Securities and Exchange Commission
Response to Congressman Wirth's Letter
of January 25, 1985 Concerning Tender Offers

July 1, 1985

Introduction

This report has been prepared by the staff of the Securities and Exchange Commission in response to a letter to Chairman Shad, dated January 25, 1985, from Congressman Timothy Wirth, Chairman of the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce. Congressman Wirth's letter requested the Commission's views on a series of questions (i) raised in the House Report on the Tender Offer Reform Act of 1984 (the "1984 House Report"); */ and (ii) relating to H.R. 5693, the "Tender Offer Reform Act of 1984". The Commission's responses to these specific questions are set forth in Parts I and II below.

I. Questions Raised in 1984 House Report

In the 1984 House Report, the Committee on Energy and Commerce expressed its intention to address various fundamental questions relating to tender offer regulation, many of which it then set forth in specific questions which the Commission has been asked by Congressman Wirth to address.

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*/ H.R. Rep. No. 1028, 98th Cong., 2d Sess. (1984).

Taken together, the questions raised in the 1984 House Report implicate broad issues of public policy that transcend existing regulatory structures. Among these issues are whether it is necessary and appropriate to adopt federal legislation to discourage certain types of corporate financing, to promote certain types of investment choices, and to direct the allocation of investment capital to preferred objectives. Such issues have not traditionally been addressed through regulation under the federal securities laws.

A number of other questions raised in the 1984 House Report were considered when Congress enacted the Williams Act. Consistent with the regulatory philosophy underlying the Securities Act of 1933 and the Securities Exchange Act of 1934, */ the Williams Act was primarily designed to protect

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*/ See S. Rep. No. 47, 73d Cong., 1st Sess. (April 17, 1933); ("The basic policy [of the 1933 Act] is that of informing the investor of the facts concerning securities to be offered"); H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933). See also 78 Cong. Rec. 2931 (May 5, 1933) (statements by Congressman Wolverton) ("The theory upon which [the 1933 Act] has been drawn is to give the public complete information as to the security offered for sale, rather than a governmental approval of the security."); Santa Fe Industries Inc. v. Green, 430 U.S. 462, 477 (1977) quoting from Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) ("The purpose of the 1934 Act [is] 'to substitute a philosophy of full disclosure for the philosophy of caveat emptor.").

investors by providing substantive protections, as well as adequate opportunity and information to make informed investment decisions about the merits of a tender offer. */ As Senator Williams explained, the Act was intended to fill a "gap" in disclosure left by the other securities laws. **/ The Williams Act was intended to promote a policy of neutrality, which favored neither bidders nor targets in a tender offer, giving

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*/ Prior legislative proposals to regulate tender offers were not neutral, but were designed to favor incumbent management. In 1965, Senator Williams introduced S. 2731. 89th Cong., 1st Sess. (1965). He explained that the bill was designed to prevent "industrial sabotage" by companies that turn "proud old companies" into "corporate shells." 111 Cong. Rec. 28256, 28257 (1965) (Statements of Senator Williams).

**/ _Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S.510 Before the Subcommittee on Securities of the Senate Committee on Banking and Currency_, 90th Cong., 1st Sess. 1 (March 21, 1967) (statement by Senator Williams) ("At present, however, some areas remain where full disclosure is necessary for investor protection but not required. The legislation before the Subcommittee today will close what I consider to be a significant gap in these last remaining areas.") ("Senate Hearings"); _see also_ Senate Hearings at 42 (Statement by Senator Kuchel) ("There still remains a significant gap within which those who would misuse the public trust and hide under a blanket of secrecy can continue to carelessly speculate with the credit and fate of the nation."); Senate Hearings at 15 (statement by Manuel F. Cohen, former Chairman of the Securi ties and Exchange Commission) ("The Commission is of a view that the legislation here proposed will fill a gap, a rather large gap, in the securities statutes").

both bidders and targets equal opportunities to state their case to shareholders. The ultimate decision about the success or failure of a tender offer was left to shareholders. */

In administering the Williams Act, the Commission has found, in general, that the statute has been sufficiently flexible to deal with novel and innovative tender offer practices. The Commission believes that the principles underlying its regulatory scheme remain sound.

Nevertheless, the Commission shares the concerns expressed in the 1984 House Report about recent developments in both bidder and target tactics. The Commission's 1984 legislative proposal addressed certain of these techniques. Since that time, the manner in which contests for control are fought has continued to evolve.

In some respects, market participants themselves have developed strategies to respond to what, last year, were perceived to be

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*/ H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968) ("1968 House Report"); S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967) ("1967 Senate Report"); accord, Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 29 (1977). As former Commission Chairman Cohen noted shortly after introduction of the proposed Williams Act, "[w]e support the bill because we believe it provides a suitable framework for giving investors adequate material information without unduly hindering tender offers which may be beneficial to them." Remarks of Manuel F. Cohen, Chairman, Securities and Exchange Commission, Before the Association of the Bar of the City of New York (April 4, 1967).

the most abusive tender offer practices. And new practices raising different questions have emerged. Whereas a year ago the focus of concern was perceived abuses by management of potential targets in responding to hostile takeover attempts, today there appears to be an equal focus on the actions of bidders and potential bidders.

These circumstances demonstrate the difficulty in identifying long-term fundamental problems that warrant legislative solutions. In light of the evolution in this area, the Commission concluded that market changes had rendered the major provisions in its 1984 legislative proposal no longer necessary or effective to address current practices.

The Commission has continued to develop an empirical base from which to evaluate perceptions of abuse and the efficacy of proposed solutions. The results of the staff's studies to date have confirmed that certain frequently attacked practices have declined and that certain harms said to result from other practices cannot be established. Set forth below are responses to the specific questions posed in the 1984 House Report.

