the particular quarter comparable figures for the same quarter of the previous year or for the 12 months period ending with the current quarter. Likewise, if in a particular case it is felt that sales or other gross revenues standing alone are inadequate because not indicative of the trend in gross or net profits, the report could include an appropriate explanation of the special circumstances, or there could be substituted a more complete though still condensed form of income statement such as is now regularly being published or sent to stockholders by many issuers.

The other principal objection was that the program imposed an unreasonable burden on reporting companies. As to the very large numbers of issuers now regularly issuing quarterly statements, we do not believe that the furnishing of the required information, either directly or by means of copies of the regular reports, involves any substantial burden. As to other companies, we feel that any added burden involved in compiling the necessary information as to sales or other gross revenues is more than outweighed by the benefit to investors and the public of interim data as to a listed company's operations. Finally, if under the circumstances of an unusual case it is impracticable to furnish the necessary information within the prescribed time, or if the required information is neither known nor available to the issuer, attention is directed to paragraphs 6 and 7 of the general instructions to Form 8-K (17 CFR, 249.308), which provide for special procedures in such cases.

[Securities Exchange Act Release No. 3803, March 28, 1946]

PART 261—INTERPRETATIVE RELEASES RELATING TO THE TRUST INDENTURE ACT OF 1939 AND GENERAL RULES AND REGULATIONS THEREUNDER [1]

Sec.

§ 261.16 *Opinion of the General Counsel relating to application of section 310 (b) where trustee under one indenture is trustee under another indenture for securities of an affiliate of the obligor.*

Some registration statements recently filed under the Securities Act of 1933 indicate that prospective indenture trustees are presently acting as trustees under indentures covering outstanding securities of affiliates of the registrants. In some cases, the affiliate is the parent of the registrant. In others, it may be a subsidiary of a common parent or a subsidiary of the registrant. I have been asked whether the dual capacity in which a prospective indenture trustee proposes to act would in such cases, result in a conflict of interest which would disqualify it under the Trust Indenture Act of 1939.

Section 302 (a) (3) of the Act states that the national public interest and the interest of investors in debt securities are adversely affected when a trustee "* * * has any relationship to or connection with the obligor * * * which * * * involves a material conflict with the interests of such investors." Clearly, conflicting interests may arise in instances where one company is trustee under indentures of both an obligor and the obligor's affiliate. The conflict might arise in drafting the indentures, during the lives of the indentures, or upon a default. In view of the Congressional statement above quoted the Congress might well have seen fit to include such conflicts within the prohibitions of the Act. However, it is apparent from the language of the Act and its legislative history that it was not intended to cover every possible conflict of interest. On the contrary, the Congress, after weighing the difficulties involved in such an effort, concluded that the wise course would be to establish "rules of thumb" prohibiting certain specific types of conflicting interests which have resulted in the greatest injury to investors. These types of conflicting interests are enumerated in section 310 (b) of the Act. This section requires that indentures shall contain provisions disqualifying an indenture trustee who has "any conflicting interest as hereinafter defined." It provides further that, for the purposes of the section, "an indenture trustee shall be deemed to have a conflicting interest if * * * he has any one or more of nine specified relationships. In my opinion, the relationships specified in section 310 (b) were intended to be exclusive.

Subsection (1) is the only portion of section 310 (b) which is of possible relevance to the type of dual trusteeship under consideration. That subsection provides that an indenture trustee shall be deemed to have a conflicting interest if "such trustee is trustee under another indenture under which any other securities * * * of an obligor upon the indenture securities are outstanding." Section 303 (12) provides that the term "obligor", "when used with respect to any . . . indenture security, means every person who is liable thereon." In view of this definition and the exclusive terms of section 310 (b), I am of the opinion that a person not liable on the indenture securities is not an obligor within the meaning of section 310 (b) (1) and, consequently, does not come within the prohibition of that subsection.

There are instances, of course, in which a parent, subsidiary, or sister company of the obligor may also be an obligor within the meaning of section 310 (b) (1). For example, it may be such if it guarantees the securities of the obligor or, as the Supreme Court said in Consolidated Rock Products Co. v. du Bois, 312 U. S. 510 (1941),

"Where a holding company directly intervenes in the management of its subsidiaries so as to treat them as mere departments of its own enterprise, it is responsible for the obligations of those subsidiaries incurred or arising during its management."

However, apart from such instances and others in which the affiliate may properly be regarded as an obligor, it is my conclusion that an indenture trustee is not to be deemed to have a conflicting interest within the meaning of section 310 (b) (1) merely because it is trustee under another indenture under which are are outstanding securities of an affiliate of the obligor.

This opinion is, of course, confined to the propriety of dual trusteeship under the terms of the Trust Indenture Act of 1939. No opinion is intended to be expressed concerning the possible application of other federal or state statutes, or of general principles of equity, which may forbid such trusteeship in instances not prohibited by the Act.

[Trust Indenture Act Release No. 16, November 14, 1941]

§ 261.30 *Opinion of the Chief Counsel to the Corporation Finance Division relating to when-issued trading of securities the issuance of which is subject to approval by a federal district court under Chapter X of the Bankruptcy Act.*

NOTE: Because the name of the company involved is not deemed material at this time, it has been deleted from the opinion.

You have requested my opinion as to the legality of trading on a when-issued basis in the new debentures and common stock contemplated by the plan of reorganization of * * * and * * * approved by the United States District Court for the Southern

[1] The interpretative opinions included herein are opinions issued in the past for the guidance of the public by members of the Commission's staff (or in a few instances by the Commission) and heretofore made public pursuant to Commission authorization. The opinions are to be read as of the date of original publication and in the context of the rules, statutes and circumstances then existing. However, opinions or portions of opinions which are clearly obsolete have been omitted. While it is not clear that publication of interpretative opinions of this kind in the FEDERAL REGISTER is required, it is believed that such publication may be helpful to the public and that it falls within the spirit of the Administrative Procedure Act.

Where rules referring to an opinion have been renumbered since the issuance of the opinion, the new designations are indicated in brackets.

District of New York on August 26, 1944, pursuant to section 174 of Chapter X of the Bankruptcy Act. It is my understanding that the plan has not yet been finally confirmed by the court pursuant to section 221 of Chapter X. Before a confirmation order can be entered, it will, of course, be necessary for the plan to be accepted in writing by two-thirds of each class of creditors of each corporation participating in the plan.

I shall speak only of when-issued trading over the counter, because when-issued trading on a national securities exchange is subject to the Commission's Regulation X-12D3 under the Securities Exchange Act of 1934. Under that Act and Regulation registration of a security for when-issued trading on an exchange is subject to various conditions in addition to compliance with the Securities Act of 1933 and, in the case of a debt security, the Trust Indenture Act of 1939.

It is my opinion that any sales or offers of sale of the new debentures or common stock made through the mails or in interstate commerce prior to final confirmation of a plan under section 221 of Chapter X would violate the registration and prospectus provisions of section 5 of the Securities Act of 1933. It is my opinion further that any sales or offers of sale of the new debentures made through the mails or in interstate commerce prior to qualification of an indenture with this Commission would violate the provisions of Section 306 of the Trust Indenture Act of 1939.

Section 5 of the Securities Act of 1933 provides in substance that no person shall sell or offer any security through the mails or in interstate commerce unless a registration statement as to that security is in effect with this Commission and a specified form of prospectus is used. Section 306 of the Indenture Act of 1939 provides in substance that no person shall sell or offer to sell any bond or debenture or other debt security through the mails or in interstate commerce unless that security has been or is to be issued under a specified form of indenture which has been effectively qualified with this Commission.

Section 264 of Chapter X of the Bankruptcy Act exempts from the registration and prospectus provisions of Section 5 of the Securities Act of 1933 "any transaction in any security issued pursuant to a plan in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property * * *." Section 3 (a) (10) of the Securities Act of 1933 exempts from the registration and prospectus provisions of Section 5 of that Act: "Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval."

Neither of these exemptions applies to the provisions of Section 306 of the Trust Indenture Act of 1939 requiring the qualification of an indenture in respect of any debt security.

So far as the new common stock contemplated by the plan is concerned, it is my opinion that there will be no exemption under either section 264 of Chapter X of the Bankruptcy Act or section 3 (a) (10) of the Securities Act of 1933 until final confirmation of a plan pursuant to Section 221 of Chapter X. It seems clear that no security can be issued "pursuant to a plan," as required by section 264, prior to its confirmation under section 221. It seems clear also that the terms and conditions of the issuance and exchange of the new common stock cannot be said to have been "approved," as required by section 3 (a) (10), until entry of an order of confirmation by the court. As I have stated in an earlier opinion (Securities Act Release No. 3000), in which I considered the similar problem of the applicability of section 3 (a) (10) to a plan approved by this Commission pursuant to section 11 (e) of the Public Utility Holding Company Act of 1935 but not yet approved or enforced by a District Court, it is my opinion that the approval contemplated by section 3 (a) (10) is the total process of approval which is required by the particular statute relied upon to grant an exemption under that section. In the case of a reorganization under Chapter X of the Bankruptcy Act, the total process of approval required for the issuance of any security pursuant to a plan is final confirmation by the court under section 221. Neither approval of a plan by the court under section 174 nor preliminary appproval of a plan by this Commission under section 11 (f) of the Public Utility Holding Company Act of 1935 where a public utility holding company is involved, as in the present case completes the total process of approval required.

