

Summary of Comments Submitted In  
Response to Proposed Amendments to  
Rule 10b-4 under the Securities Exchange Act  
of 1934

Securities Exchange Act Release  
No. 34-18050 (August 21, 1981)  
File No. S7-903

## List of Commentators

### Law Firms and Associations

- ✓ American Bar Association, Subcommittee on Proxy Solicitations and Tender Offers of the Committee on Federal Regulation of Securities, Section of Corporation Banking & Business Law ("ABA")
- ✓ Association of the Bar of the City of New York, Committee on Securities Regulation ("NYC Bar")
- ✓ New York County Lawyers' Association ("NYCLA")
- ✓ Sullivan & Cromwell ("Sullivan & Cromwell")

### Industry Associations

- ✓ Securities Industry Association, Federal Regulation Committee ("SIA")

### Self Regulatory Organizations

- ✓ New York Stock Exchange ("NYSE")

### Broker-Dealers

- ✓ Merrill Lynch White Weld Capital Markets Group ("Merrill Lynch")
- ✓ Morgan Stanley & Co., Inc. ("Morgan Stanley")
- ✓ Sheriff Securities Corporation ("Sheriff")

### Congressional

- ✓ John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives ("Dingell")

### Individuals

- ✓ F. R. Bennett ("Bennett")
- ✓ George P. Michaely, Jr., of Shaw, Pittman, Potts & Trowbridge ("Michaely")
- ✓ Richard Shemtob ("Shemtob")
- ✓ Charles F. Talbot ("Talbot")

## Introduction

On August 21, 1981, the Commission published proposed amendments to Rule 10b-4 under the Securities Exchange Act of 1934 (the "Exchange Act"). 1/ Rule 10b-4 prohibits short tendering during tender offers. The staff requested comments on two alternative proposals. The first would deregulate short tendering entirely. The second alternative would amend Rule 10b-4 by imposing additional ownership requirements for persons tendering securities, by clarifying the provisions of the rule, and by limiting the types of offers to which the rule applies. 2/

Fourteen letters were submitted by representatives of the following categories:

Law Firms and Associations	4
Industry Associations	1
Self-Regulatory Organizations	1
Broker-Dealers	3
Congressional	1
Individuals	4
	<u>14</u>

The general position of each commentator on the major issues presented is set forth in a table at the conclusion of the summary.

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1/ Securities Exchange Act Release No. 18050.

2/ The staff also withdrew a prior proposal to amend Rule 10b-4 that was set forth in Exchange Act Release No. 14157 (November 1, 1977).

Deregulatory Alternative

Of the fourteen commentators, thirteen 3/ opposed the deregulation of short tendering. 4/ The principal arguments advanced by the commentators against deregulation were the unfairness that short tendering would create for non-professional investors and the confusion and disruption of the tender offer process that unlimited short tenders would produce.

(a) Unfairness to non-professionals

Several of the commentators 5/ stated that deregulation would allow market professionals an unfair advantage at the

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3/ ABA, Bennett, Dingell, Merrill Lynch, Michaely, Morgan Stanley, NYC Bar, NYCLA, NYSE, SIA, Shemtob, Sheriff, Sullivan & Cromwell.

4/ Four commentators, ABA, Morgan Stanley, SIA, and Sullivan & Cromwell, commended the Commission for considering the alternative of deregulation although they did not support it in this context. On the other hand, Congressman Dingell stated, "I find it hard to believe that such a proposal -- a proposal which would deny tendering shareholders the protection of the Act and would produce undesirable corollary effects on the market and on tender offers -- would originate with the Commission."

5/ ABA, Dingell, NYC Bar, NYCLA, NYSE, SIA, Sheriff. Michaely pointed out that deregulation would create a potential conflict between tendering shareholders and their brokers, because short tendering by the broker would reduce the number of the customers' securities taken up by the offeror.

expense of individual investors. These commentators asserted that market professionals, because they are uniquely able to guarantee delivery of shares they do not own, would be the only parties able to engage in short tendering. Market professionals, therefore, would be able to insure that a greater portion of their holdings would be accepted in an offer that is subject to prorationing. This greater acceptance rate, it is argued, would come at the expense of individual shareholders, who will have a smaller percentage of their shares accepted as a result of their inability to short tender.

