WACHTELL, LIPTON, ROSEN & KATZ June 11, 1973

To Our Clients

Inside Information - Meetings and Dinners. The recent Avis and Faberge cases prompt reiteration of previous warnings as to the danger of meetings or dinners with select groups of security analysts or investment managers. As a practical matter, if there is a material change in market price, transactions following a meeting of a company with a select group will be presumed to be based on inside information. In the Faberge case the SEC said:

> The non-public nature of the information is also clear from the facts. The information was not disseminated in a manner making it generally available to the investing public until FBG's press release appeared on the broad tape. The message on the AutEx wire service did not constitute public disclosure inasmuch as it was transmitted to a limited number of institutional subscribers. In order to effect a meaningful public disclosure of corporate information, it must be disseminated in a manner calculated to reach the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information. Obviously, what constitutes a reasonable waiting period must be dictated by such surrounding circumstances as the form of dissemination and the complexity of the information, i.e., whether it is "readily translatable into investment action." Disclosure by a corporate officer during the course of a number of phone calls does not under any circumstances constitute public disclosure. Public dissemination of information also cannot be accomplished by disclosure to or through a favored analyst or group of analysts. On the contrary, this facilitates improper use of non-public information. Proper and adequate disclosure of significant corporate developments can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group. To hold

otherwise would be to sanction competition for tips in which the ordinary individual investor would inevitably be at a serious disadvantage.

* * *

A question arises as to the responsibility under Rule 10b-5 of a broker-dealer firm which conveys inside information with respect to a security to other persons who do not then effect any transactions in the security with that firm (as occurred in the case of IDS and Anchor). We believe that it is immaterial that the recipient of the information effects a transaction with a different broker-dealer firm. To hold otherwise would lead to complex reciprocal arrangements and in effect would put a premium on form over substance. The harm to the public is just as great regardless of who handles the transaction. Moreover, a practice has developed of firms receiving compensation for inside information in subsequent unrelated transactions. Indeed, the fact that the recipient may not effect any transaction after receiving inside information does not absolve the tipper of responsibility under the Rule. That Rule proscribes conduct which not only "operates" but also "would operate" as a fraud or deceit upon investors. In this connection, the Texas Gulf case held that corporate insiders having possession of material favorable information who brought shares of the company and recommended that others buy shares before the information was publicly disseminated violated the Rule not only by taking advantage of such inside information but also by "tipping" the information to others, since one who may not himself trade in securities without disclosing information known to him may not pass that information to others for their use in securities transactions.

* * *

At the heart of an effective compliance program is the adequate and appropriate training and education of employees. Every broker-dealer must alert its personnel to the problems in this area. The educational program should alert employees as to what falls within the definition of material non-public information and how to treat such information. Beyond the educational process, firms should take steps to assure that their employees are complying fully with firm policy. Ongoing trading review should spot trading concentrations by employees. It should also show trading concentration in particular geographical areas or branch offices.

Where the security has not been cleared by the firm's research department or transactions in the security have not received approval by a supervisory employee, an immediate inquiry should be undertaken to determine why particular salesmen are effecting multiple transactions in that security. The inquiry should include not only a financial review of the issuer, but should be directed at determining relationships between the brokerage firm's employees and management personnel of the issuer, as well as the source of the information being circulated concerning the company. <u>Finally, special supervisory procedures must be devised with respect to the research activities of the firm to make sure that inside information is not being sought or used by research personnel in connection with recommendations to customers or otherwise</u>. (emphasis added.)