What I have said thus far applies to the new debentures as well as the new stock. In addition, since the new debentures are subject to the Trust Indenture Act of 1939 as well as the Securities Act of 1933, and since neither the exemption in section 264 of Chapter X nor the exemption in section 3 (a) (10) of the Securities Act of 1933 applies to the Trust Indenture Act of 1939, a trust indenture for the new debentures will have to be effectively qualified with this Commission before there can be any when-issued trading in the new debentures.

Consequently, any dealer who makes use of the mails or any means of interstate commerce to sell or offer to sell new debentures or common stock on a when-issued basis prior to confirmation of a plan by the court will violate section 5 of the Securities Act of 1933 and section 306 of the Trust Indenture Act of 1939, and any dealer who makes use of the mails or any means of interstate commerce to sell or offer to sell new debentures on a when-issued basis prior to qualification of an indenture will violate section 306 of the Trust Indenture Act of 1939. This applies also to any broker who, as a result of a solicitation of a customer's order, sells or offers to sell "when issued" on an agency basis.

I might add that in my opinion the taking of an appeal from an ultimate District Court order of confirmation would have no effect upon any of the opinions here expressed unless the order of the lower court were stayed pending the appeal.

[Trust Indenture Act Release No. 30, August 28, 1944]

§ 261.31 *Opinion of the Chief Counsel to the Corporation Finance Division relating to when-issued trading of securities the issuance of which has already been approved by a federal district court under Chapter X of the Bankruptcy Act.*

NOTE: Because the name of the company involved is not deemed material at this time, it has been deleted from the opinion.

It has come to the attention of the Commission that a number of brokers and dealers are engaging or preparing to engage in when-issued trading in securities of . . . which are to be issued pursuant to a plan of reorganization confirmed by the United States District Court for the Eastern District of Pennsylvania under Chapter X of the Bankruptcy Act. The securities in question are General Mortgage 6% Income Bonds with common stock attached.

Although the court's confirmation of the plan exempts both bonds and stock from registration under the Securities Act of 1933, the bonds are not exempt from the necessity of qualifying an indenture under the Trust Indenture Act of 1939. No application for qualification of the indenture for these bonds has as yet been filed with the Commission.

For the reasons stated in Securities Act Release No. 3011 (August 28, 1944), it is the view of the Commission that when-issued trading in these bonds cannot legally be undertaken until an application for qualification of the indenture has become effective under the Act. Moreover, written offers of bonds will be legal thereafter only if made by or accompanied or preceded by a written statement containing an analysis of certain of the indenture provisions as required by section 305 (c) of the Trust Indenture Act.

Sales made in violation of the Trust Indenture Act will subject brokers or dealers to injunctive proceedings, criminal prosecution and other penalties imposed by law.

[Trust Indenture Act Release No. 31, January 4, 1945]

PART 271—INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT COMPANY ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER.[1]

Sec.

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[1] The interpretative opinions included herein are opinions issued in the past for the guidance of the public by members of the Commission's staff (or in a few instances by the Commission) and heretofore made public pursuant to Commission authorization. The opinions are to be read as of the date of original publication and in the context of the rules, statutes and circumstances then existing. However, opinions or portions of opinions which are clearly obsolete have been omitted. While it is not clear that publication of interpretative opinions of this kind in the FEDERAL REGISTER is required, it is believed that such publication may be helpful to the public and that it falls within the spirit of the Administrative Procedure Act.

Where rules referring to an opinion have been renumbered since the issuance of the opinion, the new designations are indicated in brackets.

§ 271.12 *Statement of the Commission respecting distinctions between the reporting requirements of section 16 (a) of the Securities Exchange Act of 1934 and section 30 (f) of the Investment Company Act of 1940.* This release is the same as Securities Exchange Act Release No. 2637 (17 CFR, 241.2687). [Investment Company Act Release No. 12, November 16, 1940]

§ 271.69 *Letter of General Counsel relating to sections 7 (b) and 26 (c).*

This is in reply to your recent letter in which you raise certain questions with reference to the registration requirements of the Investment Company Act of 1940 as applied to certain unit investment trusts which have not publicly distributed their securities for several years.

According to your letter, the sponsors and distributors of the securities of all of these trusts, for various reasons, are no longer functioning on behalf of such trusts. However, by the terms of the indentures creating such trusts they are to continue for a substantial number of years. The principal functions of the trustee at present consist of receiving and distributing the income of the trust to certificate holders and redeeming the trust certificates, either in cash or in the under-lying securities, in accordance with th terms of the trust indentures. In the case of such trusts which have issued periodic payment plan certificates, the trustee also receives and invests, in accordance with the terms of the trust indenture, the periodic payments made by the investor.

You suggest that, at least in the case of those "inactive" trusts which have not issued periodic payment plan certificates, it might be held that the present activities of the trustee, particularly that of redeeming the trust certificates, constitute "transactions merely incidental to the dissolution of an investment company" which, under the provisions of section 7 (b) of the Act, could be performed by the trustee without the necessity for registration of the trusts pursuant to section 8 of the Act.

I am unable to concur in this interpretation. In my opinion the transactions referred to in the quoted clause of section 7 (b) are those incidental to a formal dissolution of the investment company or trust, either in accordance with the instrument which created it or otherwise. Such a dissolution must be of the type which terminates the entity as to all shareholders or certificate holders in a manner which necessitates the final distribution of all the assets of the company or trust.

The problems of these inactive trusts, sometimes called "orphan trusts," and the unfortunate situation in which certificate holders of such trusts have found themselves in the past, received special consideration by the Commission in its study of unit investment trusts and by the Congress in enacting the Investment Company Act. Section 26 (c) of the Act authorizes the Commission to institute legal proceedings for the liquidation of inactive unit investment trusts when such a step is in the best interests of the certificate holders. Adequate enforcement of the Commission's duties under this section requires the registration of inactive unit investment trusts. Moreover, unless such trusts are registered their certificate holders will be deprived of the advantages of such periodic financial and other reports as the Commission may find it appropriate to require.

Undoubtedly, as you state in your letter, there may be instances in which some hardship will result from the requirement of registration for inactive investment trusts. I am advised by the Investment Company Division of the Commission, however, that in the preparation of forms of registration for investment companies special consideration will be given to the difficulties confronting such trusts and that care will be taken to prepare a form which will require only the minimum of necessary information and which can be answered at a minimum of expense.

[Investment Company Act Release No. 69, February 19, 1941]

§ 271.71 *Letter of the Director of the Investment Company Division relating to section 19 and Rule N-19-1 (17 CFR, 270.191).*

In connection with Section 19 of the Investment Company Act and the recent Rule N-19-1 (17 CFR, 270.19-1) adopted pursuant to it, you have raised some questions of interpretation.

Section 19 provides in effect that dividend payments made by a registered investment company must be accompanied by written statements adequately disclosing the source of the dividend if the dividend is paid wholly or partly from any source other than:

(1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or

(2) such company's net income so determined for the current or preceding fiscal year.

Rule N-19-1, among other things, provides in effect for the segregation of certain designated sources of dividend payments for the purpose of disclosure.

Your first inquiry, as I understand it, relates to the problem of ascertaining the presently available balances of the sources designated in Section 19 and Rule N-19-1. You point out that, prior to the time the Investment Company Act went into effect, an investment company may not have segregated its income and surplus in a way contemplated by that Section and the recently adopted rule; therefore, dividend payments in the past may not have been allocated according to the sources designated therein. You are concerned as to the method companies in this situation may use in determining *now* the sources against which past dividends are to be charged in order to determine the balances of "accumulated undistributed net income" and other sources available for the purposes of Section 19.

Where, prior to November 1, 1940 (the effective date of the Investment Company Act) any legal allocation of dividend payments has been made on the books or by resolution of the board of directors, or in some other appropriate manner, to one of the sources set out in Rule N-19-1, in my opinion, such allocation need not be changed. As to past dividends not so allocated, it is my opinion that the following allocation should normally be followed: The total amount of such dividends accrued and declared in any fiscal year should be charged first to the accumulated undistributed net income, if any, at the close of such year, and any excess should be charged to the accumulated net profits from the sale of securities or other properties, if any, at the close of such year, and any excess thereafter should be charged to paid-in surplus or other capital source. The determination of accumulated net profits from the sale of securities or other properties should be made in accordance with the company's financial accounts rather than its tax accounts.

Your second inquiry bears on the same problem. In examining the past to make the necessary determination of available balances now, transactions must be reviewed in the light of "good accounting practice," the standard set up in Section 19. Your problem is whether that standard is the good accounting practice of the present day or that of the date of any particular transaction. In my opinion, it is the latter.

Your third inquiry is in regard to certain language used in paragraphs (c) and (e) of the rule. In effect these provisions state that sources of dividends shall be determined, for various purposes, "to the close of the period as of which the dividend is paid." I believe your questions concerning the meaning of this language can best be disposed of in terms of examples:

If there are arrearages in dividends on preferred stock, and it is decided to pay in January, 1941 all or a portion of these arrearages on the basis of source balances available up to the close of the dividend period ending December 31, 1940, the period to which the quoted language refers is not the period in which the dividend accrued, nor is it the period in which it is in fact paid; it is the period ending December 31, 1940. On the other hand, if a dividend paid early in December, 1940 or in January, 1941 is intended as the distribution for the last quarter of the calendar year 1940, the quoted language refers to the period ending December 31, 1940.

