

April 23, 1973

To Our Clients:

Inside Information. The Equity Funding case is another cogent example of the necessity to handle properly inside information. Mr. Dirks should have gone to the NYSE not his clients. The Salomon Bros. complaint is based on the classic 10b-5 tippee theory. The Loews complaint is based on market information and 1933 Act theories, as well as the tippee theory. Loews alleges that (1) the Boston Co. group of sellers held over 10% of Equity Funding and this holding was of a size that would affect substantially the market if sold in a short period; therefore the intention to so sell was market information that was required to be disclosed and (2) such holding combined with the Dirks information gave the Boston Co. group the power to control Equity Funding; therefore 1933 Act registration was required.

While many lawyers continue to refuse to recognize the market information 10b-5 violation, the courts continue to move in this direction. In Birdman v. Electro-Catheter Co., E.D. Pa., Jan. 18, 1973, CCH ¶93,334, in response to a motion to dismiss, the court held that failure of an issuer to disclose, in connection with a registered offering by the issuer, impending sales of about 25% of the float could be a 10b-5 violation.

Earnings Estimates. In a recent speech Chairman Cook said that the SEC rules on estimates will not be retroactive and companies may continue to issue estimates (if so minded) under the old standards (reasonable basis). The new proposals are expected this summer.

Directors' Responsibilities. In another recent speech, Chairman Cook has outlined the views of the SEC as to directors' responsibility for securities law compliance. In addition to the usual fiduciary responsibilities, the SEC takes the position that the securities laws require a director who knows or under the circumstances should know of a securities law violation by the company to take steps to correct it. First by advising the board and if that fails by advising counsel for the company. If both fail to achieve correction, the SEC view is that the director must notify the exchange (if listed) and/or the SEC. The principal thrust of the SEC position is to require directors due diligence with respect to all material filings with the SEC (not just registration statements) and press releases and extra special due diligence with respect to annual reports and proxy statements. In this connection previous warnings as to "creative accounting" are important. As to annual reports and the duty of outside directors,

April 23, 1973

Mr. Cook said:

"[O]utside directors have a responsibility to read and examine the annual reports disseminated to their shareholders. These reports are the most basic communications between the corporation and the investing public. It is important that directors satisfy themselves that the document truly reflects the condition of the corporation and that the representations that it contains are consistent with the facts. This is particularly true of the president's message, which should set a tone of forthrightness and credibility, and not gloss over real problems."

Rule 15c3-3. The 10 day buy-in requirement has been indefinitely suspended for exempt securities.

Rule 10b-2. Rule 10b-2 has been amended to permit salesmen participating in exchange distributions to be compensated on the "usual and customary" commission basis, as well as on the former salary basis.

Rule 145 - Change of Domicile. In The Clorox Company, CCH ¶79,320 the SEC has taken the position that charter amendments to broaden the scope of a company's business do not destroy the change of domicile merger exemption in Rule 145.

Compensating Balances. The SEC has issued proposed amendments to the SX Rules with respect to disclosure of compensating balances and the effective interest rate on borrowings subject to compensating balances, and detailed guidelines with respect to their application. Material formal compensating balance arrangements will require balance sheet segregation, so too special purpose funds. Material informal arrangements may be disclosed in a footnote. Compensating balances aggregating more than 15% of cash plus marketable securities are deemed material. Whether or not compensating balances are material for financial statement presentation purposes, they must be considered in determining effective interest rates. Special reference to compensating balances maintained for third parties is required. Commercial paper outstanding must be separately stated and the backstopping lines disclosed.

Tender Offers. The SEC has withdrawn the proposed amendment to Rule 10b-13 and reverted to its former position that investment companies (and other fiduciaries) may have a duty to recapture soliciting dealer fees for the benefit of the

investment company or managed account. The release states that the SEC is concerned with the problem of soliciting dealer fees that are unusually large in relation to the tender price.

Notes as "Securities", Consequential Damages in 10b-5 Action. In Zeller v. Bogue Electric Manufacturing Corp., 2d Cir., Mar. 22, 1973, CCH ¶93,903, the Second Circuit has joined the Seventh (Sanders case) and held that the mere fact that a note has a maturity of less than nine months does not make it an exempt security unless it also fits "the prime quality not ordinarily purchased by the public" test of SA Rel. 4412. Further, the Second Circuit, in a major departure, has held that consequential damages, not just out-of-pocket loss, can be recovered in a 10b-5 action and has indicated approval of a principle of varying the degree of certainty of proof of damage with the depth of the fraud.

Jurisdiction Over Foreign Transaction. Hanover v. Zapata Corp., SDNY, Mar. 16, 1973, CCH ¶93,904, questions whether Schoenbaum and Leasco apply when the plaintiff is not a U.S. citizen and the transaction involves a foreign corporation with mainly foreign shareholders.

Margin Regulations - "Indirectly Secured". In Cooper v. Union Bank. CD Calif., Feb. 12, 1972, CCH ¶93,915, the Court held that a loan that required securities to be in a brokerage account with a broker who was liable on the loan and monthly reports of securities positions was indirectly secured within Reg. U. The court rejects the argument that a security arrangement which is not legally effective is not within Reg. U.

Disclosure. A recent complaint against Merrill Lynch alleges securities fraud in failing to disclose to customers that salesmen receive a higher commission or compensation on OTC securities sold from inventory than listed securities.

Due Diligence. In Herbst v. Able, SDNY, April 3, 1973, CCH ¶93,923, the Court held that conferences by an accountant with the staff of the SEC are relevant in proving due diligence in a §11 action on the issue whether the accountants had reasonable grounds to believe that a particular method of presentation was not misleading.