MEMORANDUM

November 4, 1979

TO : Chairman Williams

FROM : George

Re : The Staff's Legislative Proposal to Restructure the Williams Act

INTRODUCTION:

As you will recall, just before you left for the Regional Administrators' Conference last Tuesday, we received a copy of a draft legislative proposal, dated October 30, 1979, from Ralph and Ed. The draft would completely restructure the Williams Act, making it a pure sale of control statute.

Although the idea of a complete reworking of the Williams Act has surfaced several times in recent months (including Stanley's idea of integrating Sections 13(d) and 14(d)), Ralph and Ed indicate that the impetus for the instant proposal is the letter of July 3, 1979 from Senators Proxmire, Sarbanes, and Williams. At the same time, however, they indicate (pp. 3-4 of cover memo) that they are also working up an alternative response which, in a more limited fashion, would address the seven specific problem areas discussed in the Senators' letter. 1/

Thus, while it appears that the staff has undertaken to prepare two alternative responses to the Senators' letter, they have taken this opportunity to run the more comprehensive of the two alternatives past us for our comments. Moreover, they indicate (p. 4 of cover memo) that they are, at this time, seeking some direction from you as to how best to bring these two possible responses to the Senators' letter to the Commission table.

1/ It should be noted that I do not read the staff as indicating that we are faced with an "either-or" situation. They may well be comfortable in sending the Senators both alternatives.

What follows is a brief discussion of some general observations and more specific comments that you might like to keep in mind when determining how to react to the instant proposal, as well as when deciding how best to structure the Commission's consideration of the staff's two proposed, alternative responses to the Senators. Once we have received the more modest, second alternative proposal, we should probably schedule a meeting with the staff in order to discuss both the substance of each proposal, as well as the question of how we should proceed to present this matter to the Commission.

Please note, finally, that the staff would like to respond to the Senators' letter by early December. While that timetable in and of itself would not seem to call for your immediate attention to this matter, we have also scheduled the Commission meeting on the adoption of the new tender offer rules, as well as on proposing still additional amendments, for November 20, and you should -- as I discuss further below -- have a clear grasp of where you would like to go as a legislative matter in advance of that meeting on rulemaking.

DISCUSSION:

A. General Observations

For the most part, I think that the staff's instant proposal is brilliantly conceived and engineered. Moreover, I fully concur that we should seize upon the opportunity presented by the Senators' letter to undertake the thorough restructuring of the Williams Act that we have talked about for so long. Nevertheless, I do think that there are two general matters which you might want to consider in determining whether you support our proposing a "sale of control" statute at this time, as well as in deciding how the Commission should plan and coordinate its multi-faceted attack in the "tender offer" area.

1. <u>The Need for a Careful Consideration of the Fact that the Instant Proposal Calls for a "Sale of Control" Statute</u>.

As you may recall, I have on various occasions discussed with you the fact that both relief-of-pressure-on-offerees and sale-of-control-premium notions run through the present Williams Act. Indeed, we have discussed my analysis at both

the complaint and opinion stages in Sun Oil (see the attached briefing memoranda), as well as at the time of the Market Reg. presentation of its views on Rule 10b-13 concerning the "offer to all" and "same consideration" issues (memo attached). In all such instances, however, I attempted to alert you to the fact that the staff's proposed interpretations in those matters often turned the Williams Act on its head, stressing as they did the merely incidental and secondary sale-of-control aspects of the Williams Act, while ignoring or downplaying the much more fundamental pressure-on-offerees rationale.

Accordingly, as you might well guess, I am, of course, delighted with the approach that the staff has taken in the instant proposed restructing of the Williams Act. Indeed, I have discussed such an approach with Ralph and others on the staff for some time now, and Amy and I have long been advocates of it. Not only does it avoid most of the conceptual problems posed by the present Williams Act because it bases the statutory scheme on a much cleaner and clearer rationale, but it also, as a substantive matter, gets the federal government into an area which we have all felt, for some time now, needed much more significant federal involvement. In thus building on the sale-of-control rationale, it will be much easier to protect public investors not only in instances of sales to third parties, but also in so-called "going private" situations, as well. At the same time, such a sale-of-control rationale will also provide a much firmer foundation for federal involvement on the issue of "substantive fairness," than did the prior pressure-on-offeree and full-disclosure rationales.