[Investment Company Act Release No. 71, February 21, 1941]

§ 271.78 *Statement by the Commission relating to section 23 (c) (3) and Rule N-23C-1 (17 CFR, 270.23C-1).*

Rule N-23C-1 (17 CFR, 270.23C-1) permits a closed-end company to repurchase its own securities only in a limited class of situations and subject to certain safeguards. Further experience may show that it is feasible to prescribe a general rule covering a broader class of situations, but for the present it is felt that any repurchase program which does not fall within the terms of this rule, or within the statutory exceptions provided in sections 23 (c) (1) and (2), should first be submitted to the Commission in the form of an application, so that it can be considered on its individual merits.

Rule N-23C-1 (17 CFR, 270.23C-1) contains four major limitations upon the types of repurchases which may be made under the rule:

First. The rule makes no provision for the repurchase of listed securities on the over-the-counter market. Listed securities may generally be repurchased on a securities exchange pursuant to section 23 (c) (1) of the Act, if appropriate notice has been given to stockholders. The fact that repurchases under section 23 (c) (1) are made on the type of open market which an exchange provides gives the investor certain safeguards, particularly in relation to price, which are not present when a transaction is effected over the counter. Accordingly the Commission's present disposition is to permit an over-the-counter repurchase of listed securities under section 23 (c) (3) only on the basis of an application and order.

Second. Rule N-23C-1 (17 CFR, 270.23C-1) makes no provision for the repurchase of junior securities by companies which have senior securities outstanding. The problems involved in such repurchases are pointed out in our opinion in the matter of Adams Express Company (Investment Company Act Release No. 76) recently released. Moreover, companies having listed securities are in certain instances subject to stock exchange restrictions with respect to the repurchase of junior securities, and section 23 (c) certainly contemplates that over-the-counter repurchases shall be subject to at least as stringent safeguards as repurchases on a securities exchange.

Third. Repurchases from affiliated persons of the issuer are not within the rule. The abuses which may flow from such repurchases, and the consequent advisability of permitting them only upon the basis of applications describing the individual transactions, are apparent.

Fourth. The rule does not permit the repurchase of more than 1% per month of any class of the issuer's outstanding securities. It is believed that purchases in excess of this

figure are sufficiently out of the ordinary to made it desirable that they be scrutinized individually.

[Investment Company Act Release No. 78, March 4, 1941]

§ 271.87 *Letter of General Counsel relating to section 22 (d).*

You have requested my opinion concerning the application of section 22 (d) of the Investment Company Act of 1940 to a broker-dealer executing a brokerage order for a customer in the redeemable securities of a registered investment company. I assume such securities are being currently offered to the public by or through an underwriter at a price described in the prospectus covering such securities.

Section 22 (d) of the Investment Company Act of 1940 provides in part as follows: "No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus. * * *"

In my opinion the term "dealer," as used in section 22 (d), refers to the capacity in which a broker-dealer is acting in a particular transaction. It follows, therefore, that if a broker-dealer in a particular transaction is acting solely in the capacity of agent for a selling investor, or for both a selling investor and a purchasing investor, the sale may be made at a price other than the current offering price described in the prospectus. Of course disclosure of the fact that the broker-dealer is acting as agent, and of the amount of his commission, must be made to his principal or principals in accordance with the requirements of the Rules and Regulations promulgated by the Commission under section 15 (c) (1) of the Securities Exchange Act of 1934.

On the other hand, if a broker-dealer is acting for his own account in a transaction and as principal sells a redeemable security to an investor, the public offering price must be maintained, even though the sale is made through another broker who acts as agent for the seller, the investor, or both.

As section 22 (d) itself states, the offering price is not required to be maintained in the case of sales in which both the buyer and the seller are dealers acting as principals in the transaction.

[Investment Company Act Release No. 87, March 14, 1941]

§ 271.89 *Letter of General Counsel relating to section 22 (d).*

This is in reply to your request for an opinion as to the application of Section 22 (d) of the Investment Company Act of 1940 to the selling practices of an open-end management investment company.

As I understand the facts, the shares of the company are offered to the public at a current offering price described in the prospectus as net asset value plus a specified sales load. However, it is stated in the prospectus that in the case of a single investment of $25,000 or more, this sales load may be reduced at the option of the principal underwriter.

You wish to know whether an offering at a price which is thus variable in the discretion of the principal underwriter in the case of sales of $25,000 or more conflicts with section 22 (d) of the Act. Speaking generally, that section prohibits the sale of redeemable securities to any person other than a dealer or underwriter except at a "current offering price" described in the prospectus.

I believe it is permissible to charge varying prices for varying amounts of redeemable securities based on a uniform scale of sales loads for different amounts purchased. But, in my opinion, section 22 (d) requires the "current offering price" to be one readily ascertainable by a reading of the prospectus. Therefore I believe that the charging of varying prices is not permissible unless the prospectus definitely sets forth the price which a purchaser of any specific amount of redeemable securities will have to pay.

In your case the price which may be charged in the case of sales of $25,000 or more is not clearly and specifically set forth in the prospectus, and as a result of the discretion conferred upon him the principal underwriter is in a position in such cases to discriminate between purchasers of like amounts of redeemable securities. At least one of the purposes of the requirement of disclosure of the "current offering price" is to prevent such discrimination among investors.

It is my conclusion, therefore, that if the principal underwriter is given the option to vary the sales load otherwise than in the uniform manner specified above, the requirements of section 22 (d) are not satisfied.

[Investment Company Act Release No. 89, March 13, 1941]

§ 271.150 *Letter of general counsel relating to section 24 (b).*

You have indicated that a general outline of the scope and operation of Section 24 (b) of the Investment Company Act of 1940 might be helpful to the members of your committee. Such an outline is given below. I have attempted there to cover the points which most frequently arise and which are of the most practical significance from the point of view of the companies concerned. I have not attempted to chart the precise legal limits of section 24 (b) or to resolve those difficult questions of legal interpretation which may arise in a few unusual situations.

General scope of section. Section 24 (b) of the Investment Company Act of 1940 reads as follows: "(b) It shall be unlawful for any of the following companies, or for any underwriter for such a company, in connection with a public offering of any security of which such company is the issuer, to make use of the mails or any means or instrumentalities of interstate commerce, to transmit any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors unless three copies of the full text thereof have been filed with the Commission or are filed with the Commission within ten days thereafter: (1) any registered open-end company; (2) any registered unit investment trust; or (3) any registered face-amount certificate company."

It is clear from the context that the various terms used in section 24 (b)—"advertisement," "pamphlet," "circular," "form letter"—are all intended to represent types of sales literature. The term "sales literature" must, I believe, be read in the light of the definition of the word "sale," which appears in section 2 (a) (33) of the Investment Company Act and which provides, among other things, that every "attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value" is a "sale." So it may be said that every written communication used by the issuer or an underwriter with the intention of inducing or procuring, or of facilitating the inducement or procurement, of any sale of the securities of any of the companies enumerated in section 24 (b) is within the purview of that section.

It should be noted that section 24 (b) does not require the filing of sales literature if a sufficient number of copies have already been filed with the Commission pursuant to any other provision of the Investment Company Act or pursuant to any other statute administered by the Commission. The significance of this point will be brought out more fully in connection with the discussion below of specific types of selling literature.

Prospectuses. Prospectuses are of course "sales literature" and within the purview of section 24 (b). A company registering under the Securities Act of 1933, however, and fully complying with the requirements of that Act, will automatically meet the requirements of section 24 (b) so far as the filing of prospectuses is concerned. Rule 800 under the Securities Act of 1933 (17 CFR, 230.800) requires the filing of a number of copies of a prospectus at the time a registration statement is filed under that Act; it also requires the filing of copies of the prospectus within five days after the commencement of the public offering of the securities registered, and whenever thereafter the prospectus is amended. Compliance with Rule 800 (17 CFR, 230.800) will automatically make for compliance with section 24 (b) of the Investment Company Act so far as formal offering prospectuses are concerned.

Of course the above remarks apply only to material to which Rule 800 (17 CFR, 230.800) is applicable. A company or its distributor may choose to supplement a prospectus in such a way that the supplementary material is not within the scope of Rule 800. Copies of supplementary material of this nature must be filed in order to comply with section 24 (b).

Reports to security holders. When a stockholders' report is sent to an investor who is not a stockholder, it must ordinarily be regarded as "sales literature." When the report is sent to stockholders alone, it may or may not be "sales literature," depending upon the character of the statements it contains and the purpose for which it is used. In any event, four copies of any report to security holders which contains financial statements (as most reports do) must be filed with the Commission, pursuant to section 30 (b) (2) of the Investment Company Act and Rule N-30B2-1 (17 CFR, 270.3062-1) thereunder, within 10 days after transmittal. In all instances where section 30 (b) (2) applies, therefore, compliance with that section will automatically make for compliance with section 24 (b), so far as reports to security holders are concerned.