1. How can we assess the basic question of the relative benefits or harm resulting from hostile takeovers?

2. What is the impact of hostile takeovers on individual companies and their shareholders?

Answer: Most analysis to date has focused on the impact of hostile takeovers on individual companies and their shareholders. As the number and size of hostile tender offers have increased, concerns have been expressed about their effects. */ Concerns have also been raised about shareholder disenfranchisement through antitakeover amendments and changes in listing standards, **/ excessive leveraging, ***/ and the costs involved in the reallocation of resources resulting from hostile takeovers, such as plant closings. ****/ Opponents

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*/ See, e.g., Statement of Felix Rohatyn, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (June 6, 1985).

**/ See, e.g., Statement of Arthur Levitt, Chairman, American Stock Exchange, Inc., Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (May 22, 1985).

***/ See 1984 House Report at 13; see also Statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (April 23, 1985.)

****/ See Statement of Andrew Sigler, Chairman and CEO of Champion International Corp., Representing the Business Roundtable, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (June 6, 1985). It should be noted that plant closings are not unique to hostile takeovers.

have stated that takeovers cause management to focus too extensively on short-term objectives. */

At the same time, others have argued that hostile takeovers are generally beneficial. Proponents contend that takeovers can provide a check on management, ensuring its accountability to shareholders. **/ Takeovers provide shareholders of target companies with a substantial premium for their shares, a premium that can be reinvested in productive investments. Moreover, takeovers can produce synergistic benefits, economies of scale, cost savings and transfers of technology. Takeovers, therefore, often reallocate resources to higher valued uses.

Little empirical data has been presented to support these various views. The Commission's Office of

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*/ See Statement of Professor F.M. Scherer, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (March 12, 1985).

**/ See Statement of Professor Michael Bradley, Before the Subcommittee on Securities of the Senate Commmittee on Banking, Housing and Urban Affairs (April 3, 1985).

the Chief Economist and others have studied certain aspects of the economic impact of takeovers, particularly with respect to their effects on management behavior and on the share prices of bidders and targets. The results of some of these studies are set forth below.

1. Stock Prices: Target Company. Available empirical evidence indicates that corporate takeovers generate statistically significant increases in the stock prices of target firms during the time period around the announcement of the offer. */ In attempting to quantify the premiums received in tender offers, the Commission's Office of the Chief Economist has found that, from 1981 to 1984, average premiums of 53.4% above the prior market price were paid to target's shareholders. **/

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*/ Michael C. Jensen and Richard S. Ruback, The Market for Corporate Control: The Scientific Evidence, 11 Journal of Financial Economics 9-14 (April 1983) ("Jensen and Ruback"). This paper extensively reviews much of the available scientific literature on the market for corporate control. This paper is discussed at greater length in the answer to Question 11.

**/ See The Economics of Any-or-All, Partial and Two-tier Tender Offers, Office of the Chief Economist, Securities and Exchange Commission (April 19, 1985). A copy of this study is attached as Exhibit A.

In its Report, the Commission's Advisory Committee on Tender Offers discussed studies that attempted to quantify the impact of hostile tender offers in terms of share price movements. These studies indicate that during the period in "which a tender offer is considered the target company's shares rise an average of 30% while the bidder's shares increase an average of 3-4%." */

2. Stock Prices: Bidder Company. Some studies have shown that the market price of bidder's shares increase following successful tender offers. **/ With respect to mergers, however, the evidence on bidder returns is mixed, suggesting that overall "returns to bidders in mergers are approximately zero." ***/

Another study examined the returns to the shareholders of unsuccessful bidders. This study found that stockholders of the unsuccessful

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*/ Advisory Committee on Tender Offers-Report of Recommendations, at 7, n.6 (July 8, 1983).

**/ Jensen and Ruback at 16, 22. The studies discussed in this paper examined share price data over a varied range of time periods.

***/ Id.

bidding firm suffered a "significant wealth loss." */ in cases in which the target subsequently accepted a bid by another bidder. The authors interpret these results "as evidence that successful acquiring firms possess specialized resources that * * * are eventually used to put the unsuccessful bidding firm at a competitive disadvantage in the market place." **/

3. Effects on Corporate Planning. Some attempt has been made to determine empirically whether rising institutional ownership and the threat of hostile tender offers induce corporate management to pursue short-term results, at the expense of research and development and other beneficial long-term projects.

A recent study by the Commission's Office of the Chief Economist, ***/ examining 324 firms in a broad cross-section of industries, disclosed that

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*/ M. Bradley, A. Desai and E. Kim, The Rationale Behind Interfirm Tender Offers, 11 Journal of Financial Economics 183, 186 (April 1983). This portion of the study looked at whether the target companies in the sample were acquired within a five year period after the initial unsuccessful bid.

**/ Id. at 186-87.

***/ Institutional Ownership, Tender Offers, and Long-Term Investments, Office of the Chief Economist, Securities and Exchange Commission (April 19, 1985). A copy of this study, discussed in response to question 4, is attached as Exhibit B.

their average research and development expenditures ("R&D") rose from 3.38% of sales in 1980 to 4.03% in 1983, a period during which institutional ownership in these 324 firms increased from an average of 30% to an average of 38%. */ This study also suggests that investment in long-term projects such as R&D does not make a firm vulnerable to a takeover bid. If R&D investment did make firms more vulnerable to takeover bids, one would expect to find that target firms spent a higher percentage of their revenue on R&D than firms that did not become targets. In fact, however, this study disclosed that the R&D-to-revenue ratio for target firms was lower than that of firms that did not become targets. In particular, the study shows that the R&D-to-revenue ratio for target firms was less than one-half that of the industry control group in the year immediately preceding the tender offer. **/ A lower ratio of R&D-to-revenue for target firms was also present in the three years preceding the takeover. ***/

*/ *See* Exhibit B at 6-7.

