MEMORANDUM

COUNCIL OF ECONOMIC ADVISERS

March 23, 1984

TO: William Niskanen

FROM: Stephen Halpert SH

SUBJECT: SEC Tender Offer Reform Proposals

The Securities and Exchange Commission (the "Commission") met last week to review the recommendations of its Advisory Committee on Tender Offers. Under existing law, persons seeking to acquire substantial stock interests in a public corporation, whether by purchases in the open market or tender offer, are subject to regulation under the Federal securities laws. The regulation of defensive acts of incumbent managers seeking to thwart such an acquisition is, however, largely relegated to state corporation law. The Advisory Committee recommendations would substantially expand Federal regulation of bidders and would also limit some defenses by preempting state law and substituting more stringent Federal regulation of target management conduct.

The Commission responded to the Advisory Committee recommendation by adopting most minor recommendations and a few major proposals to restrict certain defenses currently subject to Federal regulation. The Commission opposed recommendations that would either substantially expand regulation of bidders or preempt state law governing defensive behavior.

As a result, the Commission's position will not significantly affect takeover behavior. Bidders will continue to be disadvantaged by the regulations (although not as severely as if all the Advisory Committee's proposals had been adopted); target managements will still have plenty of latitude to behave in antisocial ways. In short, the Commission's position will be to leave us with (almost) the worst of all possible worlds.

The Commission will now proceed by directing its staff to draft proposed regulations for comment and any necessary authorizing legislation. Chairman Shad is presently scheduled to report on the Commission's position with respect to the Advisory Committee's recommendations to the House Committee on Energy and Commerce on March 28 and the Senate Committee on Banking, Housing and Urban Affairs on April 10.

<u>Background Discussion</u>

Corporate takeovers serve an important function by disciplining inefficient management and directing corporate assets into higher-valued uses. Several empirical studies have shown that corporate acquisitions leading to mergers result in increases averaging between 6% and 10.5% in the market valuation of a combined enterprise over its preacquisition constituents (including compensation to shareholders of the acquired concern), or an approximately 40% to 50% appreciation in the market value of the acquired firm. This may understate the market value of mergers because the anticipated gains from an announced acquisition program may already be reflected in the acquiring firms' stock prices -- some studies have shown appreciation on the order of 10% in the shares of corporations announcing such programs -- and because the possibility of gaining a takeover premium has likewise been capitalized into the preacquisition stock price of the acquired firm. Although some of this appreciation in value merely represents tax benefits (e.g., where the consolidated corporation may use credits and tax loss carry-forward that would otherwise be lost), such non-social benefits account for only a small portion of takeover gains. Moreover, similar gains accrue in takeovers that involve changes in control without merger or consolidation.

Purchases of large blocks of stocks are necessary to displace incumbent management and/or effect takeovers. According to common Wall Street wisdom, no proxy contest may succeed against management unless insurgents own at least 20% of the outstanding stock. In addition to the problem of persuading a large number of passive investors to oppose management, insurgents who own minimal stock will enjoy little of the appreciation in value from a successful campaign to offset the expenses of the battle. I am unaware of a change in management initiated by a proxy contest waged without benefit of a single substantial shareholding.

Tender offers represent a method of accumulating large blocks of target company stock that may be preferable to open market purchases from the standpoint of both the bidder and target company shareholders. In a tender offer, the bidder may condition his obligation to purchase on the tender of a sufficient number of shares to achieve control. This relieves it of the risk, inherent in a program of open market purchases, that a block of sufficient size cannot be put together at a reasonable price and that the attempt to assemble such a block will fail, leaving the buyer with holdings that can be divested only at a loss. Shareholders benefit from a tender offer because notice of the terms of the offer increases their information about the value of their holdings and permits a more informed hold/sell decision.