Nevertheless, having said all that, it is also necessary to point out to you the primary short-coming of such an approach that Amy, I, and others with whom we have discussed this problem have always come back to. Simply put, you should be aware that the instant proposal involves a radical restructuring of federal-state regulation in the area of "sale of control." The staff does point out (p. 2 of cover memo) that this new approach will involve "a more direct [federal] regulation of the transfer of control of public corporations." At the same time, however, they also indicate (p. 9 of analysis) that this more direct regulation will merely "provide a somewhat broader federal role in the transfer of control" area. To me, however, the staff has understated the importance of the federalism issue which will be raised, and of the political consequences which might follow both here at the Commission, as well as in the Congress.

While I am no expert on the legislative history of the Williams Act, it seems to me that Senator Williams was able to get the Congress in 1968 to pass the Act as a specific remedy to a then-occurring phenomenon. Interestingly enough, the very fact that it was a narrow solution for the specific "tender offer" problem has led to its unworkability -- and will probably lead to its demise. Nevertheless, there may well have been some strong feelings that, although some degree of federal involvement was necessary at the time, that degree had to be carefully limited.

Such an interpretation is supported by the fact both that there is a rather extensive body of state law dealing with the sale-of-control and substantive fairness issues, and that our incursions into the area have been rather coolly received. As you know, the courts have for some time now applied state law theories of the fidiciary duty of majority shareholders to the minority, or of the control "premium" as an asset of the corporation which enures to the benefit of all shareholders, in order to get a handle on the sale of control problem, whether that sale takes place to a third party or to corporate insiders. Perhaps Perlman v. Feldman, decided under New York state law, is the prime example. Moreover, the recent Delaware state court decisions on substantive fairness might also fall under this broad rubric of dealing with the sale-of-control phenomenon.

By the same token, our efforts in the tender offer and 13e-3 and -4 areas have been challenged as being beyond our jurisdiction, as representing a greater than necessary federal involvement in the area, and as seeking substantive regulation in the guise of disclosure. Such efforts, it has been said, are especially unwise with the present regulatory reform and deregulation climate prevailing in the federal government. 2/

2/ It should be noted that, while the analysis section (p. 1) quite cryptically indicates that old Section 13(e) "would be amended somewhat to clarify the Commission's rulemaking authority with respect to issuer repurchases," it is obvious from the text of the proposed Section 13(g) (p. A-13) that the Commission's rulemaking powers would allow it to "impose limitations on ... prices" at which repurchases could be made. Such a grab for power over the "substantive fairness" of a transaction will not go unnoticed -- even if it is not flagged by us.

Given the foregoing, it seems to me that, in spite of the brilliance of its logic and the clarity of its presentation, the instant proposal might well run into rough sleding before the Commission. For example, Commissioner Karmel might well raise issues of federalism and excessive federal regulation. She is well aware of the state court cases in this area, and she could conceivably argue that the matter should -- and, perhaps, can best -- be dealt with by state courts under evolving common law notions.

At the same time, she might well argue that, based on the legislative history of the Williams Act, or given its present mood, the Congress will not at this time be receptive to such a radical change in state-federal relations. And, in my opinion, such an argument might well be correct.