**/ *Id.* at 8-10.

***/ *Id.*

Stock prices react favorably to announcements that companies are embarking on R&D projects. The increase in the equity value of 62 firms making such announcements in 1973-1983, relative to the market, was 0.80% during the two days following the announcement. This evidence appears to be counter to the argument that the market penalizes companies that invest in long-term projects.

4. Anti-Takeover Amendments. A study by the Office of the Chief Economist has demonstrated a statistically significant decline in stock prices following the adoption of certain anti-takeover provisions. */ The study showed that the adoption of supermajority provisions caused a 4% decline in stock prices. **/ The adoption of "poison pill" provisions caused a decline of 3%. ***/

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*/ See Exhibit C. The study, which examined share price reaction from 20 trading days before through 10 trading days after the announcement of a supermajority provision, is discussed at greater length in the Commission's response to Question 11.

**/ Supermajority provisions generally increase the percentage of shareholders necessary to approve mergers and similar transactions to as high as 80 to 90%.

***/ See Exhibit D. This portion of the study examined share price effects based on the price 10 trading days before and 40 trading days after the announcement of the "poison pills." "Poison pills" are defined and discussed at greater length in the Commission's response to Question 11.

The Commission's Office of the Chief Economist is also reviewing the effect on share prices of the creation of dual classes of voting stock, frequently called "A-B capitalization." An examination of five firms that created dual voting classes has shown large share price declines relative to the market (-6.26% to -20.9%) during the small period of time around their respective announcement dates.

5. Reallocation of Resources. Takeovers often involve a reallocation of resources to higher valued uses. */ The fact that resources are reallocated does not, however, necessarily compel the conclusion that prior management was inefficient, as some claim. **/ Bidders may pursue companies with strong operating managements at least as often as they pursue companies with weaker managements. ***/ Also, the cyclical nature of takeover activity may refute the notion that bidders

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*/ See generally 1985 Report of the President's Council of Economic Advisers, at 196-99.

**/ See, e.g., Thigpen, Cash Offers, Capital Market Discipline, and the 1968 Legislation Revisited, 49 Tenn. L. Rev. 1, 16 (1981).

***/ See Coffee, Regulating The Market For Corporate Control: A Critical Assessment of The Tender Offer's Role in Corporate Governance, 84 Colum. L. Rev. 1145, 1206-07 (June 1984) (hereafter "Coffee").

carefully search through the economy to find badly-managed potential targets. */ Rather, hostile takeovers have a greater correlation to changes in the regulatory or structural environment of certain industries.

An examination of target companies does indicate that such companies generally under-perform the stock market in the period preceding a takeover, **/ but the reasons for this are unclear. ***/ The Commission's Advisory Committee on Tender Offers found that "while in certain cases takeovers have served as a discipline on inefficient management, in other cases there is little to suggest that inefficiency of target company management is a factor." ****/

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*/ Id. at 1207.

**/ See Easterbrook & Fishel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981). See also Hayes & Taussig, Tactics of Cash Takeover Bids, 45 Harv. Bus. Rev. 135, 142 (March-April 1967).

***/ For example, while the bidder may tend to select the best targets available once a list of potential targets has been assembled, the bidder's search for targets may be limited to companies whose assets and organizational structure "fit" with the bidder's structure. See Coffee at 1214-15.

****/ See Report of Recommendations of the Advisory Committee on Tender Offers at 8-9 (July 8, 1983).

3. What is the impact on the credit markets and on individual companies of the tremendous borrowings used to fund mergers and leveraged buyouts?

Answer: Leveraged buyouts generally involve the purchase of a company or one of its subsidiaries by management or a small group of investors with proceeds of loans collateralized by the assets of the company being acquired. Leveraged buyouts generally involve a higher proportion of debt and smaller amounts of equity than ordinary mergers or takeovers. The use of leveraged buyouts has increased substantially in recent years. */ Recent proposals by certain entities to acquire and merge with much larger companies have also contemplated substantial debt financing.

The recent increase in leveraged buyouts is not without potential risks to the soundness of individual companies. The net effect of a leveraged buyout of a company is that equity is retired and replaced by debt. To service the debt, the company may have to divert a significant portion

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*/ By some accounts, leveraged buyouts increased from 20% of all acquistions in 1982 to 50% in 1983. See Hill & Williams, Buy-out Boom: Leveraged Purchases of Firms Keep Gaining Despite Rising Risks, Wall St. J. Dec. 29, 1983, at 1, col. 6. In 1984, approximately $15 billion in equity was retired in leveraged buyout transactions. Statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (April 4, 1985) (hereafter "Martin Statement").

of its cash flow from productive purposes, such as capital investment and research and development. Moreover, because these buyouts generally involve floating rate debt, fluctuations in the prevailing interest rates can have a magnified impact on the resulting, highly-leveraged, entities. In the event of an economic downturn, the number of bankruptcies among these companies may increase. */

It appears that leveraged buyouts and mergers may have short term impacts on credit markets. Chairman Volcker of the Board of Governors of the Federal Reserve System has noted that the changes in financial flow associated with mergers may have a measurable short-term impact on the monetary and credit aggregates, especially when the volume of merger activity is large. **/ Chairman Volcker has emphasized, however, that merger activity "should not generate significant macroeconomic effects." ***/

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*/ The Federal Reserve is monitoring this situation and has issued specific guidelines for examiners to follow in evaluating highly leveraged loans. See Martin Statement.

**/ Letter from Paul Volcker, Chairman, Board of Governors of the Federal Reserve System, to Congressman Timothy Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (May 30, 1984).