Prior to 1968, neither open market purchases nor tender offers were subject to Federal regulation, except the general antifraud provisions of the Securities Exchange Act of 1934 (the "Exchange Act"). The Williams Act, as passed in 1968 and modified in 1970, amended the Exchange Act to require that any person (or group acting in concert) acquiring a beneficial interest in shares constituting more than 5% of any class of equity security of any public corporation file an information statement ("Schedule 13D") within ten days of such acquisition. Among the required disclosures is a statement of the acquiror's intentions.

In the case of a tender offer, the Williams Act requires the filing of such an information statement prior to commencing an offer that would result in a 5% holding. The offeror is required to allow withdrwal rights for seven days at the start of an offer and after 60 days if the offer should remain open so long. In addition, if less than all shares tendered are purchased, the purchases must beprorated among holders tendering during at least the first ten days of the offer. These provisions implicitly require that offers for "any and all" shares be held open seven days and partial offers ten days. Offerors are also required to pay all shareholders the highest price paid by it during the pendency of the offer.

Beginning in 1980, acting pursuant to its jurisdiction under the Williams Act, the Commission imposed elaborate rules on the conduct of tender offers. Under these rules, the offeror must hold the offer open and permit withdrawal rights for 15 business days from the day of commencement. The withdrawal period must be extended to provide at least ten business days from the onset of a competing offer. The definition of "tender offer" is broadly drawn under the regulation and case law, and the regulatory requirements may be triggered by open market purchases including a statement of intent to purchase additional shares. (Note that the triggering statement of intent may be required as part of the Schedule 13D disclosures.)

The effect of the adoption of the Williams Act and the subsequent promulgation of the tender offer rules has been to reduce the likelihood of a successful offer and to decrease the number of corporate takeovers attempted. The primary reason is that legal regulation causes delay and delay allows target managements time to implement defensive strategies. Delay is caused both by the lengthy withdrawal period (a minimum of 15 business days) and because the elaborate legal requirements provide the basis for a lawsuit against the bidder. (Courts generally prevent the takedown of shares until discovery can be taken and a motion for preliminary injunction heard).

Conducting a corporate takeover is expensive in terms of investment of both money and executive time. Tender offer regulation reduces the yield from that investment by reducing the likelihood of success and, even where successful, by increasing the cost of acquiring the target company. It is not surprising therefore that significant declines took place in takeover activity following the enactment of the Williams Act and again later, following promulgation of the tender offer rules (see attached exhibit).

The regulation of tender offers is defended on two grounds. First, it is argued that such regulation promotes "fairness" in the sense that it provides symmetric treatment of target company shareholders. This is so because the regulation effectively favors tender offers over other forms of acquisition, requires that an equal price be paid for all shares, and provides that purchases be made pro rata from among persons tendering. Second, it is said to allow target company shareholders an opportunity to make an informed investment decision and thereby maximize their wealth.

In fact, both of these putative advantages are illusory. The apparent effect of the regulation is to redistribute wealth from shareholders in acquirors to shareholders in acquirees and from (sophisticated) holders of large blocks in the acquiree to (unsophisticated) holders of small lots. The redistribution from acquirors to acquirees is essentially random; it is certainly hard to see why it is either "fair" or desirable. The redistribution from large holders to small holders has a certain populist flavor (and seems to be the engine driving the regulatory scheme), but only until one stops to consider that the large holders are mostly pension and mutual funds and generally include the investments of the least wealthy investors.

This essentially random redistribution, moreover, is achieved at substantial cost, since the apreciation in value is lost to shareholders in corporations that either do not make acquisition attempts or are not targets because the rules deter some takeover attempts. Worse yet, during the pendency of a takeover attempt, incumbent managers, who obviously have a lot to lose if a hostile takeover is successful, have a perverse incentive to reduce the value of the corporation in order to make it less attractive to the bidder, e.g., by making a sale of assets for less than fair market value. The "scorched earth" and "poison pill" defenses, along with various others are variants on this theme. Alternatively, incumbent management may cause the target corporation to repurchase the stock of would-be acquirors, thereby diluting the equity interests of the remaining shareholders <u>and</u> denying them a share of any control change appreciation. Because takeover regulations increase the opportunities for defensive behavior, they also increase the opportunity for misbehavior.