My purpose in raising the foregoing is not at all, however, to discourage serious consideration of the instant proposal at this time. Rather, it is merely to alert you to the possibility that this extremely fundamental issue might arise, and that perhaps we should first receive from the staff any views -- beyond those noted at page 3 of the cover memo and page 9 of the analysis -- that they might have on the point. 3/

3/ In all fairness, the staff also argues (p. 9 of analysis) that, in some ways, a cleaner line of federal involvement in the sale-of-control area will lead to less federal involvement than did the merky notions of "tender offer" law. (The Telvest situation may well be one such example.) While that argument no doubt has a grain of truth, it may, however, carry little weight, either here at the Commission or before the Congress, when juxtaposed against perceptions of the clear intent and import of this proposal. Moreover, it does not address at all the quite simple fact that the instant proposal will have a profound impact on sellers, and purchasers, of control, as well as on many other transactions far removed from a true sale of "control" context, such as transactions of block size, or even less than block size (see, e.g., pp. 9-12 infra.)

2. The Need for a Careful Consideration of How, as a Matter of Process, the Commission Should Be Proceeding in this Area.

As noted above, the instant legislative proposal might be only one-half of two, possible responses to the Senators' letter. Moreover, the Commission needs to be fully aware of how any such legislative proposal would fit into its overall approach to the Code, especially with the instant perception that there is a moratorium on any parallel legislative program from the Commission at this time. In addition, the relationship of the instant proposal with the tender offer rules scheduled to be adopted on November 20, as well as with the new rules which will be proposed on that date, needs to be fully understood by the Commission. Finally, the Commission should not lose cite of the fact that it is presently engaged in litigation in a number of cases on points which will be raised by any legislative proposal at this time. I touch on each of these issues briefly below.

First, as you know, we have had no formal legislative program for some time now. While it might be said that the question of whether the instant proposal is a revival of any Commission legislative program is not even raised because the Senators initiated this correspondence, it must be kept in mind that the entire issue was as much our idea as theirs, and that the perception of a Commission proposal may win out, in any event.

Second, it seems to me that we have to have a firm grasp on how any legislative proposal at this time would relate to the Code, both as a matter of process as well as of substance. As noted immediately above, any suggested legislation at this time might well be seen by the advocates of the Code as a Commission abandonment of any thought of working exclusively within that legislative context. By the same token, however, the opponents of the Code will ralley around this legislative proposal, and any others which might follow, as the proper legislative route for the Commission to be following at this time.

Moreover, it must be noted that the instant proposal may, or may not, fit nicely with the substantive structure of the Code. In the first place, I think that the staff has somewhat overstated the case when it says (p. 3 of cover

memo) that the proposal "also incorporates significant aspects of the proposed ALI Code." As you know, the Code retains the basic "tender offer" approach, thus having to deal with difficult issues such as the definition of a "tender offer," the integration question, and even the "best price" problem. Since the instant proposal abandons the "tender offer" approach, it, of course, runs into none of those problems. Indeed, when push comes to shove, the staff only once (p. 21 of analysis) even cites the Code as the bases for a provision which it proposes -- and, in that case, it does so on the issue of preemption of state law, a question that is not really limited to the Williams Act context, and which, in fact, is dealt with in the Code in a general section far removed from its specific "tender offer" provisions.

Third, the Commission needs to have a firm grasp on how the instant legislative proposal relates to both the soon-to-be-adopted tender offer rules, and to any new rules that it might propose on November 20. For the most part, of course, the instant proposal to restructure the Williams Act is fundamentally different from the tender offer proposals. At the same time, however, some of the narrow, specific proposals contained in the rules would be incorporated into this newly-restructured statutory scheme.

Of greater concern, however, should be the more modest, alternative legislative approach which the staff is to send up shortly. To me, any such "bandaid" legislative proposal would have to be carefully compared to, and coordinated with, the similarly "bandaid" rules which we are adopting and proposing at this time. Indeed, since we do already have a "bandaid" approach pending before us in the form of rulemaking, it might not make much sense to also have a "bandaid" legislative proposal pending before the Congress. Rather, if there are issues which our "bandaid" rule proposals do not include (such as the role of commercial banks), then perhaps we should merely expand the rule proposals, and concentrate our legislative efforts on a fundamental restructing of the Act.