***/ Id.

As noted by Chairman Volcker, leveraged buyouts do not appear to have significant long term effects on credit markets. Vice Chairman Martin of the Board of Governors of the Federal Reserve System recently testified that merger and acquisition transactions "should not generate lasting reductions in the amount of financial resources available to other borrowers." */ Consistent with the statements of Chairman Volcker and Vice-Chairman Martin, the Tender Offer Advisory Committee found that no material distortion in the credit markets results from changes in corporate control. **/

4. <u>What is the impact of the increasing presence of institutional investors in the securities markets?</u>

<u>Answer</u>: The term institutional investors generally encompasses such diverse institutions as pension and retirement funds, investment companies such as mutual funds, insurance companies, trust fund foundations, educational endowments and savings banks. Many of these institutions, including pension plans, the fastest growing category of

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*/ Martin Statement at 4.

**/ Report of Recommendations of the Advisory Committee on Tender Offers at 14 (July 8, 1983).

institutions, manage funds on behalf of large numbers of individuals. Institutions that manage pension plans covered by the Equity Retirement Income Security Act ("ERISA") are subject to various fiduciary duties, including the requirement that plan assets be invested in a "prudent" fashion and for the "exclusive benefit" of participating employees.

Since the 1940's, ownership of outstanding equity securities by institutional investors has increased steadily, accounting today for approximately 45% of public stock ownership and 70% of the daily trading volume on the New York Stock Exchange. */

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*/ Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications, Consumer Protection and Finance at 1 (May 23, 1985). The growth in the holdings of institutional investors has occurred primarily in the post-war era. Between 1860 and 1922, holdings of institutional investors other than personal trust funds declined. Institutional Investor Study Report, H. Doc. No. 92-64, 92d Cong., 1st Sess. 58 (March 10, 1971) (hereinafter "Institutional Investor Study"). By 1952, however, institutional ownership was between 19 and 24% of total stock outstanding, compared with 7% at the turn of the century. Id. at ix. The holdings of institutional investors began to undergo dramatic growth in the 1960's, as investment programs shifted away from government and private debt securities to equity securities. Securities Industry Study, Report of the Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess. 64 (1973).

In recognition of the growing importance of institutional investors, Congress in the late 1960's directed the Commission to study the role of institutions in the securities markets. */ In the resulting eight-volume study, the Commission analyzed the involvement of institutional investors in the takeover process and, among other things, concluded that institutions were "major forces in the facilitation" of changes of corporate control. **/

Congress also expanded the available information about the holdings of institutional investors by amending the Securities Exchange Act to require certain institutional investor managers to file reports with the Commission containing information

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*/ Pub. L. No. 90-438 (July 29, 1968). The study was intended to provide additional economic information about the "extent and nature of institutional participation in the securities market." S. Rep. No. 1237, 90th Cong., 2d Sess. 1 (June 17, 1968).

Even before authorization of this study, former Chairman Cohen noted the Commission's interest in institutional investors: "As you might imagine, this increased activity of institutional investors in the equity markets, combined with the steaady increase in their overall holdings of equity securities, has not gone unnoticed by the Commission."

Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission, Before the American Pension Conference (May 28, 1968).

**/ Institutional Investor Study at 2843.

about their portfolios. */ Data from these reports reveals that institutional investors often own a majority of the outstanding shares of a publicly traded company. **/

The influence of institutional investors may continue to increase. A number of large state and local pension funds recently formed the Council of Institutional Investors. The Council has approximately 22 members whose collective assets exceed $100 billion. Jesse Unruh, California State Treasurer and a member of the Council of Institutional Investors, testified before Congress

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*/ Section 13(f), 15 U.S.C. § 78m(f). Section 13(f) requires institutional investment managers exercising investment discretion over accounts containing securities with an aggregate fair market value of $100 million to file reports required by the Commission.

**/ For example, as of December 31, 1984, institutional investors subject to the reporting requirements in Section 13(f) of the 1934 Act owned in excess of 60% of the outstanding shares of a large number of Fortune 500 companies. Among those companies with high institutional ownership were Phillip Morris, Inc. (60.6%), Citicorp (64.9%), McDonald's Corp. (61.1%), Motorola, Inc. (60.5%), Honeywell, Inc. (70.9%), Monsanto, Inc. (60.8%), Texas Instruments, Inc. (69.9%), K-Mart Corp. (70.7%), Cigna Corp. (68.3%) and G. D. Searle & Co. (68%). Because the filing requirements in Section 13(f) do not extend to institutional investment managers with assets accounts containing less than $100 million, these percentages may have understated the institutional ownership of the respective companies. See Spectrum 4: 13(f) Institutional Investors xvi (Dec. 31, 1984) (published by Computer Directions Advisors, Inc.).

that the Council will encourage its members, in the exercise of their fiduciary duties, to participate actively when financial resolutions are presented to shareholders. */ Institutions often have the resources and market expertise to develop sophisticated investment strategies. These attributes place institutional investors in a position to block charter amendments that make takeovers more difficult or to take other actions to prevent steps they believe would otherwise adversely affect the company. **/

The increased participation of institutional investors in the securities markets appears to have significant benefits. They appear to have contributed to the depth and liquidity of the equity markets. Their active interest in the management

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*/ See Statement of Jesse M. Unruh, California State Treasurer, Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary (April 24, 1985).

**/ A survey of 2500 institutional money managers indicated that these managers oppose certain anti-takeover charter amendments, such as supermajority provisions, by a ratio of three to one. See Blustein, Measures to Discourage Takeovers Stir Controversy at Annual Meeting, Wall St. J., April 18, 1983, at 29, col. 4. The study also showed that these managers favored some anti-takeover charter amendments such as fair price provisions. Id.

of the companies in which they invest may promote the informed exercise of shareholder voting.