"Tombstone" advertisements. Such an advertisement, which merely "states from whom a written prospectus meeting the requirements of section 10 [of the Securities Act] may be obtained and, in addition, does no more than identify the security, state the price thereof, and state by whom orders will be executed" is excluded from the definition of the term "prospectus" and is therefore not ordinarily filed under the Securities Act of 1933. It is clear, however, that such an advertisement is a kind of "sales literature," and three copies of each such advertisement should therefore be filed pursuant to section 24 (b). It is not necessary that identical advertisements appearing in different newspapers or periodicals, or appearing at different times, be treated as separate pieces of sales literature; it is sufficient if one set of three copies of each such advertisement is filed regardless of the number of publications in which it appears. It will simplify our administrative job, however, if in filing copies of such an advertisement the company or underwriter indicates some of the publications, or briefly describes the nature of the publications, in which the advertisement will appear and the frequency with which it will appear.

Form letters. The companies will presumably have no difficulty in filing copies of the

ordinary printed or mimeographed form letter. Letters which are individually written or typewritten present a more troublesome problem. It would certainly be contrary to the spirit of section 24 (b) if its provisions could be evaded by the device of individually typing a large number of substantially identical sales letters. On the other hand, I recognize that in writing individual letters to stockholders and prospective investors, investment companies or their underwriters may frequently make use of more or less stereotyped explanations and arguments. In order to give effect to the policy of section 24 (b) without subjecting the companies and their distributors to unwarranted inconvenience, paragraph (a) of Rule N-24B-1 (17 CFR, 276.246-1) defines "form letter" to include "one of a series of identical sales letters" and also "any sales letter a substantial portion of which consists of a statement which is in essence identical with similar statements in sales letters sent to 25 or more persons within any period of 90 consecutive days." Only a single set of three copies of each form so used need be filed with the Commission; it is not necessary to file copies of individual variants of the form, and it is immaterial whether the variants are written during or after the 90-day period prescribed by the rule.

Communications to Dealers and Salesmen. Ordinarily communications from the issuer or distributor to dealers and salesmen, containing information and instructions, need not be filed pursuant to section 24 (b). On the other hand, if pamphlets or other written sales material is sent to dealers or salesmen to be physically passed on to prospective investors, it is clear that copies must be filed, since they constitute "sales literature * * * intended for distribution to prospective investors." A less obvious but equally significant situation is presented when selling arguments are sent to dealers or salesmen in written form, with the understanding or intent that the dealers and salesmen will use these arguments orally in attempting to sell securities to the investing public. Certain types of investment companies, particularly those which sell face-amount certificates and periodic payment plan certificates, rely to a considerable extent upon oral representations to sell their securities. The Commission's view is that the realities of this situation, when viewed in the light of the purpose of section 24 (b), require that selling arguments sent to dealers or salesmen in written form, in order that they may be passed on to the investing public by word of mouth, come within the purview of Section 24 (b). Accordingly paragraph (b) of Rule N-24B-1 (17 CFR, 276.246-1) in effect defines the term "distribution" to include oral distribution.

Examination by Commission's staff. I am advised by the Investment Company Division that it will not ordinarily be practicable for the Division's staff to give the companies filing material under section 24 (b) any indication of the propriety or impropriety of the contents of the material. It has never been contemplated that such material would be examined with the regularity and the meticulous attention given such fundamental documents as registration statements, annual reports and reports to stockholders. Such registration statements and reports are a primary source of detailed information, whereas the purpose of section 24 (b) is not so much to provide a source of information as to facilitate the enforcement of the anti-fraud provisions of the statutes administered by the Commission, particularly section 17 (a) of the Securities Act of 1933, section 15 (c) of the Securities Exchange Act of 1934 and section 3 (b) of the Investment Company Act of 1940. For this reason, and because of the great volume of material filed under section 24 (b), I am advised that no regular routine of examination or issuance of deficiency memoranda in respect of such material will be followed, at least for the present. Neither can the Commission's staff ordinarily undertake to pass upon or give even tentative advice concerning material submitted in advance of its use. I am sure you will appreciate the practical administrative considerations which make this course necessary.

In concluding, let me refer briefly to Rule N-24B-2, which has been found necessary because of the tendency of many companies to forward a variety of documents without properly indicating the purpose for which they are being filed. If no indication of the reason for filing is given, it is sometimes difficult for the staff of the Commission to know whether the material is sent only for the staff's information, as a matter of courtesy, or whether it should be put in the public files which have been set up for material the filing of which is required by law. Difficulties are also encountered when the indication of the purpose of filing is incorrect (as when copies of a stockholders' report are stated to be filed under section 24 (b) of the Investment Company Act, and no reference is made to section 30 (b) (2). Since these filing problems center almost entirely about Section 24 (b), it is believed that careful compliance with Rule N-24B-2 (17 CFR, 270.246-2) will prevent any substantial difficulties on this score in the future and will simplify matters both for the companies and for the Commission.

[Investment Company Act Release No. 150, June 20, 1941]

§ 271.167 *Opinion of General Counsel relating to sections 8 (b) (1) and 13 (a).*

The question which you have raised involves Sections 8 (b) (1) and 13 (a) of the Investment Company Act of 1940 and Items 39 to 45 of Form N-8B-1 (17 CFR, 274.11) adopted thereunder.

Section 8 (b) of the Investment Company Act requires every investment company which has filed a notification of registration pursuant to section 8 (a) of the Act to file subsequently, within a period of time fixed by Commission rule, a detailed registration statement giving certain information regarding the company and its policies and operations. Among the items of information for which section 8 (b) makes provisions are the following:

"(1) a recital of the policy of the registrant in respect of each of the following types of activities, such recital consisting in each case of a statement whether the registrant reserves freedom of action to engage in activities of such type, and if such freedom of action is reserved, a statement briefly indicating, insofar as is practicable the extent to which the registrant intends to engage therein: (A) the classification and subclassifications, as defined in sections 4 and 5, within which the registrant proposes to operate; (B) borrowing money; (C) the issuance of senior securities; (D) engaging in the business of underwriting securities issued by other persons; (E) concentrating investments in a particular industry or group of industries; (F) the purchase and sale of real estate and commodities, or either of them; (G) making loans to other persons; and (H) portfolio turn-over (including a statement showing the aggregate dollar amount of purchases and sale of portfolio securities, other than Government securities, in each of the last three full fiscal years preceding the filing of such registration statement);

(2) a recital of the policy of the registrant in respect of matters, not enumerated in paragraph (1), which the registrant deems matters of fundamental policy and elects to treat as such;"

Section 13 (a) of the Act reads as follows:

"Section 13 (a). No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

"(1) change its subclassification as defined in section 5 (a) (1) and (2) of this title or its subclassification from a diversified to a non-diversified company;

"(2) borrow money, issue senior securities, underwrite securities issued by other persons, purchase or sell real estate or commodities or make loans to other persons, except in each case in accordance with the recitals of policy contained in its registration statement in respect thereto;

"(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, or deviate from any fundamental policy recited in its registration statement pursuant to section 8 (b) (2); or

"(4) change the nature of its business so as to cease to be an investment company."

Items 39 to 45 of Form N-8B-1 (17 CFR, 274.11) (which is the detailed form of registration statement for management companies) generally follow the language of sections 8 (b) (1) of the Act. Item 39 (b), which is typical, reads as follows:

"(b) Describe the policy of the registrant with respect to issuance of bonds, debentures and senior equity securities. (Registrant may reserve freedom of action to issue such securities, but if such freedom of action is reserved, a statement must be made briefly indicating insofar as is practicable, the extent to which registrant intends to issue such bonds, debentures, or senior equity securities.)"

You state that you intend to answer item 39 (b) as follows:

Registrant reserves freedom of action to issue bonds, debentures or senior equity securities.

Registrant does not intend to issue any bonds, debentures or senior equity securities.

Your request confirmation of your opinion that, if the item is so answered, your company will not be guilty of a violation of section 13 (a) (2) of the Act if at some subsequent date it issues senior securities without first obtaining a stockholders' vote.

Section 13 (a) (2) requires that the issuance of senior securities by a registered investment company, unless authorized by a vote of security holders, be made only "in accordance with the recitals of policy contained in its registration statement in respect thereto." The phrase "recital of policy" is not defined in the Act, but it is clear from the wording of section 8 (b) (1) that the phrase includes any statement made in order to comply with that section, whether the statement is expressed in terms of policy, intention or freedom of action. Moreover, section 8 (b) (1) requires that (to the extent practicable) a statement of the registrant's intention be made with regard to engaging in each of the activities enumerated in the section. This required statement of intention is the element of the "recital of policy" upon which section 13 (a) (2) has its impact. Corporate action cannot be said to be "in accordance with the recitals of policy" in a company's registration statement, within the meaning of section 13 (a) (2), if such corporate action departs in any respect from the registrant's statement of intention. Or to put the point more concretely, if your company answers Item 39 (b) of Form N-8B-1 as you propose, a stockholders' vote will be necessary before the company may issue senior securities.

