WACHTELL, LIPTON, ROSEN & KATZ

July 17, 1972

To Our Clients

Recent Developments

1. Adoption of Revised Form S-16. See separate memo enclosed.

2. Amendments to Regulation S-X. Pursuant to Accounting Series Release No. 125, June 27, 1972, the SEC has adopted extensive amendments to Regulation S-X effective for fiscal periods ending after December 31, 1972. Of special significance are the following changes: (1) specific disclosure of the media advertising expenses are required; (2) the test of a significant "subsidiary" is changed from 15% of assets or revenues to 10%; and (3) more details are required with respect to deferred r and d expenses and changes in accounting principles between periods.

3. Same-day Margin Substitution. The FRB has amended the margin regulations so as to limit same-day substitutions in situations were the value of the margin securities in the restricted account is less than 40% of the indebtedness.

4. Stock Dividends. Accounting Series Release No. 124, June 1, 1972, reiterates the SEC position that stock dividends (distributions of less than 25%) require a charge to retained earnings equal to the fair market value of the shares distributed. The SEC takes the position that failure to make this charge or paying a stock dividend in the absence of retained or current earnings equal to the value of the dividend is a misleading practice.

5. Commercial Paper. The 1969-70 liquidity crises and the 1970-71 recession have given rise to a number of significant developments with respect to the treatment of commercial paper under the securities laws. In Sanders v. John Nuveen & Co., Inc., a recent Seventh Circuit case, CCH ¶ 93,517, the court held that the 1934 Act exclusion of short term notes from the definition of "security" is not available for commercial paper sold in small denominations to individual investors and therefore Rule 10(b)-5 is applicable.

There have been several no action letters with respect to commercial paper issued by REITs. The most recent is the denial of a no action position to First Union Real Estate Equity and Mortgage Investments, May 2, 1972, CCH ¶ 78,837, where it was proposed to sell through a prominent investment banking firm nine-month or shorter notes in minimum denominations of $75,000 with the proceeds to be invested in mortgages with maturities of less than three years, but no commitments for long term takeouts. It appears that the SEC position is evolving into permitting use of the commercial paper by REITs to finance mortgage warehousing or construction only where the turnover period is three years or less, there is an underlying firm commitment from a major institution for permanent financing or a bank letter of credit running with the commercial paper and the denominations and method of placement are such as to assure that the market is professional rather than individual investors.

6. Notes, Leases, and Franchises as Securities. There is a quickening accretion of case law holding all notes to be securities. The most recent extension in this area is MacAndrews & Forbes Co. v. American Barmag Corp., (U.S.D.C., S. Car. 1972) CCH ¶ 93,532, in which it was held that bills of exchange given in partial payment of the purchase price for allegedly defective machinery are "securities" and

therefore a 10(b)-5 cause of action is available for what otherwise would be a typical breach of warranty or breach of contract case. In U.S. v. Austin, 10th Cir., 1972, CCH ¶ 93,475 it was held that a loan commitment letter is a "security".

While Mr. Steak, Inc. v. River City Steak, Inc., 10th Cir., 1972, CCH ¶ 93,475 held that a real franchise (financially secure franchisor and real control of the business operation in the franchisee) is not a security, a substantial body of case law is developing to effect that sale of a franchise by a financially weak franchisor is a sale of security and that the fairly typical method of financing the construction of buildings for franchisees through sale of the real estate with a percentage lease is also a security. See Huberman v. Denny's Restaurants, Inc., (U.S.D.C., - N.D. Cal. 1972) CH ¶ 93,469.

8. Spinoffs. The SEC no action letter in American Research and Development Corp., CCH ¶ 78,851, states that the SEC is still considering its position with respect to spinoffs beyond that stated in Release 33-4982 and sets forth what may be assumed to be the present staff position as to the requirements for an unregistered spinoff:

(1) Parent and subsidiary both 1934 Act reporting companies and subsidiary has been such for five years.

(2) Subsidiary is current in 1934 Act reporting and meets Form S-7 standards.

(3) Shareholders of parent receive a proxy statement containing information about subsidiary substantially equivalent to that which would be contained in a S-7 prospectus.

(4) Parent and subsidiary are listed on national securities exchanges.

(5) Shares of subsidiary have been held by parent for a long period (15 years in the instant case).

9. Disclosures re Long Term Contracts. In Release 33-5263, June 22, 1972, the SEC emphasizes the need for full disclosure with respect to reporting of income from long term contracts; annual reports should contain same information as Form 10-K; no specific guidelines adopted; reiterates SEC position on timely disclosure of material corporate developments (Release 33-5092, October 15, 1970). This is another instance of the SEC position on disclosure moving toward the NYSE position and despite the very sparce statutory basis there can be little doubt that this trend will continue not just in SEC enforcement proceedings such as Texas Gulf Sulphur, but will apply in private 10(b)-5 damage cases.