Opponents of hostile tender offers often argue that institutional investors' clients judge their performance on a quarterly basis and that, as a result, institutional investors favor opportunities for short-term profits. This is said to encourage corporate management to pursue short-term results, at the expense of capital investment, research and development, and other long-term projects. Proponents of this view have not provided empirical evidence of this phenomenon. Findings made in a recent study by the Commission's Office of the Chief Economist failed to support this view. */

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*/ This study examined data on R&D expenditures for 57 target firms during the year immediately preceding their tender offers. The data reveals that the average R&D expenditures of these firms amounted to 0.77% of their revenues, less than one-half of the average expenditures of 1.66% by their industry control groups. In addition, the R&D-to-revenue ratio of the target firms in the year immediately preceding their tender offers actually increased slightly over the ratio in the previous three years (0.75%). The average percentage of equity held by institutional investors in 177 target firms was 19.3% in the quarter immediately preceding the tender offer, as compared with a corresponding average of 33.7% for firms in an industry control group of non-target firms. This data, while not conclusive, undercuts the opinion that heavy institutional ownership per se gives rise to hostile tender offers. The study is attached as Exhibit B.

5. <u>What is the impact of arbitrageurs in hostile takeover battles?</u>

<u>Answer</u>: The term arbitrageur is commonly used to refer to any person both buying and selling an asset, such as a stock, bond or commodity, in two different markets at approximately the same time in order to take advantage of any price difference between the two markets. */ Such persons, who are likely to be sophisticated investors or market professionals, play an important role in the securities markets. Their willingness to put their money at risk enhances

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*/ P. Wyckoff, <u>Dictionary of Stock Market Terms</u> 12-13 (1964) ("<u>Arbitrage</u> - The purchase of a security or commodity in one market and the almost simultaneous sale * * * of the same security or commodity in another market at a different price. The object is to profit from any price difference between the two markets."). <u>See also</u> L. Loss, <u>Securities Regulation</u> 1108, n.276 (1961) (hereafter "Loss").

Regulation T defines the term "'bonafide' arbitrage" to include "(a) a purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable for the purpose of taking advantage of a difference in prices in the two markets, or (b) a purchase of a security which is without restriction other than the payment of money, exchangeable or convertible within 90 calendar days of the purchase into a second security together with an offsetting sale of the second security at or about the same time, for the purpose of taking advantage of a concurrent disparity in the prices of the two securities." 12 C.F.R. § 220.7.

the liquidity of the securities markets, and arbitrage activity tends to improve market efficiency by correcting anomalies in price. */

The term arbitrageur has also been used to refer to professional stock traders who buy the stock of companies that become the target of hostile takeovers, often tendering their shares to the bidder. **/

In the context of hostile tender offers, arbitrageurs play a significant facilitating role. Arbitrageurs provide liquidity to the market and assume the risk that tender offers will be unsuccessful. If the probability of a bid's success increases or higher bids are received, the price will generally rise further, but if the target wards off the tender offer and succeeds in remaining independent, the price will generally fall. Shareholders who do not wish to assume this risk

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*/ *See* Loss at 1108-09, n.276 ("Professional arbitrageurs, by buying in the lower market and selling in the higher, serve a legitimate economic function in thus bringing the prices in two markets together.").

**/ Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, Case & Comments 35 (Nov.-Dec. 1984).

can sell their shares into the market which arbitrageurs help to create. */ In partial tender offers, shareholders who sell into the market avoid the risk that they will receive only pro rata acceptance of the shares they tender.

Arbitrageurs generally have the resources and specialized skills to gauge the probable outcome of tender offers, mergers, recapitalizations and other transactions. They have, however, on occasion suffered multi-million dollar losses. **/ The keen competition among arbitrageurs appears to be reflected in higher market prices than would otherwise be available, to the benefit of all of the company's shareholders.

Two principal concerns have been raised about the role of arbitrageurs in hostile tender offers.

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*/ For a discussion of the benefits provided by arbitrageurs, see Johnson, Disclosure in Tender Offer Transactions: The Dice are Still Loaded, 42 Pitt. L. Rev. 1, 11 (1980); see also Remarks of Phillip A. Loomis, Jr., General Counsel, Securities and Exchange Commission, before the New York City Bar (April 14, 1967).

**/ One arbitrageur reportedly lost $80 million on one aborted takeover attempt. See Wall Street's Risk Takers Roll the Dice Again, U.S. News & World Report p. 60 (Feb. 18, 1985).

It is argued that they lack any long-term interest in the companies in which they hold shares. There is also a perception that they enjoy unfair informational advantages that may facilitate improper insider trading activity. */

It is not clear that the short-term ownership of shares by arbitrageurs, as distinct from that of other investors, presents a particular regulatory or policy concern. The concern over arbitrage activities may be a reflection of more fundamental concerns about the orientation of professional investors. Attempts to address such concerns through securities regulation would represent a major departure from the traditional objectives of the federal securities laws.

With respect to arbitrageurs' alleged informational advantages, the Securities Exchange Act, including the Williams Act and the tender offer rules thereunder, provide the Commission with authority to restrain insider trading violations by any person.

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*/ See Testimony of Felix Rohatyn, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (June 6, 1985).

Commission Rule 14e-3 specifically establishes a disclose or abstain from trading rule for any person who is in possession of material information that relates to a tender offer by another person, if he knows or has reason to know the information is nonpublic and if the information was acquired, directly or indirectly, from the bidder or from the issuer which is the subject of the tender offer. Rule 14e-3 also establishes an anti-tipping rule with respect to material, nonpublic information relating to a tender offer. */ Where there is evidence of violations of these proscriptions, the Commission will continue to take appropriate enforcement action against any entity or individual, including any arbitrageur, who violates the federal securities laws.

6. Should large, open-market purchases of the shares of public companies be conducted totally outside the tender offer process?

