February 28, 1973

To Our Clients:

RECENT DEVELOPMENTS

1. Discretionary Accounts. In a recent memo we noted that a senior staff member of the SEC had raised a question as to brokers selling market-maker inventory or underwriting allotments to discretionary accounts. To meet the potential problem we suggested an annual letter exchange with discretionary accounts disclosing specifically the possibility of this type of transaction. A form of letter was attached to our memo. The SEC Advisory Committee on Investment Management Services for Individual Investors has also considered these questions. The Committee concluded that special disclosure of the type we suggested and compliance with the special confirmation disclosure required by Rule 15c1-4 was adequate in the market-maker inventory situation, but that the potential conflict of interest in the underwriting allotment situation was so acute that the broker "should be prohibited from purchasing for clients any security with respect to which it . . . is acting as an underwriter during the existence of the distribution or selling syndicate, unless the client makes a request for such purchase unsolicited by the [broker]." While the Committee did not address the issue it would appear that block-positioner inventory (and abnormal market-maker inventory) should be treated the same as underwriting allotments; this point having been made in the SEC Institutional Investor Study and noted in the Report of the Senate Securities Subcommittee. Underwriting allotments and block-positioner inventory should not be sold to discretionary accounts.

2. Puts and Calls. The SEC has proposed the following rules:

(a) 3a11-1 -- at the request of the FRB, amending the 1934 Act definition of equity security to include puts and calls and therefore make them subject to the margin regulations.

(b) 9b-2 -- imposing disclosure, suitability and net capital requirements on brokers dealing in options. Special suitability requirements would be imposed with respect to down-and-out options and uncovered options, including, in the case of the latter, a suitability determination even though the broker did not recommend or solicit the transaction.

(c) 238 -- a 1933 Act §3(b) exemption for options if the premiums for any one type with an expiration date in the same month issued by the same writer or endorser do not exceed $500,000.

Although 9b-2 would appear to countenance down-and-out options, our reservations under both the fraud provisisions of the 1934 Act and the margin regulations continue, and we are still of the opinion that brokers should not deal in such options and that clients should not write such options. There is presently pending a class action seeking damages from 25 brokers on behalf of all call option buyers who lost money on the ground that calls are securities required to be registered under the 1933 Act. (The question to which proposed Rule 238 is addressed.) The suit is by one of the most experienced firms specializing in this type of class action. It would not be surprising to see a similar action with respect to down-and-out options.

3. Earnings Estimates. The SEC has announced that it will propose rules with respect to earnings estimates. The major outlines of the rules, expected in a few months, are:

(a) Estimates will be voluntary, not mandatory.
(b) Estimates in 1933 Act prospectuses and proxy statements and other 1934 Act documents will be permitted only for reporting companies with substantial earnings histories.
(c) Companies issuing estimates will have to make public announcement and comply with the special SEC reporting requirements with respect thereto.
(d) Estimate reports will require disclosure of underlying assumptions and comparisons of actual results with the estimates.
(e) Accountants verification will not be permitted and there will be insulation from liability for failure to achieve an estimate if it was made in good faith and on a reasonable basis.

4. Short-Swing Profits. In Morales v. Arlen Realty & Development Corp., S.D.N.Y., 1/10/73, CCH ¶ 93,730, Judge Knapp held that a noncontrolling officer-director of the acquired company does not "purchase" (within the meaning of §16(b)) stock of the acquiring company in a merger.

5. Definition of Security. In SEC v. Glenn W. Turner Enterprises, Inc., 9th Cir., 2/1/73, CCH ¶ 93,748, the court in finding the Turner "Dare to be Great" scheme to be a security abandoned the "solely from the efforts of others" test of an investment contract used by the Supreme Court in the Howey case in favor of a test based on "whether the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise". While the Turner case is a garden-variety fraud and the court's holding is to be expected, the new language can be expected to be cited in the franchise and lease cases.

6. Proxy Statement Disclosure of Asset Values. Brown Company Securities Litigation, S.D.N.Y., 1/24/73, CCH ¶ 93,751, contains a good summary of the cases on the question of when asset values can and should be discussed in SEC disclosure documents.

7. Market Information. In SEC v. Charles A. Morris & Associates, Inc., W.D. Tenn., 2/1/73, CCH ¶ 93,756, the court states: "The failure to inform the customers that the bonds were sold at prices greatly in excess of the then current market prices constituted an omission to disclose a material fact within the meaning of §17(a) and Rule 10b-5." While the case involves a boiler-room-high-mark-up situation and the holding could be supported on those grounds, even though § 15(c) was not applicable because it was an unregistered municipal bond broker, the opinion does constitute a direct holding on the market information point and demonstrates that in appropriate situations the courts will have no difficulty in applying 10b-5 to market information, just as it is applied to inside corporate information.

8. Customer's Damages for Broker's Margin Violation. Landry v. Hemphill, Noyes & Co., 1st Cir., 2/7/73, CCH ¶ 93,758, holds that a customer can recover from his broker the customer's entire market loss on a transaction that violated the margin regulations even though only a portion of the transaction was so violative. The case also holds that an experienced investor who receives currently confirmations is estopped to assert churning.

9. Tender Offers. In Gulf & Western Industries v. The Great Atlantic & Pacific Tea Co., S.D.N.Y., 2/13/73, CCH ¶ 93,765, Judge Duffy refused to integrate prior open market purchases up to the 5% filing limit of §14(d) with a subsequent formal tender offer even though there was evidence to indicate that the tender offer was contemplated at the time of the purchases. Conceptually this is inconsistent with the Charles Morris holding with respect to market information and the general SEC concept of integration based on the ultimate purpose of the transactions. We doubt

whether the holding will be sustained and continue to be of the opinion that open market purchases cannot be made, even though less than 5% in the aggregate, if in fact a decision to make a tender offer has been made or disclosure of the fact of the intention to buy up to 5% is material information that may have a substantial effect on the market price.

10. Qualified Stock Options. The IRS has ruled that a short sale prior to the expiration of the three-year holding period is a disqualifying disposition of the option stock and destroys the capital gain treatment otherwise available.

M. Lipton