(b) Potential for confusion and disruption

Four commentators 6/ stated that deregulation would increase the confusion that exists in the market for the target stock during a tender offer. This additional confusion would result from the fact that the number of shares tendered would not represent those actually owned. Therefore, it was argued, there would be no ceiling in the amount of shares that could be tendered and later be withdrawn, and

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6/ ABA, Merrill Lynch, NYSE, Sullivan & Cromwell. Sullivan & Cromwell stated, "We also do not believe, and think the Commission will agree, that a return to the days prior to Rule 10b-4 when bidders received tenders for more shares than the company had outstanding is not conducive to the promotion of orderly exchange markets."

announcement of preliminary tendering totals would be seriously misleading. Also, market disorder in the form of a classic short squeeze would result in cases in which over 100% of the outstanding shares were tendered.

Three commentators 7/ specifically mentioned Congressional support for rulemaking by the Commission to prohibit short tendering. The SIA stated, "the Committee is not inclined to contest the conclusion of the 90th Congress that short tendering should be proscribed . . . Rule 10b-4 was adopted to address concerns -- voiced by, among others, the Commission and members of a Senate subcommittee on securities during hearings on the bill later enacted as the Williams Act -- that short tendering is an abuse of the tender process."

One individual commentator, Talbot, questioned the need for technical rules such as 10b-4, expressed a general belief that the securities industry is overregulated, and urged that Rule 10b-4 be eliminated.

#### Prohibition of Hedged Tendering

The second proposed alternative would amend Rule 10b-4 to prohibit the tender of securities "unless at the time of

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7/ Dingell, Michaely, SIA.

tender, and at the end of the pro rata acceptance period or period during which securities are accepted by lot", the tenderor owns the subject security or an equivalent security. The effect of this amendment is to prohibit hedged tendering. 8/ Of the twelve commentators addressing the issue, seven 9/ favored the proposed prohibition of hedged tendering, and five 10/ opposed the proposal. The bulk of the comments dealt with three points: the similarity of hedged tendering and short tendering, the possible benefits of hedged tendering, and the availability of hedged tendering to non-professional investors.

(a) Similarities of hedged tendering and short tendering

Four of the commentators 11/ supporting the proposed prohibition of hedged tendering did so because they perceived the effects of hedged tendering as being similar to those of short

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8/ Although the proposed amendment gives tenderors the flexibility to sell short after tendering so long as they repurchase the shares before the end of the pro rata period, SIA and ABA observed that this flexibility would be of limited economic benefit.

9/ ABA, Dingell, Michaely, NYC Bar, NYCLA, Shemtob, Sheriff.

10/ Merrill Lynch, Morgan Stanley, NYSE, SIA, Sullivan & Cromwell.

11/ ABA, Dingell, NYC Bar, Sheriff.

tendering 12/. Sheriff observed that hedged tendering was not used before the adoption of Rule 10b-4. He asserted that "the practice of hedging tenders during the pro rata period of a tender is an artificial device which has been created by persons tendering to get around the outright prohibition on short tendering." The NYC Bar found it anomalous to prohibit short tendering and not to prohibit hedged tendering, since the effects of each were the same.

Conversely, two commentators 13/ strongly emphasized the distinctions between short tendering and hedged tendering. Specifically, these commentators noted that short tendering has a greater potential for market disruption than hedged tendering, because the short tenderor tenders a non-existent position. The hedged tenderor tenders only shares that he owns, and this constraint prevents an unlimited number of shares from potentially being tendered.

NYSE also pointed out that in short tendering an arbitrageur incurs no costs. In hedged tendering, on the other hand, an arbitrageur cannot decrease his risk without incurring costs. These costs include the expenses involved in

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12/ The ABA, by addressing short tendering and hedged tendering simultaneously, did so implicitly.

13/ Merrill Lynch, NYSE.



borrowing stock to deliver following the short sale, and the capital an arbitrageur must commit to establishing the position that he tenders.

(b) Benefits of hedged tendering

Each of the five commentators 14/ opposing the proposed prohibition on hedged tendering argued that hedged tendering ultimately benefits those shareholders who choose not to tender but to sell in the market in order to avoid prorationing and other risks. These commentators asserted that an arbitrageur who reduces his prorationing risk by post-tender sales of shares into a market that reflects the tender offer price will as a result be able to purchase more shares, at a higher price.

As stated by Merrill Lynch,

Hedged tendering substantially amplifies the public benefits of risk arbitrage. The ability to reduce the risk of loss on returned securities enables risk arbitrageurs not only to increase the volume of their open market purchases of subject securities but also to bid and pay prices which are higher than they otherwise could offer. Consequently, more non-professional shareholders are able to transfer the risks of proration or failure and to achieve the equivalent of 100% acceptance. . .