The general framework of the Act, its legislative history and the practical aspects of the problem, as well as a strict reading of its provisions, all tend to support this interpretation. For example, there is a clear contrast between sections 8 (b) (1) and 13 (a) (2) on the one hand and section 8 (b) (2) and the corresponding provision of section 13 (a) (3) on the other. It is clear that section 8 (b) (2) merely affords the registrant an opportunity, without in any way obliging it, to make statements of fundamental policy which will bind the company in the absence

of a stockholders' vote. The emphasis of section 8 (b) (1) is very different; it implies an obligation on the part of the registrant to make as definite a statement of policy as is practicable with respect to each of the matters enumerated therein. The same inference is to be drawn from the following statement appearing in the Report of the Senate Committee on Banking and Currency, which considered the Investment Company Bill:

"* * * In addition, the registration statement must state the policy of the company as to items specifically enumerated in the bill." (S. Rep. 1775, 76th Cong., 3d sess., p. 13).

The only possible alternative to the construction of the statute which I have advanced is to say that it is only that portion of a recital of policy which relates to "freedom of action" which in any way binds the registrant for the purposes of section 13. Such a construction would lead to this absurd conclusion: every registrant, with respect to every type of activity enumerated in section 8 (b) (1), could make whatever statement of policy it wished in the form of a statement of intention, deriving every possible benefit in the eyes of the investing public which it is possible to derive from an indication that the company has a definite policy, and then might prevent its statement of policy from having any effect under section 13 by merely making a formal recital that it reserves "freedom of action."

If what I have said is correct it seems to me that it would serve little purpose for you to answer Item 39 (b) of Form N-8B-1 as you propose. Since your proposed statement of intention is an unqualified negative which will bind the registrant under section 13 (a) (2), the purported reservation of "freedom of action" has little meaning.

Admittedly a registrant may meet practical difficulties in attempting to recite its policy in those numerous situations in which neither an unqualifiedly negative nor an unqualifiedly affirmative statement is possible. This practical problem is recognized in section 8 (b) (1) and in the items of Form N-8B-1 adopted thereunder by providing that the registrant need only briefly indicate, "insofar as is practicable, the extent to which the registrant intends" to engage in the particular activity. To the extent that specification is practicable, however, it is the duty of the company to furnish statements of policy or intention which are specific, precise and informative.

It is obviously impossible to lay down any general rule for determining whether a particular statement of intention is as specific and definite as it is practicable to make it. The definiteness of the statement will necessarily vary with the nature of the registrant's business, the registrant's history and experience, and the nature of the activity to which the statement relates. For example, an answer which might be reasonably specific in the registration statement of a non-diversified closed-end company might be too general in the registration statement of a diversified open-end company. Again, a registrant which has adhered to certain well-defined policies in the past may in some instances be expected to describe its future policy with more particularity than a registrant which is formulating a policy for the first time. Nor can individual items be considered in isolation; a registrant's answer to one item, which might seem insufficiently definite considered by itself, may nevertheless be acceptable because its response to other items, which are interrelated as a practical matter, is unusually specific. In the last analysis, each registrant presents special problems and will require an application of the test of practicability which is suited to those problems.

The Investment Company Division of the Commission has advised me that it will be glad to consider informally any company's proposed or tentative answers to Items 39 to 45 of Form N-8B-1.

[Investment Company Act Release No. 167, July 23, 1941]

§ 271.214 *Letter of General Counsel relating to section 10 (a).*

This is in reply to your request for an opinion as to the proper interpretation of the term "employees" as used in Section 10 (a) of the Investment Company Act of 1940.

As I understand the facts, a registered investment company proposed to have a board of directors consisting of 15 persons. Of the proposed board, two directors will be officers of the investment company and seven will be partners of the firm which acts as investment adviser. It is proposed that X, a partner in the law firm which is on a general retainer from the investment company, be nominated as one of the six remaining directors. You wish to know whether X is an "employee" of the investment company within the meaning of section 10 (a).

Cases involving the construction of the term "employees" indicate that that term has no fixed meaning, but must be construed in the context and connection in which it is used. Attorneys have been held by the courts to be "employees" under some statutes and not under others. The settled rules of statutory construction require that the term, as used in a particular section of a statute, must be interpreted in the light of the purpose of the particular section and the evil sought to be remedied thereby. The legislative history of the Investment Company Act makes it manifest that the intent of section 10 (a) is to provide that at least 40% of the board shall be "independent" of the management, and shall be in a position to make an independent check upon the management's acts. I believe that counsel to an investment company who is regularly and continuously employed on a general retainer is so closely related to the management that he cannot be considered to be the "independent" type of person which the Act contemplates. The usual work of such counsel and the questions which confront him relate to the management of the company. He provides the legal advice which guides the management of the company in its activities. The purpose of Section 10 (a)—to provide an independent check on management—can hardly be accomplished if a person so closely related to the management is permitted to be included in the minority portion of the board which is designed to check independently on management activities. The same reasoning, of course, follows as to a partner or associate in a firm of attorneys employed on a general retainer basis.

My opinion is strengthened by a consideration of the effects of adopting a contrary interpretation. Such an interpretation would permit a company to choose a board composed exclusively of management directors and attorneys on retainer. Under this view a board of five directors might be composed of three officers or investment advisers and two partners in the law firm employed on general retainer by the company. Clearly any interpretation which so completely deprives stockholders of the independent check Congress intended to grant them must be rejected.

In view of the foregoing, it is my conclusion that an attorney on a general retainer from a registered investment company, or a partner or associate in a law firm which acts on that basis, is within the meaning of the term "employees" as used in Section 10 (a). Consequently, in the situation presented, this section would prohibit X from acting as a director of the company.

[Investment Company Act Release No. 214, September 15, 1941]

§ 271.446 *Extract from letter of Director of the Corporation Finance Division to sections 20 and 34 (b).* The Securities and Exchange Commission today made public an extract from a letter of Baldwin B. Bane, Director of its Corporation Finance Division, to an officer of a corporation who had inquired whether the Commission considered the company's annual report to security holders to be a part of the proxy soliciting material which, under the provisions of Rule X-14A-4 (17 CFR, 240.146-4) of the General Rules and Regulations under the Securities Exchange Act of 1934, is required to be filed with the Commission. The text of the extract from the Director's letter follows:

The rules in Regulation X-14 provide in effect that no proxy solicitation relating to a meeting of security holders at which the election of directors is an item of business shall be made by the management of the issuer unless each person solicited is concurrently furnished or has previously been furnished with an annual report to security holders containing such financial statements for the last fiscal year as will, in the opinion of the management, adequately reflect the position and operations of the issuer. The rules further require that copies of the annual report to stockholders must be mailed to the Commission in order that it may check compliance with the rule. You inquire whether the reports thus mailed are considered by the Commission to be material "filed" with the Commission within the meaning of Section 18 of the Act and therefore to be subject to the liabilities imposed by that section.

We do not regard the copies of annual reports so mailed to the Commission to be proxy solicitation material "filed" with the Commission or subject to the proxy rules or to the liabilities of section 18[1] of the Act except in cases in which the issuer specifically requests that it be treated as part of the proxy soliciting material or in cases in which it is incorporated in the proxy statement by reference. This is so whether the annual report is sent to the persons solicited and to the Commission in advance of the proxy statement or concurrently with it.

[Investment Company Act Release No. 446, February 5, 1943]

§ 271.448 *Excerpts from letters of the Director of the Corporation Finance Division relating to section 14 and Schedule 14A under Regulation X-14.* This release is the same as Securities Exchange Act Release No. 3385 (17 CFR, 241.3385). The Securities and Exchange Commission today made public excerpts from letters of * * * Director of the Corporation Finance Division, to officers of corporations who had asked for interpretation of certain provisions of the amended rules in Regulation X-14 relating to the solicitation of proxies. The first excerpt refers to paragraph (H) of item 5 of Schedule 14A which reads as follows:

Describe briefly any interest, direct or indirect, of each person who has acted as a director of the issuer during the past year and each person nominated for election as a director and any associates of such director or nominee in any transaction during the past year or in any proposed transaction to which the issuer or any subsidiary was or is to be a party. No reference need be made to immaterial and insignificant transactions. If the interest was or is to be in the purchase or sale, other than in the ordinary course of

[1] Section 34 (b) of the Investment Company Act of 1940 contains a provision similar to that of Section 18 of the Securities Exchange Act of 1934.

business, of property by the issuer or a subsidiary, include a statement of the cost of the property to the issuer or subsidiary and a statement of the cost to the purchaser or vendor.

The definition of the term "associate" in Rule X-14A-9 (17 CFR, 240.14a-9), which is referred to in the Director's letter, reads as follows:

The term "associate," used to indicate a relationship with any persons, means (1) any corporation or organization (other than the issuer or a majority owned subsidiary of the issuer) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10% or more of any class of equity securities, (2) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity, and (3) any relative or spouse of such person having the same home as such person.

The Director's comment on this item follows:

In general, the following principles should be observed in preparing the information called for by paragraph (H) of item 5.

The word "interest" means a material interest. In determining the materiality of a person's interest, the scope of the definition of the word "associate" in Rule X-14A-9 (17 CFR, 240.14A-9) may be considered as indicating the type of interest in respect of which information should be furnished. For example, the fact that a director of the issuer is also a director of another company is not enough of itself to establish the materiality of his interest in transactions between the two companies. On the other hand, if the director of the issuer were an officer or holder of 10% or more of the stock of the other company, his interest in transactions between the two companies should be disclosed unless the transactions were immaterial and insignificant.

