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Comments on the
Very Preliminary Outline of Issues

The preliminary outline is well organized and fairly comprehensive. The Advisory Committee will do well to address most of the questions on the outline. My principle advice is to pare down the list somewhat by grouping repetitive questions and closely related issues under the same headings. Also, I will point out what I feel are bogus issues that should be excluded from serious consideration.

The paramount question is whether the current regulatory scheme is "neutral"? This is not a well-formulated question, since neutrality has not been defined. Is no regulation non-neutral? This must be the SEC's presumption here. It is impossible to consider rules that do not either "promote or discourage tender offers", unless tender offers result from purely fortuitous events. But, the question does focus attention on what have been the actual effects of SEC regulations under the Williams Act. Have the pre-regulation abuses been reduced or eliminated? Indeed, the set of five questions under part I-C comprise essentially the same question -- is the current regulatory scheme neutral? Rather than use loaded words like "neutral" or "reasonable" to describe current regulation, the real focus must be on describing the actual effects of the regulation. This kind of investigation is not helped by these normative labels. What is good for the target is usually bad for the acquirer, with some important exceptions (like rules that serve mainly to enrich the clients' lawyers and accountants).

The Committee must determine the benefits of providing the "typical small investor" with time and disclosed information. Do these small-fries

really need this stuff? How much would they pay for an extra week, or for more facts about the source of the acquirer's funds? Must they read the disclosed material to be benefitted by its mandated disclosure?

The basic questions concerning the source of the gains to takeovers (I-5 and I-6) deserve their own section. After all, determining the costs of deterring takeovers requires one to theorize about the source of gains to takeovers. If takeovers result from corporate insiders "stumbling on" underpriced firms which would be priced correctly in due time absent a takeover, then rules that force almost all of the gains from takeovers to go to targets will not deter much of their activity. Plus, deterrence is not costly, since the takeover provides little real value to society anyway. If, on the other hand, question I-6 has an affirmative answer, then the appropriate legal model is that provided by patent law. The right thing to do is to preserve the property rights in the takeover gains to the inventor-acquirer. If takeovers result from ego-trips by the managers of corporate acquirers, and actually harm society, then deterrence is a good thing.

I think that the three fundamental issues are: 1) Describe the nature of tender offers (what is the best theory to explain the source of the gains to takeovers); 2) determine the actual effects of the post-1970 tender offer regulations; and 3) determine the regulatory response that is in the public's best interest.

Issue #2 includes part I-C, plus under II-B questions a through d, especially d1. Also included under issue #2 is question II-B-4, on "Auction Markets". Questions like d3 (under II-B), II-A, and most of the other

questions under II are properly considered to be relevant to issue #3.

Therefore, the major change I urge is to group together the questions that relate to the actual effects of the existing regulatory scheme under a general heading that is addressed right after the question about the nature of the gains to takeovers. The current outline needs only a little adjustment to meet this objective.

The real bogus issue on the outline is item IV on "Financing". It is reassuring that it appears on the last page, but disconcerting that the Senate Banking Committee mentions it first. There is no effect on capital formation of tender offers, since the acquirer's payout equals precisely the tenderer's receipts. The sellers will put these funds into savings accounts, or purchase goods allowing those sellers to invest. Tender offers affect the capital stock like the NYSE volume does. It causes transfers of funds, not reductions or increases in funds available for investments.

The other bogus issue contained in the Senate Banking Committee's letter is the theory that an active market for corporate takeovers causes an over-emphasis by corporate managers on short-term objectives, to keep their stock price up, at the expense of "longer term investment needed for economic growth." First, there is no evidence to support the view that the capital market is myopic -- rewarding investments with short-term benefits over those with longer-term payoffs. The market discounts payoffs according to the timing of their fruition, but it does not systematically over-price short-term earnings over long-term earnings. New computer firms that face

years of losses sell stock at a positive price, and firms with high earnings (but lousy outlooks) trade at low price-earnings ratios.

Second, the more conventional theory is that once the target becomes a division of the acquirer, then the distortion by managers becomes potentially important. Business managers are well aware of the incentive to sacrifice long-term profits to make short-term accounting returns look good. By skimping on maintenance, for example, the plant manager "controls costs" and gets promoted, leaving the mess to the next manager. If anything is credible, it is the fear that once acquired the target's investment goals will become distorted.

Many of the Senate Banking Committee's questions presume that takeovers are undesirable, and that we should all consider ways to tax further acquirer's bent upon growth through acquisition. This approach is not very constructive, given the broad mandate of the Commission to explore the issues at their most fundamental level.

My particular area of interest is the actual effects of the post-1970 SEC regulations on the takeover premiums that are paid, on the frequency of auction-style takeovers, on the returns to the acquiring firms, and on the extent of litigation surrounding takeovers. As a student of the empirical effects of many kinds of public regulation, I am genuinely stunned by the apparent effects of the current regulatory scheme of redistributing the gains to takeovers from the acquirers to the targets. The current rules induce in a dramatic fashion lively auctions for identified targets that result in very large windfall gains to targets. Since I believe 1) most takeovers create large social gains (as measured by the appreciation in the

market value of the merged entity) and 2) the acquirer possesses the knowledge that produces these gains once it acquires control, then my concern is that the law discourages valuable combinations. Faced with the prospect of paying 75% or 100% premiums, compared with the 25% or so pre-1970, only the most lucrative takeovers will be acted upon.

I realize that measuring this deterrence effect is critical to the above argument. It is difficult to measure this, and the aggregate figures on the number of takeovers might cast doubt that much deterrence has taken place. (This is loose statistical inference, since one must ask how many takeovers would have occured without the SEC regulations.) But, my main objective is to present this empirical evidence to the Committee and relate it to the very important questions contained in the SEC's outline.