Finally, the present confusing configuration of the Williams Act has, as you know, spawned a great deal of litigation in which the Commission is now participating. As my analysis of the Sun Oil case shows, I was not always comfortable with the conceptual positions we were taking.

Be that as it may, however, we have in the recent past been involved in a number of enforcement actions (Sun and Salem), and participationed in several other cases as a amicus (Kidwell, Brascan, Hoover, and Telvest).

Once again, I view such litigation as a mere stop-gap or "bandaid" along the route to a more fundamental restructing of the Williams Act. For that reason, the Commission should consider whether or not its continued involvement in litigated cases based on a possibly soon-to-be outmoded statutory scheme is the best use of its limited resources in this area. Of course, any such assessment will turn primarily on projections concerning the probability that a more fundamental restructuring can get through the Congress in the near future.

B. More Specific Comments

I have noted on my copy of the draft a number of minor and technical comments. There are some, however, which can be grouped along themes which you should be aware of. Set forth below is a brief discussion of how careful we have to be in the use of language in this area, how careful we have to be about how any proposal might treat certain possible factual situations, and how careful we should be to compare the purposes and affects of the instant proposal with those of other current proposals that are pending at this time.

1. The Need for Careful Use of Language.

As you well know, one of the most troublesome aspects of the current Williams Act is the fact that it uses a term, "tender offer," to describe one species of a more fundamental problem, and that it does so without ever either defining the term or clearly articulating the rationales on which the regulation of such transactions is based. Indeed, calling something a "tender offer" should be the final, rather than the first, step in any analysis. Nevertheless, in spite of the troublesome history of the Williams Act's use of language, it seems to me that the staff may here be falling into a similar quagmire.

For example, although the staff clearly recognizes that its proposal will center on "sales" of "control," it uses the term "public offer" to deliniate those offers which must be made to all shareholders for the same consideration. To me,

it would avoid confusion, and further rather than inhibit analysis, to term such transactions "control" "acquisitions" or "sales" of "control," and thus leave the "public offer" notion as one of many consequences which flows from a determination that a "control acquisition" will take place. In other words, the use of the words "public" and "offer" are conclusory and beg the fundamental question, much the same as did the term "tender offer."

By the same token, we must at all cost avoid the use of the term "tender offer" itself. While the staff is not always successful (p. 12 of analysis) in avoiding the use of the term, I am sure that they would agree with me that we should speak solely in terms of "sale of control" and "control acquisition" transactions.

Nevertheless, it should be noted that, for perceptual and political reasons, it still might well be helpful, both before the Commission and the Congress, to package and present the instant proposal as one dealing with current problems in the narrow "tender offer" area. As discussed above, the Commission and the Congress, just as may have been the case in 1968, may well be much more receptive to "bandaid surgery," in this area, than they will be to any radical restructuring of federal-state relations.

2. The Need for a Careful Consideration of the Treatment of Possible Factual Situations.

While, just as is the case with any legislative proposal, an effort should be made to foresee possible hypothetical situations and to deal with them as clearly and cleanly as possible in the statute, to me, such an approach is especially necessary in any area, such as the instant one, where there has been some legislative experience and a new proposal is now being put forth as "reform" legislation. By the same token, such experience imposes the additional burden of logic and workability on the drafters of proposed legislation.

Given those assumptions, we should be particularly careful to make sure that factual situations with which we have experience -- or of which we can conceive -- can be dealt with logically and practically under our proposed statutory scheme. Nevertheless, it seems to me that there may well be some factual possibilities which have not been addressed in the instant legislative proposal. I will offer but three brief examples.

First, please note that the draft proposal (pp. 2 and 4 of analysis) provides two alternative means by which a person who acquires five percent or more of a corporation can fulfill his disclosure obligations. If the person is going to acquire "exactly" five percent, immediate after-the-fact notification is permissable. If, however, the acquisition is going to result in a holding of something greater than "exactly" five percent, preacquisition notice is required.