Answer: With the one exception discussed below, the Commission does not believe that additional legislation governing open market purchases is

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*/ Commission Rule 14e-3, 17 C.F.R. 240.14e-3; Securities Exchange Act Release No. 17120 (September 12, 1980).

necessary at this time. The primary federal interest operating in the regulation of open market purchases is to assure adequate notice to investors of significant accumulations of equity securities and of their opportunity to participate in any open market purchase program. */ The Commission believes that existing regulation of open market purchases serves these ends and preserves the free and open auction market in which open market purchases take place.

Open market purchases are subject to Section 13(d) of the Exchange Act, which provides that any person who acquires the beneficial ownership of more than five percent of the equity securities of a public company must file a statement within ten days after the acquisition of such interest describing, *inter alia*, the background of the purchaser, the purposes for the acquisition, and any plans or proposals for acquiring control of,

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*/ In creating the regulatory scheme embodied in the Williams Act, Congress expressly determined not to subject ordinary open market purchases to the regulatory provisions governing tender offers. *See* 113 Cong. Rec. 856 (1967) (Remarks of Senator *Williams*).

merging with, or liquidating the issuer. */ By Congressional design, the initial filing under Section 13(d)(1) is a post-acquisition requirement, and Section 13(d)(1) does not prohibit further open market purchases by a person who has acquired more than five percent of a corporation's stock. **/

On May 20, 1985, the Commission voted to continue to support its 1984 proposal to close the ten-day filing window in current Section 13(d) of the Exchange Act. This proposal would, in a manner that does not involve pre-acquisition filing, more effectively accomplish the Congressional intent of alerting the issuer, the market and all investors to rapid accumlations of equity securities. ***/

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*/ This statement is required to be sent to the issuer and the exchanges on which the security is traded, and to be filed with the Commission.

**/ Congress considered and rejected the imposition of more restrictive provisions, including a requirement for advance public announcement, with respect to these types of non-tender-offer purchases.

***/ The Commission's proposal would permit it to require immediate public announcement of a triggering acquisition, to specify the time, after acquisition of a 5% interest, for filing a statement and to specify a length of time not to exceed 2 business days after filing, for which additional purchases may be restricted. The legislation would not provide authority to impose a requirement of a pre-acquisition filing of the statement.

In addition to regulation under Section 13(d), the Commission believes that third-party and issuer acquisition programs intended to, or reasonably likely to, pressure shareholders to tender are tender offers subject to registration under the Williams Act and the Commission's rules. */ This applies whether the purchases are made in the open market or in face-to-face dealings. **/

Issuer repurchase programs raising the concerns that the Williams Act was designed to address, *e.g.*, undue pressure on shareholders to part with their shares, are subject to Rule 13e-4, the

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*/ *See, e.g.*, Securities Exchange Act Rel. No. 16385, 44 Fed. Reg. 70349 (Nov. 29, 1979) ("To say that purchases take place on the floor of a securities exchange * * * does not end the inquiry. The use of facilities of an exchange may be a mere formality to disguise what is otherwise in effect a tender offer * * *"); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd on other grounds*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1522 (1983). *See also* Securities Exchange Act Release No. 16385, 44 Fed. Reg. 70349 (Nov. 29, 1979) (proposing a definition of the term "tender offer"); Memorandum of the Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs Proposing Amendments to the Williams Act (Feb. 15, 1980) (proposing, *inter alia*, to define the term "statutory offer" in Section 14(d) of the Exchange Act).

**/ *See* 1984 House Report at 12.

Commission's issuer tender offer rule. The rule acts to prohibit the issuer from repurchasing its stock in the market absent certain disclosures. */

In SEC v. Carter Hawley Hale Stores, Inc., 587 F. Supp. 1248 (C.D. Cal. 1984), affirmed, Nos. 84-5897, 6001 (9th Cir. May 13, 1985), the Commission unsuccessfully alleged that an open market repurchase program initiated by Carter Hawley Hale in response to a hostile tender offer violated Rule 13e-4. The Commission argued that Carter Hawley Hale's repurchase program of approximately 50% of its outstanding shares in 7 trading days was itself a tender offer,

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*/ If a target company's managers wish to compete with an outstanding tender offer by making a tender offer for their company's own shares, Rule 13e-4 requires that they abide by essentially the same rules as the third party. Issuers must disclose certain material information, allow shareholders to withdraw tendered shares for a minimum of 10 business days following the commencement of the offer and for 7 business days following the commencement of a competing offer, and accept shares tendered during the first 10 business days of the offer on a pro rata basis if the offer is over-subscribed. 17 C.F.R. 240.13e-4(f). The Commission's rules require that issuers generally hold their tender offers open for 15 business days. Rule 13e-4(e), 17 C.F.R. 240.13e-4(f). However, in order to ensure that competing tender offers are conducted in accordance with the same rules, the Commission's rules require that the issuer hold its tender offer open for 20 business days if its offer is made in anticipation of or in response to a third-party's tender offer. Rule 14e-1(a), 17 C.F.R. 240.14e-1(a). See Securities Exchange Act Rel. No. 16384 44 Fed. Reg. 70326 (Nov. 29, 1979).

and that shareholders did not have an adequate opportunity to participate in the offer. The Ninth Circuit upheld the district court's conclusion that Carter Hawley Hale's open market purchase program was not a tender offer. However, the Commission continues to believe that open market purchase programs that exhibit the indicia of a tender offer are subject to regulation under the Williams Act and the rules thereunder, and will continue to take action against those who engage in tender offers without compliance with the federal securities laws.

7. What are the consequences of two-tier and partial tender offers?

Answer: Some have criticized two-tier and partial tender offers as "coercive" and suggested that such offers be prohibited or restricted. The principal argument advanced by those who believe two-tier offers are harmful has been that they coerce shareholders to accept the initial offer, because if the initial offer is successful, the remaining shareholders will receive a lower price for their shares in the second step. The same reasoning has been applied to partial offers, in which shareholders may receive a lower price for their shares in subsequent offers or in subsequent open market sales.

