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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Broker-Dealer Registration by Banks

As reported in the August 2001 issue of Update, the Securities and Exchange Commission ("SEC") adopted interim final rules addressing the bank exceptions to registration as a broker-dealer which were effective as of May 12, 2001, and replaced the long-standing exception by banks from the broker-dealer registration provisions under the Securities Exchange Act of 1934. The interim rules gave banks until October 1, 2001, to register as a broker-dealer and gave banks until January 1, 2002, before their compensation arrangements must meet the conditions of certain statutory exceptions. Under the interim final rules, banks with non-exempt securities activities would have to register as broker-dealers or move the activities into a broker-dealer affiliate. Many banks would prefer to avoid registration because it subjects them to more regulation by another regulatory agency. Federal bank regulators argue that the rules go beyond the SEC's power and are based on a misunderstanding of banking industry practices. Criticism of the rules by federal bank regulators, include excluding some traditional trustee relationships from the definition of "trustee"; the rules' exemption for investment advice given for a fee is narrower than intended by the Gramm-Leach-Bliley Act (the "Act"); and the Act allows a bank employee to receive a nominal one-time fee of a fixed amount for referring customers to an associated broker-dealer but the SEC rules limit this by restricting the fee to no more than one hour's compensation and prohibiting the payment of bonuses. Under pressure from the bank regulatory agencies, the time periods have been extended until May 12, 2002. Copies of SEC Release No. 34-44570 extending the compliance dates are available from our firm.

Securities Secondary Liability

In *Ziemba v. Cascade Int'l Inc.*, No. 99-14681, the United States Court of Appeals for the Eleventh Circuit held that in order for a secondary actor such as a law firm to be primarily liable under Section 10(b) of the Securities Exchange Act of 1934, the investors must show reliance on a misstatement or omission by the law firm. In this case, the investors did not allege any misstatements by the law firm upon which they relied. The law firm could not be held secondarily liable for its role in drafting, creating, reviewing or editing allegedly fraudulent letters or press releases. As determined by the United States Supreme Court in *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994) aiding and abetting a violation of Section 10(b) of the Securities Exchange Act of 1934 is not actionable in private suits. Section 10(b) provides: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange – (b) to use or deploy, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of the investors. An accounting firm was also not liable to investors for allegedly improperly advising a client that its financial results did not need to be consolidated with an affiliate. The investors could not show that they relied on this advice or that any audit report prepared by the accounting firm was incorporated into any of the company's public documents. Failure of the accounting firm to include "going concern" qualifications in its audit reports of subsidiary companies of a client was not actionable. While violations of Generally Accepted Accounting Principles and the failure to heed "red flags" indicating fraud can be sufficient to state a claim of securities fraud, the investors did not allege facts suggesting actual awareness by the firm of any fraud. <u>This case provides an excellent summary regarding the issues relating to secondary liability by professionals in connection with the offer and sale of securities</u>. The case is reprinted in (Current Binder) Fed. Sec. L. Rep. (CCH) ¶ No. 91, 470 or, alternatively, copies of the case are available from our firm.

Pooling of Interests Accounting

The Financial Accounting Standards Board ("FASB") has concluded its work in connection with the issuance of two Statements: Statement No. 141, *Business Combinations*, and Statement No. 142, *Goodwill and Other Intangible Assets*. These two Statements will change the accounting for business combinations and goodwill in two significant ways. First, <u>Statement 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001</u>. Use of the pooling-of-interests method is prohibited. Second, Statement 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. As a result, amortization of goodwill, including goodwill recorded in past business combinations, will cease and for companies with calendar year-ends, will be effective January 1, 2002. In its News Release, the FASB stated that Statement 141 improves the transparency of the accounting and reporting for business combinations by requiring that all business combinations be accounted for under a single method, i.e., the purchase method, and <u>Statement 142 requires that goodwill no longer be amortized to earnings, but instead, be reviewed for impairment, providing investors with greater transparency regarding the economic value of goodwill and its impact on earnings</u>. Under the purchase accounting method, the price paid above the acquired company's net worth is accounted for as goodwill, which must be amortized or subtracted from the combined companies' reported earnings over a period of time. Following June 30, 2001, companies will be required to check goodwill (the difference between the purchase price of an acquired company and the net value of it assets) to an impairment test. If the test determines that goodwill has fallen in value, it would then have to be amortized. Since the impairment test will not take effect for most companies until January 1, 2002, companies will generally have to continue to amortize goodwill regardless of its relative value during the intervening period between June 30 and December 31. Companies would be required to perform the first step of the impairment test (comparison of the fair value of a reporting unit to its carrying amount) on all reporting units within six months of adoption. If the fair value of a reporting unit is less than its carrying amount, an impairment loss would be recognized and treated as a change in accounting principle. That change in accounting principle must be recognized by year-end. An impairment loss recognized as a result of an impairment test occurring after the first six months of adoption would be reported as part of operating income. Goodwill and intangible assets required in a transaction completed after June 30, 2001, but before Statement 142 is initially applied, would be accounted for in accordance with the amortization and nonamortization provisions.