10. Dividend Reinvestment Programs. In a May 1972 no action letter to J. P. Morgan & Co., Inc. the SEC permits inclusion of cash contributions ($50 minimum; $1000 maximum, per dividend period) in a typical unregistered dividend reinvestment program, such contributions to be invested at the same time as the dividends are invested.

11. Mutual Fund Advisory Contracts - Expense Limitations. In a letter to Cumulo Fund, Inc., March 23, 1972, the SEC takes the position that mutual-fund-investment-advisory-fee payments should be made only if at the time of payment they exceed any expense-limit reimbursement due to the fund from the adviser and that such expense reimbursements should be offset against the advisory fees. If such reimbursements exceed the fees, the reimbursements should be paid at least annually and the receivable should be booked immediately for the purpose of determining net asset value.

12. Securities Problems in Distress Loan Situations. See article enclosed.

M. Lipton

Enclosure

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REVISED FORM S-16

Pursuant to Release 33-5265, June 27, 1972, the availability of Form S-16 has been extended (officially effective August 15, 1972, but optionally immediately at the election of the issuer) in two significant directions:

(a) NASDAQ securities, as well as listed securities, are now eligible, and

(b) the "regular-way"-exchange-sale concept has been abandoned completely with solicitation of buy orders now permitted.

The following summarizes the rules with respect to Form S-16, as amended, and the principal considerations with respect to the use of Form S-16.

1. Eligibility of Issuer

Form S-16 is available only to issuers that meet the requirements of Form S-7, which are:

(a) issuer is an exchange listed or domestic 12(g) registered company,

(b) issuer has timely filed all required 1934 Act reports for the last three years,

(c) a majority of the present board of directors have been directors of the issuer or predecessors of the issuer (acquired companies) for each of the last three years,

(d) neither the issuer nor any subsidiary has defaulted in the past ten years in servicing its debt or preferred stock or paying lease rentals,

(e) issuer has had net after tax income before extraordinary items of at least $500,000 for each of the last five years, and

(f) if the securities registered are common stock or convertible into common stock, issuer has earned any dividends (including fair market value of stock dividends) which were paid in each of the last five years on all classes of securities.

Form S-16 is also available to a closed end management investment company, but only for secondary offerings, if such company

(a) is registered under the 1940 Act,

(b) has timely filed all reports required by Sections 20(a) and 30(a) and (b) of the 1940 Act, and

(c) meets the requirements for use of Form S-7 set forth in items (c) through (f) above.

2. <u>Transactions for which Form S-16 is Available</u>. Form S-16 is available for:

(a) <u>Secondary Offerings.</u> Outstanding securities offered for the account of any person other than the issuer, if securities of the same class are listed on a national securities exchange or quoted on NASDAQ;

(b) <u>Conversions</u>. Securities offered upon conversion (typically where the 3(a) (9) exemption is not available because of a cash payment) of outstanding convertible securities of the issuer, or an affiliate of the issuer (typical Eurobond convertibles where 3(a)(9) is not available because issuer of convertible is not same entity as issuer of underlying security), provided no commission or other remuneration is paid for soliciting the conversion; or

(c) Exercise of Transferable Warrants. Securities of the issuer offered upon exercise of outstanding transferable warrants of the issuer (the issuer of the warrant and underlying security must be the same and Form S-16 is not available for nontransferable warrants, options or other rights such as employee stock options, both qualified and nonqualified), provided no commission or other remuneration is paid for soliciting the exercise.

The rules as to availability are fairly clear. The major open issue appears to be availability in cases of secondary offerings by persons who acquire in private placements. How long must the privately placed securities be held before it is clear that they are not being offered for the account of the issuer? Will there be a distinction between cash private placements and acquisitions treated as private placements? As originally proposed Item 3(c) of amended Form S-16 would have required information as to the transaction in which the offered securities were acquired, if within the past two years. As adopted this proposal was changed to require such information only if the seller is an officer, director or 10 percent holder, or an associate of such person, and then only if such information has not previously been filed in a 1933 Act registration statement or a 1934 Act report or proxy statement. Release 33-5265 does not explain the reason for the change. While the SEC has been liberal in allowing Form S-16 to be used for partial sales of securities received in acquisitions treated as private placements, the "offered for the account of any person other than the issuer" language provides a clear basis for restricting availability in situations where most of the sellers were really bargaining for cash and it may be assumed that the SEC will so hold.