To me, such a scheme is neither logical nor practical. Indeed, one might well conclude that the second alternative of preacquisition notice is the only viable one, and that the post-acquisition possibility for those who are acquiring "exactly" five percent is a sham -- a mere transparent concession to the present configuration of Section 13(d), which, in its own right, was probably based on a balancing between the need for privacy in certain economic transactions and the need for sufficiently prompt public notice when significant acquisitions take place. 4/ Since, however, it is unlikely that acquisitions will ever bring a person to "exactly" five percent, we in effect have a preacquisition notice requirement for those who acquire greater than five percent. To me, this might lower the threshhold too far.

In terms of logic, practicality, and even policy, I would think that we might explore an alternative such as the following: In the first place, a person acquiring up to five percent would have no notice requirement. Next, however, someone who has acquired five percent, or greater than five percent, but less than ten percent, would have a post-acquisition filing requirment, including a two-day moratorium on additional purchases. In addition, someone acquiring greater than ten percent, but less than fifteen percent, would have a preacquisition filing requirement.

4/ We have, of course, discussed this tension in various contexts before, including the beneficial ownership rules of Section 13(f) and the "13(d) override" which allows a tender offeror to accumulate up to five percent without having any Williams Act or Rule 10b-5 disclosure obligation as discussed in the long footnote in Chiarella, and as embodied in our proposed Rule 14e-3(c).

Finally, someone acquiring greater than fifteen percent would have not only a preacquisition filing requirement, but also the requirement that the offer be made to all shareholders on the same consideration. While such a breakdown might be much too detailed, it at least shows the considerations of logic and practicality which I think should enter into any scheme that we are proposing in this area.

Second, note (p. 10 of analysis) that the staff has borrowed the present statutory rule allowing two percent of the class to be purchased in any twelve-month period. Unless I am misunderstanding the scheme of their proposal, their borrowing the two percent per year exemptive rule from the Williams Act makes little sense as a matter of logic or practicalities in the context of the instant proposal. In the first place, it is a rule which attempted to exempt even significant market purchases from the species of transactions called "tender offers." Since the instant proposal abandons that statutory framework, I wonder why the two percent rule was blindly dragged into this new statutory framework.

By the same token, if I read the proposal correctly, if an individual holding greater than fifteen percent makes <u>any</u> market purchase -- no matter how small -- it would be necessary, unless the purchase is covered by an exemption, for that individual to make a "public offer" to all shareholders at the same consideration, accepting their tenders pro rata if his purchases are to be for less than the entire outstanding number of securities. Accordingly, if a fifteen percent shareholder were to buy an additional one hundred shares, and had already purchased more than two percent in a twelve-month period, he would have to make such a "public offer" and proration the acceptances. To me, such a result is ludicrous, and in such situations after-the-fact disclosure of the present 13(d) nature should suffice. Finally, while there appears to be (p. 10 of analysis) a block transaction exemption under certain circumstances, we have the anomalous result that, even if the block is much greater than one hundred shares, but the transaction is not on an exchange, that exemption may apply.

Accordingly, as a matter of logic and practicalities, if the focus of our new proposal is to be rapid changes in corporate control (as the Senators requested), then there should be a viable exemption governing gradual market purchases, rather than a blind carrying over of

the present statute's two percent rule. Indeed, to my way of thinking, after-the-fact notice might well be sufficient, especially if it is coupled with a post-notification moratorium on additional purchases, if the acquiror does not purchase more than two percent, on the market or otherwise, during any given month or quarter.

Third, I have some reservations concerning the analysis (pp. 10-11) of block transactions. As noted above, there are certain considerations of privacy that must be balanced against the public's need to have notification that a block transaction involving a possible shift in control will take place. Indeed, we heard such comments when we put our beneficial ownership (Section 13(f)) rules out for comment.