The Commission, however, has not determined that partial and two-tier tender offers should be outlawed. Partial offers have long been an accepted practice that serve valid business purposes. Among other things, such acquisitions: (i) allow companies to invest in others, with less than 100% financial exposure; (ii) facilitate technological exchanges and relationships; (iii) permit proportional recognition of 20% or larger interests, under corporate equity accounting; (iv) facilitate venture capital, foreign and other direct investments; and (v) permit investors to become familiar with potential acquisitions, before deciding to increase their investment.

Restriction of partial bids would raise concerns about immunizing large issuers from tender offers. Moreover, there is little evidence that individual shareholders have had difficulty in participating in offers for less than all the shares.

In addition, partial and two-tier offers provide substantial premiums to shareholders. A study by the Commission's Office of the Chief Economist shows that in 1981-84, the average blended premium for any-and-all offers was 59.6%, 54.5% for two-tier offers and 20% for partial offers. */

To the extent that two-tier offers are perceived to present the greater risk of harm, it is important to note that it would be difficult to regulate two-tier offers without also regulating partial offers. Because of such valid business purposes of partial offers as those identified above, such regulation could have significant economic consequences.

If the Congress were to prohibit two-tier offers, there is a significant possibility that, rather than causing more bidders to make any-and-all bids, bidders would react to such a bar by resorting more frequently to partial offers. Shareholders as a result would be denied the greater values historically provided in two-tier offers.

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*/ See Exhibit A. See also Securities Exchange Act Rel. No. 21079 (June 21, 1984), 49 Fed. Reg. 26751 (Commission concept release on partial and two-tier bids). In response to a request from the Senate Banking Committee, the Commission provided members of that Committee and members of the House Committee with its summary of the 18 comment letters received in response to this concept release. They expressed a diverse range of views on the subject of two-tier bidding, partial bids and non-tender offer purchase programs.

In any case recent data indicates that the incidence of two-tier bidding has decreased since of the adoption of Rule 14d-8. */ That rule expands protections for shareholders by requiring unlimited pro rata acceptance of tendered shares throughout the offer.

FISCAL YEAR	TOTAL TENDER OFFERS	TWO-TIER BIDS **/	PARTIAL BIDS
1983	92	22	19
1984	121	15	19
1985 (as of May 20, 1985)	103	2	28

The steady reduction in the number of two-tier offers over the past three years indicates that any problem presented by two-tier offers is now minimal.

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*/ Securities Exchange Act Rel. No. 19336 (November 29, 1983), 44 Fed. Reg. 70326.

**/ No one definition of what constitutes a two-tier bid is unanimously accepted. For purposes of this chart, a two-tier bid involves an acquisition that is accomplished in two steps. In the first step, the bidder uses a tender offer to buy, at a premium price and generally for cash, enough shares to establish a controlling position in the target. Once control is established, the offeror will engage in a second step business combination, usually a merger, freezing out the minority shareholders with a consideration, usually securities, valued at a lower price than the original tender offer price. The second step merger and its lower consideration are disclosed in the tender offer materials.

8. What is the impact of our current tax structure on takeovers and leveraged buyouts? Does the current structure give too many incentives to "unproductive" acquisition activity, financed in part by Federal tax deductions?

Answer: The Commission has no special expertise in the tax area. It is clear, however, that the following tax provisions affect tender offers and leveraged buy-outs in a number of ways:

- the interest deduction on large amounts of debt;
- the ability to write-up assets to higher values, creating a higher tax basis;
- accelerated cost recovery under the Tax Reform Act of 1981;
- incentives in the tax code relating to employee benefits plans that enable management to repay certain indebtedness with pre-tax dollars and allow lenders to ESOPs to exclude from income 50% of the interest income received on loans used by the ESOPs to acquire employee securities;
- the dividend exclusion for corporations; and
- the excise tax on "golden parachutes."

These provisions may affect not only tender offers and leveraged buyouts, but also mergers and other business-combination transactions. Since these issues are matters primarily within the jurisdiction of other federal agencies, the Commission has taken no position with respect to the various incentives and disincentives built into the tax code.

9. Should the regulation of leveraged buyouts be changed to ensure that shareholders are treated fairly?

Answer: A leveraged buyout is simply one method by which management or third parties may acquire control of a company. Such buyouts are characterized both by heavy debt financing and use of the company's assets to collateralize the debt.

Leveraged buyouts per se are not regulated under the federal securities laws. Nonetheless, they may implicate a number of concerns addressed by the Williams Act. These include Commission regulation of those leveraged buyouts structured as going private transactions, as well as regulation of all leveraged buyouts that involve a tender offer as part of the transaction. Also, when a leveraged buyout involves a merger, compliance with the Commission's proxy rules will be required.

The Commission's proxy rules are set forth in Regulation 14A under the Securities Exchange Act of 1934. These rules make it unlawful for any person to furnish any communication to holders of a class of securities registered under Section 12 of the 1934 Act under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy without first furnishing them a proxy statement.

Schedule 14A under Regulation 14A sets forth the information required in proxy statements distributed pursuant to Regulation 14A. Schedule 14A requires that proxy statements include a description of all matters being proposed for shareholder action. The description required generally must include information regarding the reasons the matter is being proposed, the effect upon shareholders should the proposed matter be approved, and the vote required for approval. Any substantial interest of certain persons in the matter to be acted upon, including interests of the person(s) on whose behalf the solicitation is being made, must be described. Where the matters to be acted upon include the election of directors, Schedule 14A requires the disclosure of certain information about the background and experience of the nominees. Where the matters proposed for action involve the authorization or isssuance of securities, the modification or exchange of securities, or a merger, consolidation, acquisition or similar matter, Schedule 14A generally requires that a proxy statement include financial statements and a discussion and analysis by management of the issuer's financial condition and results of operations.