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14/ NYSE, Merrill Lynch, Morgan Stanley, SIA, Sullivan & Cromwell.

Similarly, Morgan Stanley said that to the extent market professionals can control the risk of proration through hedged tendering, the market price of the subject security will more closely approximate the tender offer price and more shares will be purchased by arbitrageurs, to the benefit of shareholders seeking to avoid both proration risk and the risk that the tender offer may not be completed. This commentator also stated that the active presence of arbitrageurs is needed to avoid undue burdens upon specialists, market makers and block positioners during tender offers.

Commentators favoring the proposed amendment 15/ were aware of the above argument, but believed the disadvantages of permitting hedging tendering outweighed the advantages. For example, Sheriff wrote,

It is difficult to understand what justification exists for helping persons who wish to sell their securities at the expense of shareholders who elect to tender and retain the balance of their holdings. Moreover, it is greatly to be doubted whether the increased price that could theoretically be obtained by persons who elect to sell their stock will in any way approximate the resultant loss of income which will be visited upon security holders who tender.

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15/ ABA, Dingell, Michaely, NYC Bar, Sheriff.

(c) Availability of hedged tendering

Eight commentators 16/ addressed the question of whether hedged tendering was generally available to public investors. Of these commentators, only Merrill Lynch suggested that hedged tendering was available to all shareholders.

Four commentators 17/, at least in part, based their conclusion that hedged tendering should be prohibited on the unequal availability of the practice to all shareholders. The NYSE noted that the ability of an investor to use a hedged tendering strategy during a tender offer depends upon whether he has the kind of business relationship to a member firm that would allow him to borrow the necessary stock, as well as upon his sophistication. NYSE observed that in practice, it is mostly market professionals who engage in risk arbitrage, and thus in hedged tendering. The NYSE, however, did not believe that the limited availability or use of hedged tendering was a justification for prohibiting the practice. It observed that the Commission previously has interpreted portions of the Securities Exchange Act so as to facilitate risk arbitrage, citing Section 11(a), and argued that the benefits of hedged tendering justify similar treatment.

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16/ ABA, Dingell, Merrill Lynch, Michaely, Morgan Sullivan  
NYSE, SIA, Shemtob.

17/ ABA, Dingell, Michaely, Shemtob.

Merrill Lynch said that some sophisticated individual investors do hedge their tenders, and claimed that the majority of public shareholders do not hedge their tenders because "they lack the sophistication to know about or understand the practice." Merrill Lynch argued that differences in sophistication among market participants should not justify regulatory intervention. Merrill Lynch did concede, however, that "borrowing stock may be more difficult for small investors during a tender offer if demand for the shares is tight." 18/

(d) Other arguments

Several other reasons were set forth in opposition to the proposed prohibition of hedged tendering. Two commentators, SIA and Sullivan & Cromwell, asserted that hedged tendering is not a manipulative or deceptive device or contrivance, but a legitimate market strategy. Sullivan & Cromwell also stated that, "the proposal, if adopted, would only force market professionals to engage in other transactions even further removed from the realm of transactions that a 'non-professional' shareholder would be likely to take advantage of", without elaborating on the nature of such transactions. This

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18/ Merrill Lynch suggested that the Commission's real concern was double tendering and that it should focus any amendment on that practice and not on hedged tendering. The NYSE also suggested that the Commission focus specifically on the problem of double tendering.

commentator predicted that postponing permissible hedging until after the proration period would create large volume and price volatility at that time.

Merrill Lynch asserted that increased limitations on the actions of risk arbitrageurs would force marginal arbitrageurs from the field, thereby decreasing competition. This commentator also said that hedged tendering, by causing additional shares to be tendered, may contribute to the success of some tender offers conditioned on a minimum number of shares being tendered. 19/

Finally, Morgan Stanley and Sullivan & Cromwell, noting that the writing of call options would not be restricted, did not see a rational basis for allowing the equivalent of hedged tendering only when there are exchange-traded call options.

#### Multiple Tendering

Proposed Rule 10b-4(b)(3) would prohibit a tendering securityholder from tendering the same securities to more than one partial offer at the same time, a codification of

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19/ Michaely and NYC Bar disagreed, observing that other factors besides the risk of prorating, such as the risk that the offer will not be consummated, and economic gain in general, govern an arbitrageur's willingness to enter the market.

the staff's interpretation of current Rule 10b-4. Six of the commentators 20/ favored the proposed amendment; four opposed it. 21/

The commentators disagreed concerning the availability of multiple tendering to public shareholders. Those in favor of multiple tendering claimed that public shareholders would be able to use multiple tendering to the same extent as market professionals, because notices of guaranteed delivery are readily available to any shareholder who may request one from his broker.