Moreover, it appears that if, there is to be greater regulation of blocks that are transferred on an exchange, rather than off an exchange, the disclosure regulations might well lead to a significant distortion in market activity -- a distortion which, in the long run, might be counter-productive to other objectives of the Act, such as achieving a national market system, or in terms of aggrevating problems such as the by-passing of limit orders on an exchange's book.

3. The Need To Carefully Coordinate the Instant Reforms with Other Current Proposals.

To me, especially given the pendency of the Code, if indeed we are going to attempt to restructure any area of the securities laws, we need to have a full grasp of the cosmic approach which we will eventually take to the entire area. For example, you may recall that Ralph's shop sent up a proposed revision of Section 18 of the Exchange Act to take care of every conceivable problem under the sun, from private rights of action, to the scienter issue, to questions of class actions. Interestingly enough, that final point -- the treatment of class actions -- resulted, as I recall, in a rather ingenious proposal from OGC. As you may recall, OGC indicated that it might be wise as a matter of policy to propose that, if a defendant in a class action were willing to pay the cost of notice to class members, the quid pro quo that he would receive in return would be a limitation on the ultimate amount of damages.

The instant proposal (pp. 18-19 of analysis) appears to touch on some of these issues, but not all. This is especially troublesome when one considers that it was the Piper "tender offer" case which was one of the clearest instances in which the Supreme Court reacted to the prospects of an overwhelming damage award when it decided whether or not to grant standing in the case in the first place. Of course, my only point here is that, if we are going to propose a radical restructing in this area, we need to coordinate any such restructuring with what we are doing in other areas, such as revisions to Section 18.

By the same token, the instant proposal (pp. 18 and 19-22) touches on the damages issue. In addition to the limitation-of-damages point made above, please also recall our unease with any radical damage arrangement growing out of sale-of-control situations -- a point which we have discussed in both the Financial General and Sun Oil matters.

Finally, the analysis (pp. 15-16) indicates that the new proposed Section 13(g) will broaden our rulemaking authority in the present Section 13(e) area. As discussed early on in this briefing memo, and as reiterated by Ralph at some of the open sessions on the Code with Loss, the question of our power in this area -- especially as it pertains to having any control over the substantive fairness of a transaction -- is a very volitile policy and political issue at this time. Once again, I merely caution that we be fully aware that such an issue might arise in the instant proposal; that we develop a uniform and coordinated course of action on it; and that we do not allow ourselves to be locked into such a provision, with its broad-ranging policy implications, without a sense of full awareness of the need for, as well as the consequences of, the Commission's having, or even seeking to have, such power. 5/

5/ There are, of course, other changes of note in the instant proposal that should, perhaps, be addressed in a uniform manner throughout the securities laws -- for example, importing a "due diligence" concept into an area beyond the registration context (p. 18 of analysis), and whether and when "business justifications" are defenses to failures to disclose material information (id.).

CONCLUSION:

All in all, I must once again stress how intrigued I am with the instant legislative proposal. By the same token, however, I think that it is very important that the Commission understand all the ramifications -- both as to its substantive mandate, as well as to its processes -- of our proposing such a radical restructuring of the Williams Act at this time. 6/

If, after we receive the second alternative piece, you wish to discuss this matter further, or to schedule a meeting in your office with the staff, please let me know. Finally, if you do have time in the next week or so, it might be fruitful to discuss these issues further.

6/ As should be clear from your reading of this memorandum, I have the impression that there are a number of significant, and many more minor, issues lurking in this proposal; that the staff has, perhaps, not sufficiently flagged most, nor thought out some; that, after a less-than-thorough review, I have been able to identify and analyze only some of these issues; and that, based on what I have uncovered so far, many more are likely to exist, but have escaped my detection in this first go-around. I am sure that there will be a second -- and a third.

Moreover, I have just received a copy of Andy Klein's marginal notes (attached) on a prior draft of the proposal and have not as yet had time to review them. Once again, I am sure that, given their tone, there will be some food for thought there, as well.