Your letter sets out a list of transactions between your company and other companies or firms in which a director of your company is a director or partner of the other party to the transaction. If the director's interest in the transaction arises merely from the fact that he is a director of the other company, it appears in the light of the principles stated above that no mention of the transaction need be made. However, in commenting on your questions I shall assume that your director is an officer, partner or 10% stockholder of the other party to the transaction.

Your list is as follows:

1. A bank which makes commercial loans to the company at the going rate of interest and also issues Letters of Credit, etc. at the going rate.
2. An insurance company which issues policies of Marine Insurance in the usual form and at the usual rates.
3. An industrial company from which the Company makes purchases of machinery, equipment or supplies.
4. A law firm which is employed on an annual basis to handle various legal matters.
5. A tenant at a substantial rent of part of an office building owned by a subsidiary of this company.
6. A railroad over which this Company ships most of its products.
7. A telegraph company.
8. A telephone company.
9. An electric light company.
10. A sales agent for one particular line of fabrics in one city.

I believe that a director's interest in transactions with the companies referred to in 7, 8 and 9 need not be referred to under paragraph H if the transactions involved the ordinary services rendered by such companies and the services were rendered at the usual and regular rates. If the transactions involved extraordinary, unusual or special services and were not immaterial and insignificant, the interest of directors in them should be disclosed.

Directors' or their associates' interest in transactions with the companies referred to in 1 to 5, inclusive, and in 10 should be disclosed unless the transactions were immaterial and insignificant.

If a choice between two or more carriers is available to the company in determining the route over which its products should be shipped, I should consider that the director's interest in the transactions referred to in 6 should be disclosed unless the transactions were immaterial and insignificant.

The description of the transaction and of the director's interest in it should be brief. Details such as the dollar amount involved and the precise terms of the arrangements need not be stated.

To another inquiry regarding the same provision of the rule, the Director wrote as follows:

You state that a director of the issuer is an officer of a banking institution with which the company may have funds on deposit, or which may act as trustee under a mortgage or other indenture, or as transfer agent of stock, or as registrar with respect to outstanding stocks or bonds. You ask whether the director's interest in these transactions should be disclosed under item 5 (H).

Where a director of the issuer is an officer of a banking institution which during the period covered by the statement has rendered services as trustee under a mortgage or other indenture, the existence of such relationship should be disclosed unless the whole matter is immaterial and insignificant. Directors' interests in the other transactions mentioned in this item need not be disclosed.

Another excerpt refers to the paragraph (I) (3) of item 5 which require in respect of each director, nominee, or person who has acted as an officer but not as a director and who has received remuneration in excess of $20,000 during the fiscal year, a statement of:

the amount paid or set aside by the issuer and its subsidiaries primarily for the benefit of such director, officer or nominee, pursuant to each pension or retirement plan of the issuer and its subsidiaries or other similar arrangement, and the amount of the annual benefits estimated to be payable to such director, officer or nominee in the event of retirement.

The Director's comment on this paragraph follows:

You state that your employees' retirement plan provides for contributions to the retirement fund both by the employees and by the company. The amount of retirement benefits, if any, which a particular officer or director will receive will depend upon his continuance in the company's employ until he reaches retirement age and upon the amount of his salary in future as well as past years. In view of these uncertainties and of the fact that his retirement benefits will result in part from his own contributions, you suggest that you should not include in the tabulation called for by item 5 (I) the estimate of annual retirement benefits specified in paragraph (3) thereof.

I think you should include the required estimate in the tabulation, computing it upon the assumption that an employee will continue in the employ until normal retirement age at his present salary and explain in a footnote the assumptions upon which the estimate is based. The footnote may also include a statement to the effect that part of the sum is attributable to the employee's own contributions.

The following excerpt refers to a paragraph (L) of item 5 which calls for the name of each person other than a director, officer or employee of the issuer whose aggregate remuneration from the issuer exceeded $20,000, the amount received by each such person and the capacity in which it was received.

You point out that paragraph 5 (L) of item 5 of Schedule 14A is substantially the same as item 11 of Form 10-K (17 CFR, 249.310), the form on which the company files its annual report with the Exchange and with the Commission under the Securities Exchange Act of 1934. You ask whether the instructions as to item 11 of the Instruction Book for Form 10-K may be used as a guide in determining what disclosure should be made in the proxy statement under item 5 (L).

Item 5 (L) is intended to elicit information similar to that required to be given under item 11 of Form 10-K (17 CFR, 249.310) and the instructions as to that item may properly be used as a guide in the preparation of that part of the proxy statement.

[Investment Company Act Relase No. 448, February 17, 1943]

§ 271.735 *Letter of the Director of the Corporation Finance Division relating to section 20 and to Rule X-14A-7 under the Securities Exchange Act of 1934 (17 CFR, 240.14a-7).*

This is in reply to your recent letter in which you inquire whether certain proposals presented to you by a stockholder of the company for inclusion in the management proxy statement pursuant to the provisions of Rule X-14A-7 of Regulation X-14 of the General Rules and Regulations promulgated pursuant to the provisions of the Securities Exchange Act of 1934 are proper subjects for action by your company's security holders at its next annual meeting. The resolutions presented by such stockholder propose that dividends paid to stockholders shall not be subject to Federal Income Tax where the income from which such dividends are paid has already been subject to corporate income taxes; that the anti-trust laws and the enforcement thereof be revised; that all Federal legislation hereafter enacted providing for workers and farmers to be represented should be made to apply equally to investors. Other resolutions which are proposed are of similar nature. You state that these proposals are obviously of a political and economic nature and that your corporation is an industrial corporation which is not empowered to engage in political activity nor is such activity within the scope of its business operations.

Speaking generally, it is the purpose of Rule X-14A-7 (17 CFR, 240.14A-7) to place stockholders in a position to bring before their fellow stockholders matters of concern to them as stockholders in such corporation; that is, such matters relating to the affairs of the company concerned as are proper subjects for stockholders' action under the laws of the state under which it is organized. It was not the intent of Rule X-14A-7 to permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social or economic nature. Other forums exist for the presentation of such views.

It is my conclusion that the proposals which have been presented to you are not "proper subjects for action" by your company's stockholders within the meaning of that phrase as used in Rule X-14A-7 (17 CFR, 240.149-7). Consequently, it will be unnecessary for you to include the proposals in the management's proxy statement if you do not wish to do so.

[Investment Company Act Release No. 735, January 3, 1945]

PART 276—INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT ADVISERS ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER.[1]

Sec.

§ 276.2 *Opinion of General Counsel relating to section 202 (a) (11) (C) of the Investment Advisers Act of 1940.*

OCTOBER 28, 1940.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
821 15th Street, NW.,
Washington, D. C.

GENTLEMEN: You have requested my opinion whether participation by an over-the-counter broker or dealer in transactions of the character described below renders him an "investment adviser" within the meaning of Section 202 (a) (11) of the Investment Advisers Act of 1940.

In each of the situations presented, a broker who is not a member of a national securities exchange transmits to a broker who is a member of such an exchange an order for the member broker to purchase or sell a security listed on the exchange for the account of a customer of the non-member broker. In each case the non-member broker charges his customer an "overriding commission" or "service charge" in addition to the regular commission which the member broker receives for executing the transaction. In no instance is the amount of the "overriding commission" or "service charge" greater than the regular commission charged by the member broker.

I understand that there are four district practices or policies followed by over-the-counter brokers in making such charges:

1. Frequently the over-the-counter broker charges the overriding commission or service charge in every instance in which he transmits such an order to a member broker, and the amount of such additional commission or charge is the same for all transactions of the same size, no matter who the customer is or how much consultation or advice the over-the-counter broker has given him.

2. Other over-the-counter brokers charge an overriding commission or service charge which may be uniform in amount, but which is charged only to those customers to whom the broker has given advice. In these cases the non-member broker receives no remuneration on transactions in listed securities if the customer has simply asked him to have an order executed, without seeking or receiving any advice.

3. A number of over-the-counter houses charge, on a uniform basis, an overriding commission or service charge for the execution of such transactions, except that they make no charge to certain clients, for example, clients who do a substantial amount of over-the-counter business through or with the house.

4. Occasionally an over-the-counter broker follows the practice of charging an overriding commission or service charge to all customers and on all transactions, but the amount of the charge varies in relation to the amount of consultation between the broker and his customer regarding the transaction.

The pertinent provisions of section 202 (a) (11) of the Investment Advisers Act, under which these questions arise, are the following:

"'Investment adviser' means any person who, for compensation, engages in the business of advising others * * * as to the value of securities or as to the advisability of investing in, purchasing, or selling securities * * *; but does not include * * * (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor * * *"

I shall assume for the purposes of this letter that, in every situation outlined above, the transaction is "solely incidental to the conduct * * * business as a broker or dealer." The precise question presented, therefore, is whether in each of these situations the over-the-counter broker in taking an overriding commission is receiving "special compensation for" advice which he may have given his customer.

Clause (C) of section 202 (a) (11) amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause (C) which refers to "special compensation" amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities. It is well known that many brokers and dealers have investment advisory departments which furnish investment advice for compensation in the same manner as does an investment adviser who operates solely in an advisory capacity. The essential distinction to be borne in mind in considering borderline cases, such as those which you have presented, is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental.

