

Oct 14, 1963

BY MESSENGER

Mr. Joe Matters
Legal and Monetary Subcommittee
House Committee on Government Operations
House of Representatives
218 George Washington Inn
Washington, D.C.

Dear Mr. Matters:

This will confirm our recent telephone conversation in which you told me that the Committee is interested in practices by which corporate balance sheets are dressed up or inflated in order to improve the appearance of the financial statement and asked if matters of this kind had come before the Commission, and what the Commission's position with respect to them is.

Practices of this nature takes a variety of forms, including simple falsification of financial statements by including worthless or over-valued assets, etc. I assume that you are not interested in these situations but rather in practices which tend to dress up the financial statements in a somewhat more subtle way.

Problems of this nature have come before the Commission in a number of cases. Unfortunately, we do not have an index digest which would make it possible for me to identify all of the situations of this kind which have come before the Commission. I do recall at least three cases involving broker-dealers with which I had something to do which have presented questions of this nature.

Under the Commission's rules, registered broker-dealers are required to file financial statements with the Commission and are also required to comply with the Commission's capital rules. There are thus instances where a broker-dealer wishes to dress up his balance sheet which is a public document either to improve his apparent capital or to give an appearance of financial solidity.

A situation of this kind arose in In the Matter of Whitehall Corporation, 38 S.E.C. 259, 272 (1958). There a broker-dealer filed with us a financial statement showing as an asset advances to one of its principal officers, i.e., loans to him in the amount of approximately \$20,000. Our staff questioned the admissibility of this advance as an asset. The officer personally then borrowed \$10,000 from a bank giving his 30-day notice therefor and paid this money to the firm which then filed with us another balance sheet showing that the indebtedness of the officer had been reduced to \$10,000 and cash in the bank had been increased by \$10,000. Just before the note fell due, the firm advanced \$10,000 to the officer who used it to pay the note, thus reverting to the usual position. The Commission held that these transactions rendered the

Mr. Joe Matters

Page Two

second balance sheet filed with us misleading in a material respect and consequently found filing it with the Commission violated the Commission's rules with respect to financial statements.

A somewhat similar situation arose in In the Matter of Associated Underwriters, Inc., Securities Exchange Act Release No. 7075 (1963), a copy of which is enclosed. As you will note from the Findings, Opinion and Order an incorporated broker dealer filed with the Commission a financial statement showing cash of \$2000 and no liabilities as of May 4, 1961. Upon investigation it developed that the cash represented funds loaned to the president of the broker-dealer firm individually and deposited by him in its capital account, and that four of five days later, he withdrew most of this money and used it to repay the loans. Financial statements were found to be false and misleading.

Another case along this line, but presenting a somewhat different situation, arose in In the Matter of Wendell Weston, 30 S.E.C. 296, 311 (1949). This broker-dealer was required to file a financial statement before the end of the year 1945 showing his financial condition as of a date not earlier than the middle of October. Early in November a customer filed a claim against the broker-dealer for a substantial amount. In December he filed a financial statement including a balance sheet as of October 31 which made no reference to the claim. He contended that this was proper since the claim was asserted after October 31. The Commission held that while the use of an October 31 balance sheet would normally be permissible, a broker-dealer could not take advantage of this "in order to conceal a material change which, to the knowledge of the registrant, has taken place between the date of the statement and its filing." The financial statement was accordingly held to be misleading.

There are undoubtedly other cases of this nature in the Commission's files. If you need further information in this regard, please let me know and we will be happy to obtain it.

Sincerely yours,

Philip A. Loomis, Jr.
General Counsel

Enclosure

Cc: Orbal DuBois

PALoomis/rs
10-14-63