Four of the commentators opposing multiple tendering 22/ mentioned the unavailability of multiple tendering to public shareholders as a factor in their conclusions. Sheriff stated, "[M]ultiple tendering is unfair to individuals whose shares are not located at brokerage houses and do not have the same option available to them of guaranteeing delivery of shares."

The commentators in favor of multiple tendering indicated that flexibility is the major benefit resulting from

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20/ ABA, Dingell, NYC Bar, NYSE, Michaely, Sheriff.

21/ NYCLA, Morgan Stanley, SIA, Sullivan & Cromwell.

22/ Dingell, Michaely, NYC Bar, Sheriff.

the practice. 23/ Three of the commentators opposed to multiple tendering 24/ feared that unnecessary confusion 25/, distortion of the market 26/, and serious overtenders 27/ could result.

Limitation of Rule 10b-4 to Partial Offers

Proposed Rule 10b-4 applies only in the context of partial offers. Proposed Rule 10b-4(a)(3) defines "partial offer" as "any tender offer for, or request or invitation for tenders of, any security in which (i) the bidder offers to purchase less than the total amount of securities outstanding of a particular class or series, and (ii) tenders are accepted either by lot or on a pro rata basis for a specified period."

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23/ Sullivan & Cromwell suggested that prohibition of multiple tendering could hurt public shareholders. "Prohibiting such a practice might actually work to the disadvantage of non-professional shareholders in a situation where a tender offer is on a "first-come-first-served" basis, since non-professional shareholders who must go through the steps of withdrawing tendered shares before retendering will in all likelihood not be able to execute the necessary steps as quickly as market professionals with a back-office to rely on."

24/ ABA, NYSE, Sheriff.

25/ ABA.

26/ NYSE.

27/ Sheriff.

The four commentators 28/ addressing this issue unani-  
mously favored the amendment. Each commentator stated that  
the risk of hedged tendering and pro rata acceptance exists  
only in the context of partial tender offers. Sullivan &  
Cromwell, however, recommended that in the event the proposed  
restriction on multiple tendering is approved, it should be  
expanded to include situations involving a partial offer  
against a competing any and all offer, because the incentive  
to multiple tender would also exist in this situation.

#### Tendering of Borrowed Securities

Two commentators 29/ argued that borrowed securities  
should be included within the definition of ownership in para-  
graph (a)(1) of the proposed rule if the borrower receives a  
commitment from the owner not to tender or otherwise dispose  
of the securities. Morgan Stanley asserted that, "the right  
to tender subject securities should be as freely transferable  
as any other incident of ownership."

#### Miscellaneous Comments

Two commentators, ABA, and Morgan Stanley, specifically  
commended certain provisions in the proposed amendments.

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28/ ABA, NYC Bar, Morgan Stanley, Sullivan & Cromwell.

29/ Morgan Stanley, SIA.



Morgan Stanley approved of proposed paragraph (c) of the rule, which would permit the granting of an exemption on written request or on the Commission's motion. ABA praised the definition of the term "tender" because it makes clear that physical delivery of shares is not required.

Bennett appeared to suggest that tendering shareholders should be required to execute an affidavit of ownership upon tender.

Morgan Stanley observed that "many of the Commission's concerns raised in connection with short tendering and hedged tendering may be eliminated if the withdrawal period and pro-ration period for a tender offer end on the same date."

Morgan encouraged the Commission to consider, and to solicit comments on such a proposal. 30/

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30/ See Securities Exchange Act Release No. \_\_\_\_\_, which proposes that tenders at any time during an over-subscribed offer be accepted on a pro rata basis.

Table I

Summary of Commentator Positions

	Deregulation		Prohibition of Hedged Tendering		Codification of Prohibition of Multiple Tendering	
	Favor	Oppose	Favor	Oppose	Favor	Oppose
ABA		X	X		X	
Bennett		X				
Representative Dingell		X	X		X	
NYC Bar		X	X		X	
NYCLA		X	X			X
NYSE		X		X	X	
Merrill Lynch		X		X		
Michaely		X	X		X	
Morgan Stanley		X		X		X
IA		X		X		X
Hemtob		X	X			
Heriff		X	X		X	
Mullivan & Cromwell		X		X		X
Albot	X					
<b>Total</b>	<b>1</b>	<b>13</b>	<b>7</b>	<b>5</b>	<b>6</b>	<b>4</b>