Let me turn now to the four specific situations as to which you have inquired. In the first situation the over-the-counter broker charges an overriding commission or service charge for participating in the execution of every purchase or sale of listed securities. While the time and expense involved in giving advice to customers may be among his motives for charging the overriding commission or service charge, they represent only one part of his general expenses, and are no more directly related to the charge, which he makes than is similar advice given customers with respect to over-the-counter transactions for which the broker receives a regular commission. In this first situation the imposition of the overriding commission or service charge does not in itself make the over-the-counter broker an "investment adviser" within the meaning of the Act.

The second situation presents a clear antithesis to the first. Here the charge is directly related to the giving of advice. Those customers who receive the advice have to pay an additional charge, while those who do not receive advice do not.

The fourth situation is no different in principle from the second. Although all customers must pay an additional charge, at least part of the charge to customers receiving advice is attributable to such advice, and it is therefore clear that the charge includes "special compensation" for advice. It is my opinion that in both the second and fourth situations the over-the-counter broker is acting as an investment adviser.

From a practical point of view the third situation presents a difficult problem. It is true that if the broker's discrimination between customers bears no relation to the nature or amount of advice which they receive from him, the additional charge does not in principle appear to be "special compensation." Nevertheless, I am sure you will recognize that difficult questions of fact are presented whenever the additional charge is not imposed on a wholly uniform basis. If a broker is confident that his discrimination between customers follows a clear and consistent policy, bearing no relation whatsoever to the rendition of investment advice to his customers, he may safely consider himself excluded from the definition of the term "investment adviser." When the circumstances are not so clear, I suggest that you recommend to your members that they call their peculiar problems to the Commission's attention, and take the precaution of registering under the Act pending the Commission's determination of the question. If the Commission is of the opinion that the broker is not an "investment adviser" within the meaning of the Act, he will be entitled to withdraw his registration pursuant to section 203 (g).

Very truly yours,

CHESTER T. LANE,
General Counsel.

[Investment Advisers Act Release No. 2, October 28, 1940]

§ 276.8 *Opinion of the General Counsel relating to the use of the name "investment counsel" under section 208 (c) of the Investment Advisers Act of 1940.*

You have raised the question of a possible conflict between the provisions of Section 208 (c) of the Investment Advisers Act of 1940 and the provisions of certain State laws regulating investment advisers. These State laws require, in one form or another, that a person giving advice with reference to security investments obtain a license to act as an "investment counsel". Under the Investment Advisers Act, on the other hand, if such person is not primarily engaged in the business of rendering "investment supervisory services" (as defined in Section 202 (a) (13)), it will be unlawful for him "to represent" that he is an "investment counsel" or "to use the name investment counsel as descriptive" of his business.

Section 208 (c) of the Investment Advisers Act attempts to restrict the use of the term "investment counsel" by persons registered under the Act to those who are primarily engaged in giving continuous advice as to the investment of funds on the basis of the individual needs of their clients. Although the state licensing laws referred to above use the phrase "investment counsel", the context in which the phrase is used indicates that the intent of the statutes is to establish a general descriptive category for administrative purposes rather than to distinguish between investment advisers who give general market

[1] The interpretative opinions included herein are opinions issued in the past for the guidance of the public by members of the Commission's staff (or in a few instances by the Commission) and heretofore made public pursuant to Commission authorization. The opinions are to be read as of the date of original publication and in the context of the rules, statutes and circumstances then existing. However, opinions or portions of opinions which are clearly obsolete have been omitted. While it is not clear that publication of interpretative opinions of this kind in the FEDERAL REGISTER is required, it is believed that such publication may be helpful to the public and that it falls within the spirit of the Administrative Procedure Act.

Where rules referring to an opinion have been renumbered since the issuance of the opinion, the new designations are indicated in brackets.

advice and those who give individualized service. I believe that the purposes of the Investment Advisers Act and of the state statutes are not necessarily conflicting.

A person who is registered under the Investment Advisers Act but who is not an investment counsel within the meaning of that Act should in his general advertisement and on his letterhead refer to himself as an investment adviser or some other appropriate term other than investment counsel. In so doing he certainly would not be violating the state statutes and he would be conforming with the Investment Advisers Act. On the other hand, if he were asked whether his company is licensed under a state law, it would be entirely proper to reply that he is licensed to do business in that state as an investment counsel. Similarly a certificate issued by a state authority setting forth that he has qualified under the law as an investment counsel can properly be hung on the wall of his office. In such cases the investment adviser would simply be advising concerning his technical legal status under the state law.

In a large measure the whole question is one of good faith. As a practical matter, if the investment adviser confines reference to himself as an "investment counsel" to those situations in which there is common-sense justification for pointing out his legal status under a State law, he will run no other risk of violating section 208 (c).

[Investment Advisers Act Release No. 8, December 12, 1940]

§ 276.40 *Opinion of Director of Trading and Exchange Division, relating to section 206 of the Investment Advisers Act of 1940, section 17 (a) of the Securities Act of 1933, and sections 10 (b) and 15 (c) (1) of the Securities Exchange Act of 1934.*

The question has been presented whether it is permissible for an investment adviser to sell a security to or buy a security from a client. You ask also what disclosure is necessary if such a transaction is permissible. Section 206 of the Investment Advisers Act of 1940 provides:

"It shall be unlawful for any investment adviser registered under section 203, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

"(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

"(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

"(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

"An investment adviser is a fiduciary. As such he is required by the common law to serve the interest of his client with undivided loyalty. In my opinion a breach of this duty may constitute a fraud within the meaning of clauses (1) and (2) of section 206 of the Investment Advisers Act (as well as the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934).

It follows that an investment adviser may not effect a transaction as principal with a client unless he obtains the client's consent to the transaction after fully disclosing any adverse interest he may have, together with any other information in his possession which the client should possess in order to determine whether he should enter into the transaction. The disclosure should include, as a minimum, (a) the capacity in which the investment adviser proposes to act, (b) the cost to the adviser of any security which he proposes to sell to his client (or, if he proposes to buy a security from his client and knows or is reasonably certain of the price at which it is to be resold, a statement of that price), and (c) the best price at which the transaction could be effected by or for the client elsewhere if such price is more advantageous to the client than the actual purchase or sale price. Moreover, any disclosure of the cost to the investment adviser (or the price he expects to receive on resale) should be so phrased that its full import is obvious to the client. The disclosure should include a statement of the total amount of the cost or resale price (or the total profit) in dollars and cents; it would not suffice, in my opinion, merely to express a formula by which those amounts may be computed, or to limit the disclosure to a percentage figure or to a maximum number of points or dollars per share or bond.

What has been said thus far is not limited to investment advisers who are registered under the Investment Advisers Act. Although section 206 of that Act applies only to registered investment advisers, the overall effect of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to cover any transaction in a security by any person where use is made of the mails or of some means or instrumentality of interstate commerce. Consequently, investment advisers who are exempted from registration by one of the clauses of section 203 (b) of the Investment Advisers Act are nevertheless subject to the anti-fraud provisions of the 1933 and 1934 Acts when, notwithstanding their fiduciary status, they seek to deal with clients on a principal basis.

It is not essential that the disclosure of adverse interest be in writing so far as clauses (1) and (2) of section 206 of the Investment Advisers Act, as well as the anti-fraud provisions of the 1933 and 1934 Acts, are concerned. However, aside from the general requirement of full disclosure and consent imposed by these provisions, clause (3) of section 206 of the Investment Advisers Act, which applies only to *registered* investment advisers, requires specifically that the disclosure of the *capacity* in which the investment adviser is acting be given *in writing* and the client's consent obtained before the completion of the transaction. In my opinion the requirements of written disclosure and of consent contained in this clause must be satisfied before the completion of each separate transaction. A blanket disclosure and consent in a general agreement between investment adviser and client would not suffice.

It will be noted that the specific provisions of clause (3) of section 206 do not apply "to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."[1] Whether an investment adviser is subject to the duties of a fiduciary under clauses (1) and (2) (and under the anti-fraud provisions of the 1933 and 1934 Acts) in respect of such a transaction depends on all the facts (including the type of general investment advice rendered) in each case.

[1] In any event, of course, section 15 (c) (1) of the Securities Exchange Act of 1934 and the Commission's Rule X-15C1-4 (17 CFR, 240.15C1-4) thereunder require every broker or dealer to give his customer written notification of his capacity "at or before" the completion of each transaction.

Everything which has been said thus far with respect to a transaction in which an investment adviser buys or sells for his own account as principal applies equally to a transaction for the account of a client in which the investment adviser acts as a broker for some other person. In such a transaction, of course, it is the investment adviser's total commission which must be disclosed in dollars and cents.

Finally, it must be borne in mind that this opinion is limited to the requirements of federal law. I can express no opinion as to the applicable state law. It is clear, however, that investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship.

[Investment Advisers Act Release No. 40, February 5, 1945]

PART 281—INTERPRETATIVE RELEASES RELATING TO CORPORATE REORGANIZATIONS UNDER CHAPTER X OF THE BANKRUPTCY ACT[1]

Sec.

§ 281.1 *Letter of the Commission with respect to transmission to the Commission of all petitions, answers, orders, applications, reports and other papers filed under Chapter X of the Bankruptcy Act.* The Securities and Exchange Commission today made public a letter that it was transmitting to each of the 94 Federal District Court Clerks with reference to the provisions of Chapter X of the Chandler Act relating to the transmission to the Commission of the various papers and documents filed in reorganization proceedings under that Chapter.