3. Manner of Offering Secondary Distributions. As noted above, original Form S-16 restricted secondary offerings to "regular way" exchange transactions. This was an unfortunate choice of language in that if it had any previous usage meaning, it meant normal five day settlement and was not descriptive of a kind of transaction meaningful in a 1933 Act context. The SEC

interpreted "regular way" to mean no solicitation of buy orders and no special selling effort, except that the broker could contact any person who had indicated interest in the previous 60 days. Thus old Form S-16 permitted sales on the floor of the exchange, either with the specialist or in the crowd, and crosses where the buy order was unsolicited (except in the case of the 60 day indication of interest).

The SEC proposed to amend Form S-16 to reflect these interpretations of "regular way" by substituting that the securities be offered in "unsolicited transactions". As finally adopted Form S-16 contains no restriction on the manner of offering. Thus solicitation of buy orders for securities registered on Form S-16 is now permitted. As in all distribution situations Rules 10(b)(2) and 10(b)(6) are applicable to Form S-16 offerings and Release 33-5265 makes specific note of such applicability.

Listed securities registered on Form S-16 may now be sold on the exchange or in the third market. NASDAQ securities may be sold in the over-the-counter market apparently without any requirement of use of an NASD broker or NASDAQ facilities. Item 2 of Form S-16 now requires a description of the nature of the offering, the names of the brokers to be used and the amounts to be sold by each and a description of any Hazel Bishop or Amex volume limitation agreements. Implicit is a limitation of Form S-16 offerings to brokerage type transactions as distinguished from firm commitment underwritings. However, there is no provision limiting the broker's compensation to the "usual and ordinary broker's commission" as in Rule 144. While NYSE Rule 394 limits the ability of NYSE members to sell in the third market, nonmember brokers are not limited and apparently may charge more than the normal NYSE commission on third market sales of listed securities. Further it appears that, if described in Item 2, the various types of on board and off board NYSE distributions may be used.

Since it is doubtful that the broker could establish that it is not an "underwriter" of a Form S-16 offering whether the seller is a controlling person (in which case there is really no question at all) or not (in which case there may be an argument that the dealer exception in Section 2(11) applies if the commission is usual and customary but which argument is not accepted by the SEC), there is no purpose served (other than competition and compliance with the regulatory limits on markups) by the broker limiting his commission to the usual and customary.

The staff of the SEC continues to take the position that the purchaser of 10 percent or more of a registered offering (the amount of securities registered for the particular offering; not the total amount outstanding) acquires underwriter status in connection with resales. The staff position apparently applies to offerings registered on Form S-16. While the policy considerations (broadened availability and use of Form S-16) underlying the abandonment of the no solicitation limitation on use of Form S-16, militate against applying this 10 percent rule to Form S-16 offerings, particularly when the amount of securities registered is a small percentage of the total outstanding, until the staff position is changed it should be considered applicable and sales structured accordingly. This will undoubtedly limit severely the institutional market for Form S-16 offerings.

4. The Form. Form S-16 continues as a seven item prospectus. The essential changes in Items 2 and 3 have been referred to above. In addition, an instruction has been added to Item 6 calling attention to the requirement of Rule 439 that accountants consents to incorporation of certified financial statements be filed as part of Form S-16 unless the consent is contained in the material which is incorporated by reference. Thus, if the consent is contained in future incorporated filings, it is not necessary to amend the Form S-16 to include the consent.

5. Liability Problems. Section 11 of the 1933 Act applies to the Form S-16 registration statement, including the 1934 Act

filings incorporated by reference. Thus, the strict liabilities of Section 11 become applicable to filings that before Form S-16 incorporation were measured by the lesser standards of Section 18 of the 1934 Act and Rule 10b-5. 1934 Act filings generally have not been of the same caliber as 1933 Act registration statements. In addition to whatever infirmities exist in the 1934 Act filings incorporated when the Form S-16 is filed, future 1934 Act filings are incorporated when made and thereupon become subject to Section 11 liabilities. In many situations selling shareholders, and the brokers who act for them, will have no control over, or opportunity to participate in, the preparation of the 1934 Act filings. As noted above the broker for the Form S-16 selling shareholder will in all probability be a 1933 Act underwriter. As an underwriter the broker can avoid Section 11 liability only if it can establish the due diligence defense. The practical and economic difficulty of so doing is obvious. Only in large transactions where a due diligence investigation is practical (larger than usual and customary commissions or spreads now being permissible in Form S-16 offerings) or where the broker is also the regular investment banker for the issuer, is the broker able to protect itself. The Wheat Report proposed to solve the problem by providing that the broker used due diligence if it read the Form S-16 and incorporated material and didn't know of any misrepresentation. This proposal has not been implemented, and like the aforementioned 10 percent "rule", the failure of implementation is a substantial limitation on full utilization of Form S-16.

M. Lipton.