Advisory Committee Recommendations

The Advisory Committee or Tender Offers forwarded 50 recommendations to the Commission.

Recommendations 1-9 constitute a statement of philosophical principles, favoring a balance between treatment of bidders and targets and Federal regulation of the process. The Commission concurred with these positions, although it expressed a desire not to intrude into state corporation law except where "shareholders are being abused and the purposes of the federal regulatory scheme are frustrated." The Commission did express a wish that state courts more closely review management behavior in contest situations.

Recommendations 10-32 deal with the regulation of takeover bidders. Most of the proposals would effect minor changes to existing regulation, e.g., tender offers would be required to be open for 20 business days with proration and withdrawal for the entire period instead of 15, but competing offers should not trigger an increase in the minimum period. A proposal that would revolutionize the regulatory scheme -- and greatly exacerbated the anti-takeover bias of the rules -- by prohibiting open market or private purchases (other than from the issuer) that would result in a holding greater than 20% of a corporation's outstanding shares was rejected by the Commission. Likewise, a number of other proposals that would have made acquisition of control blocks more difficult were rejected or deferred for further consideration. On balance, the recommendations as adopted by the Commission would not significantly change the regulation of bidders.

Recommendations 33-43 related to takeover defenses. The Advisory Committee proposed to foreclose a number of measures that can be used to impede takeover that are generally not in shareholders interest; other measures that impede takeovers but may be desirable to some shareholders (e.g., supermajority provision, change of control compensation negotiated prior to a takeover attempt) would be permissible, but would be subject to a periodic non-binding "advisory" vote by shareholders. Although sympathetic to the Advisory Committee's objectives, the Commission demurred from preempting state law and opposed the concept of an "advisory" vote. The Commission would, during the pendency of a control contest, prohibit "golden parachutes," and self-tenders altogether, and would require shareholder approval for an issuance of stock equal to more than 5% of the class outstanding class. Repurchases of stock from holders of less than two-year duration without shareholder approval would also be barred.

In effect, what the Commission did was to approve those Committee recommendations that would impede certain abusive practices of incumbent management already subject to Federal regulation, but leave untouched those abuses whose remedy would require intruding upon matters previously left to state law. Thus, reducing share values by sales of stock at bargain prices to friendly buyers would be prohibited because the Commission has traditionally exercised regulatory power over the purchase and sale of securities; defensive bargain sales of other assets, not currently subject to Federal regulation, would continue to be permitted. This approach, although it will result in proliferating regulation, cannot prevent abusive defenses.

(Recommendations 44-48 and 49-50 dealt with short tendering and antitrust law compliance.)

Exhibit

Number of Tender Offers by Year

Fiscal Year	Number of Tender Offers*	Fiscal Year	Number of Tender Offers*
1965	105**	1974	105
1966	77**	1975	113
1967	113***	1976	100
1968	115***	1977	162****
1969	70	1978	179
1970	34	1979	147
1971	43	1980	104
1972	50	1981	205
1973	75	1982	117

*Data for fiscal year 1969 and following have been obtained from the Commission and represent tender offers commenced.

**These figures were obtained from a study on "Tactics of Cash Takeovers Bids" prepared by Professors Samuel L. Hayes, III, and Russell A. Taussig, 45 Harv. Bus. Rev. 135 (1967), which was submitted in 1967 to the Senate and House committees holding hearings on the bill that became the Williams Act. The figures are based on a calendar rather than fiscal year. See Hearings on H.R. 14475, S. 510 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 2d Sess. 21 (1968).

***These figures were obtained from W.T. Grimm & Co. They are based on a calendar year and represent tender offers commenced. Grimm has indicated that it obtained this information from news stories in the financial press and that the figures include tender offers for companies not subject to section 12 under the Exchange Act, but do not include tender offers for securities other than common stock.

****In 1977, the federal government changed its fiscal year. Accordingly, this figure is based on an extended fiscal year from July 1, 1976, to September 30, 1977.