* * * * *

As you know, at the last session of Congress a statute was enacted extensively revising the National Bankruptcy Act. This revision, known as the Chandler Act, was approved by the President on June 22, 1938; and as a general matter the Act is to take effect and be in force on and after three months from the date of its approval.

Section 77B of the National Bankruptcy Act, relating to Corporate Reorganizations, is to be superseded by Chapter X of the Chandler Act. Chapter confers upon the

[1] The interpretative opinions included herein are opinions issued in the past for the guidance of the public by members of the Commission's staff (or in a few instances by the Commission) and heretofore made public pursuant to Commission authorization. The opinions are to be read as of the date of original publication and in the context of the rules, statutes and circumstances then existing. However, opinions or portions of opinions which are clearly obsolete have been omitted. While it is not clear that publication of interpretative opinions of this kind in the FEDERAL REGISTER is required, it is believed that such publication may be helpful to the public and that it falls within the spirit of the Administrative Procedure Act.

Where rules referring to an opinion have been renumbered since the issuance of the opinion, the new designations are indicated in brackets.

Securities and Exchange Commission various duties and functions in connection with proceedings for the reorganization of corporations under that Chapter. In order that the Securities and Exchange Commission may be informed of the nature and status of the reorganization proceedings and may expeditiously perform the duties imposed upon it, it was provided that copies of the various notices, petitions, applications, orders, reports and other documents filed in the proceedings should be transmitted to the Securities and Exchange Commission.

Accordingly the Commission has requested me to call to your attention section 265 (a) of Chapter X which provides for the transmission to this Commission of copies of all petitions, answers, orders, applications, reports and other papers filed in all reorganization proceedings instituted under the Chandler Act on or after September 29, 1938, in the United States District Court for your judicial district. For your use we are pleased to send you herewith a number of copies of that section.

Further, under section 276 (c) of the Chandler Act, Chapter X will apply to all proceedings pending under Section 77B where the petition in such proceeding under Section 77B was approved on or after June 22, 1938. Accordingly, we would like to obtain copies of all papers and documents which are filed hereafter in connection with proceedings under Section 77B in your judicial district where the petition was approved on or after June 22, 1938. Also we would greatly appreciate it if you could send us a list (name of the debtor and docket number) of all proceedings instituted under 77B in your judicial district in which the petition was approved between June 22, 1938, and the date of your receipt of this letter.

The letter also stated that it was the hope of the Commission that the Clerks would make arrangements, so far as possible, to have all papers and documents mailed to the Commission on the same day that they are filed. Also it was requested that copies of all papers and documents be sent, in duplicate, one copy to be mailed directly to the Securities and Exchange Commission at Washington, District of Columbia, and the second copy to be mailed to the Regional Office of the Commission in which the District Court is located, with the exception of the District Courts located within the area of the Washington Regional Office of the Commission and a few other instances, where a single copy was requested.

The letter concluded as follows:

Your cooperation in sending us the documents in these cases will be greatly appreciated. I shall be happy to correspond with you further upon any of the matters I have mentioned and any inquiries you may wish to make will be most welcome. It is our earnest desire to meet your convenience in these matters in any way we possibly can.

[Corporate Reorganization Release No. 1, September 26, 1938]

§ 281.2 *Statement by the Commission summarizing Chapter X of the Bankruptcy Act.*

A substantially amended federal bankruptcy act was enacted by the Third Session of the 75th Congress and approved by the President on June 22, 1938. These amendments, known as the Chandler Act, constitute a general revision of the entire Bankruptcy Act of 1898, as amended, with the exception of those provisions which relate to railroad reorganizations, municipal debt readjustments and extensions and compositions of agricultural debts. This general revision, the first of its kind in forty years, is the culmination of six years of study and effort by the Judiciary Committees of the Senate and House of Representatives, by the National Bankruptcy Conference, and by the Securities and Exchange Commission.

Chapter X of the Chandler Act imposes certain new duties upon the Securities and Exchange Commission. This chapter, dealing with corporate reorganization, replaces the former Section 77B of the Bankruptcy Act. It clarifies the many ambiguities and contradictions of the former Section 77B, and provides a number of fundamental improvements in corporate reorganization procedure.

Briefly stated, the two principal changes embodied in Chapter X are as follows:

1. In corporate reorganizations involving liabilities of $250,000 or more, the court shall appoint an independent and disinterested trustee to administer the estate, who will also act as the court's representative in studying the affairs of the corporation and in the formulation of a plan of reorganization.

2. In its consideration of all cases under Chapter X, the court will have at its disposal the facilities of the Securities and Exchange Commission.

The independent trustee will perform two particularly important functions. First, he will report to the court the facts about the corporation's financial condition, its assets and liabilities, the activities and competence of its management, and all other matters relevant to the preparation of a plan and the collection of assets. Second, as the court's representative, the independent trustee will hear and give consideration to the proposals of creditors and stockholders who wish to make suggestions as to the reorganization plan. He will then proceed to formulate and file a plan within a time fixed by the court. Thus, under Chapter X, the reorganization plan will be formulated under the guidance of a disinterested officer of the court, who will be entirely independent of conflicting interests.

In the consideration of reorganization plans and the complex financial and business problems which they involve, there will be made available to the courts expert and impartial assistance. Under Chapter X the court may request from the Securities and Exchange Commission an advisory report on any reorganization plan. In the larger cases, where the scheduled liabilities of the debtor corporation undergoing reorganization are over $3,000,000, the court automatically refers proposed reorganization plans to the Commission for an advisory report. In the smaller cases, the court may, or may not, refer plans to the Commission, as it sees fit.

The advisory report will be an independent analysis prepared by the Commission's expert legal and financial staff, and, of course, will be subjected to the scrutiny and approval of the Commission itself. It will provide the court with a non-partisan survey and critique of the plan, appraising its fairness and soundness and revealing any weaknesses or inequities. In addition, upon approval of a plan by the judge the Commission's advisory report will be sent to all investors for their examination at the time they are asked to vote upon the plan. Investors will also receive copies of the court's opinion on the plan and such other information as may be relevant.

In addition to the advisory report on a reorganization plan, the court may obtain the advice and assistance of the Commission throughout the reorganization by making the Commission a party to the legal proceedings. In any case under Chapter X the court may invite the Commission, or upon the request of the Commission may permit it, to intervene as a party to the proceedings.

The Commission desires to emphasize the following:

1. The Commission has no authority under the Chandler Act either to veto or to require the adoption of a reorganization plan. Nor has it authority to adjudicate any of the other issues arising in a proceeding. Its functions are purely advisory. The facilities of its technical staff and its disinterested judgment are at the service of the court.

2. The Commission has no power to restore the lost investment of any security holder or any class of security holders. No change in corporate reorganization procedure, and no readjustment of capital structures, however drastic, can be expected to give value to securities or claims which are intrinsically worthless. The most that can be expected of any system of corporate reorganization is that it will provide adequate machinery for the preservation of the assets of the corporation—the realization of all the values that are in the enterprise—and the fair and equitable allocation of those values among the several classes of security holders and claimants. In addition, of course, the procedure should be so designed that the corporation will emerge from reorganization under a financially sound plan and in the hands of competent and loyal management.

* * * * *

In the period since the passage of the Chandler Act, the Commission has been engaged in adding properly qualified members to its legal, financial, and accounting staff, both in Washington and in each of its eight Regional Offices, in order to facilitate the performance of its functions under the Act. In a four-day meeting held in Washington recently, the full regional and Washington staff of the Reorganization Division undertook a thorough study of these functions, and discussed at length the related problems of administration under the Act.

Insofar as these functions are primarily concerned with representing the Commission in proceedings in which the court has requested or permitted the Commission to intervene, or with obtaining the facts required in the preparation of the Commission's reports on plans, they will ordinarily be handled by the eight Regional Offices. The Commission believes that the convenience of the various United States District Courts, as well as the convenience of investors and other interested parties, will best be served by this procedure.

On the other hand, it is expected that the advisory reports on plans will be prepared in final form at the Washington headquarters for submission to the Commission on the basis of data and information submitted by the Regional Offices. In addition, as under the 1933 and 1934 Acts, the Washington headquarters will of course be charged with the duty of formulating for consideration and determination by the Commission the policies to be pursued in the administration of the Act, and with the task of seeing that those policies are uniformly carried out throughout the country. It will also make available to each Regional Office the results of the research conducted and experience gained in the country-wide administration of the Act.

Each field unit of the Reorganization Division will be an integral part of the Regional Office to which it is assigned, and its work will be under the general administrative supervision of the Regional Administrator. On the basis of available figures with respect to petitions filed under Section 77B during the first eight months of 1938, the Commission estimates that approximately three-fourths of the proceedings under Chapter X will arise within the territorial jurisdiction of its New York and Chicago Regional Offices.

[Corporate Reorganzation Release No. 2, September 26, 1938]

LEONARD HELFENSTEIN,
For Herbert B. Cohn, Executive Assistant to the Commission.

[F. R. Doc. 46-16839; Filed, Sept. 17, 1946; 10:12 a. m.]