<u>Institutional Membership</u>. In an attempt to narrow the availability of institutional membership and nonmember access discounts, the NYSE has issued an interpretation of the Rule 318 definition of "affiliated person" for the purpose of the 80/20 test which includes as "affiliated" a pension account managed by (1) a broker that is the company's regular investment banker, (2) a bank that has a commercial banking relationship with the company or (3) an insurance company that writes insurance coverage for the company. Also defined as "affiliated" are discretionary accounts which cannot be terminated (1) on 30 days or less notice, (2) without payment of a penalty or (3) without substantial hardship or expense, such as where space and clerical help are "thrown in." Where an insurance company "separate account" is under local law the property of the insurance company, the separate account is

"affiliated." The NYSE is considering amendments to Rule 318 to further narrow institutional membership and access, particularly reinstatement of the primary purpose and parent tests for institutional affiliates seeking the nonmember access discount and elimination of crediting brokerage commissions against management fees. (This latter proposal, insofar as it may be applicable to investment companies, being inconsistent with the philosophy underlying § 15(c) of the 1940 Act.)

Discretionary Accounts. SEA Rel. No. 10181, June 1, 1973, part of the hot issue series, states that an underwriter must disclose specifically its conflict of interest when confirming sales of underwritten securities to discretionary accounts. The release implies similar obligations with respect to all principal transactions. Our memo of February 28, 1973 with respect to this matter should be reviewed.

Registration and Reporting Requirements Expanded. The SEC has adopted, effective August 1, 1973, a major portion of last year's proposals. Among the new requirements:

(a) Summaries on page 3 for all S-1 and S-2 prospectuses, including financial summaries for S-1 prospectuses.

(b) Submission of supplemental information as to the underwriter's due diligence investigation of new or speculative issues.

(c) Inclusion of factual basis underlying boilerplate, except that the proposal to require disclosure of bases for opinions as to litigation has been dropped.

(d) New issue pricing information must be included in a circulated preliminary propsectus with disclosure of the factors considered in determining the price.

(e) Annual 10-K description of business plus material changes during past year.

(f) New product information, but not if it would result in premature disclosure of confidential business information. (The qualification does not limit the requirement of disclosure of material information whatever the status.) The proposal for specific disclosure of market studies has not been adopted. Market studies will be requested as supplemental information.

(g) The description of competition has been expanded, "if known or reasonably available to registrant."

(h) The proposal requiring cash budgets from new issuers has been tabled pending reconsideration along with the forthcoming projection rules. The existing narrative disclosure with respect to the issuers cash requirements has been formalized and disclosure of the plan of operation for next half year has been adopted.

(i) Disclosure with respect to background and experience of management has been expanded, but the proposal for disclosure of salaries in former positions has been abandoned.

(j) New issue prospectuses will have to disclose underwriters' plans to confirm to discretionary accounts.

(k) Certification of the availability of stock certificates for new issues is made a condition to acceleration.

Accountants - SEC Compliance. Laventhol, Krehstein, Horwath & Horwath has entered into a consent decree in the Everest Management case in which it was accused of not being independent and of participating in a fraud. The consent decree sets forth standards for determining independence with respect to clients, procedures to be followed to insure that clients comply with SEC filing requirements and the due diligence investigation to be performed in connection with the acquisition of another accounting firm.

Extraterritorial Application of the Securities Laws. In U.S. v. Clark it has been held that the antifraud sections of the federal securities laws are applicable to acts in the U.S. with respect to a Eurodollar issue sold in Europe to non-U.S. investors by an offshore subisidiary of a U.S. company.

Blue Sky Laws - Brokers Telephone Solicitation. A recent South Dakota U.S. District Court case, Boehnen v. Walston & Co., holds that the Blue Sky laws of the customer's domicile apply to a telephone solicited transaction by an out-of-state broker whose only contact with the customer was by mail and telephone, broker's domicile choice of law provision in the customers agreement to the contrary notwithstanding.

Rule 145 - Creation of Holding Company. In the Merrill, Lynch letter, (avail. 5/21/73) the SEC has ruled that the typical merger of the existing corporation into a wholly-owned subsidiary of a new holding company in exchange for holding company securities whereby the existing corporation converts itself into a wholly-owned subsidary of the holding company is subject to Rule 145 and requires registration under the 1933 Act with payment of the full registration fee.

Rule 145 - Change of Domicile. While the migratory merger is excepted from Rule 145, an asset for stock transaction to accomplish the same purpose is not exempt. Sir Speedy, Inc. (avail. 5/18/73).

M. Lipton