Pursuant to Section 13(e) the Commission adopted Rule 13e-3, which regulates "going private" transactions. */ Consistent with the general philosophy of the Williams Act, Rule 13e-3 requires issuers to disclose information necessary for shareholders to make informed decisions. Rule 13e-3 implements this policy by requiring issuers to reveal: (1) the purpose, alternatives, reasons and effects of the transaction; (2) the benefits and detriments of the leveraged buyout on the company, affiliates and shareholders; (3) a statement as to whether management reasonably believes that the going private transaction is fair or unfair to shareholders; and (4) a statement as to whether management has received any report,

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*/ Generally, the phenomenon of "going private" involves a transaction in which controlling shareholders eliminate remaining minority shareholders. See Securities Exchange Rel. No. 17719 (April 13, 1981) (going private occurs when the transaction "would result in one or more classes of equity securities of the issuer no longer having attributes of public ownership"). Often, the number of shareholders declines sufficiently to obviate the company's obligation to make the periodic filings required under the Securities Exchange Act.

appraisal or opinion from an investment banker or other expert with respect to the terms of the transaction. Any such report, appraisal or opinion must be described and made available to shareholders.

If a leveraged buyout is structured as a tender offer, Commission rules require third party bidders to file a Schedule 14D-1. */ A Schedule 14D-1 must include information relating to the subject security and the subject company, information concerning the identity and background of the persons filing, source and amount of funds used or to be used for the acquisition, the securities of the subject company acquired and contractual and other arrangements and understandings relating to the securities being acquired. The Schedule 14D-1 must also disclose the exact number of shares being sought; the consideration being offered; the identity of the principal market in which the securities are traded; and

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*/ Rule 13e-4 promulgated under the Williams Act imposes similar disclosure requirements in connection with issuer tender offers. The detailed requirements of Rule 13e-4 are discussed in the Commission's response to Question 6, supra.

for the immediately preceding three full years, must describe any transactions, including negotiations, between the bidder and the subject company. The Schedule must also disclose the purpose of the tender offer and the plans of the bidder relating to changes in management, transfer of assets, and extraordinary corporate action such as a merger or liquidation. If the bidder is not a natural person and its financial condition is material to the investment decision being presented, appropriate financial information relating to the bidder must be included.

The Commission's role in leveraged buyouts ensures conformity with the full disclosure requirements of the Williams Act. The Commission does not assess the "fairness" of transactions, */ but rather requires accurate and complete disclosure that will enable investors to decide for themselves whether or not a transaction is fair. The fairness of such transactions may be subject to

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*/ In 1975, the Commission proposed a rule that would have required issuers "going private" to pay "fair value" for shares, as determined in good faith. Securities Exchange Act Rel. No. 11231 (Feb. 6, 1975) (proposing Rule 13e-3A). The Commission did not, however, adopt the proposed rule. See Securities Exchange Act Rel. No. 14183 (Nov. 17, 1977).

state fiduciary standards. A few states have adopted statutes designed to ensure fair treatment of shareholders in going private transactions. */ Most states, however, rely on fiduciary duties and the business judgment rule in assessing such transactions. **/

In March 1984, the Commission testified that it

> agrees with the Advisory Committee's recognition of the general preeminence of state corporate law with respect to the internal affairs of a corporation. However, in the application of the business judgment rule in a change of control context, the Commission believes that shareholders would be better served if the courts gave greater recognition to potential conflicts of interest between management and shareholders. ***/

However, the Commission has not determined that there is a need for federal preemption of state corporate law in the governance of going private transactions.

10. What is the proper relationship between State and Federal law in regulating the takeover process?

Answer: The relationship between state and federal regulation of the tender offer process presents

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*/ See, e.g., Wis. Admin. Code § 6.05 (1985).

**/ See generally Lyons, Fairness in Freezout Transactions: Observations on Coping with Going Private Problems, 69 Ky. L.J. 77 (1980).

***/ Statement of John S.R. Shad, Chairman, Securities and Exchange Commission, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, at 10-11 (March 28, 1984).

constitutional questions. Under the Supremacy and Commerce Clauses of the Constitution, the role of states in this area is limited. As has often been observed, "[t]ender offers are a nationwide phenomenon." */

The Commerce Clause was expressly designed to create a nationwide "area of trade free from interference by the states * * *." **/ Untoward interference by states in the tender offer process, therefore, will constitute an impermissible burden on interstate commerce and violate the Commerce Clause. In Edgar v. MITE Corp., ***/ the Supreme Court struck down the Illinois anti-takeover statute, holding that it violated the Commerce Clause because it imposed "excessive" burdens on interstate commerce. Following that decision, several state statutes have been invalidated on Commerce Clause grounds. ****/

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*/ Mesa Petroleum Co. v. Cities Service Co., 715 F.2d 1425, 1429 (10th Cir. 1983)

**/ Freeman v. Hewitt, 329 U.S. 249, 252 (1946).

***/ 457 U.S. 624, 643-44 (1982). Five Justices joined in the Court's opinion, authored by Justice White. Three Justices dissented on the ground that the case was moot.

****/ See, e.g., Mesa Petroleum Co. v. Cities Service Co., 715 F.2d 1425, 1429 (10th Cir. 1983) Martin-Marietta Corp. v. Bendix Corp., 690 F.2d 558, 565 (6th Cir. 1982).

A state anti-takeover statute violates the Supremacy Clause if it "stands as an obstacle to the accomplishment and execution of the full purposes" of the Williams Act. */ A state statute will also be preempted under the Supremacy Clause whenever "compliance with both federal and state regulations is a physical impossibility." **/ A number of state anti-takeover provisions have been invalidated under the Supremacy Clause. ***/

The Commission's Tender Offer Advisory Committee considered the appropriate relationship between state and federal law in takeover regulation. ****/

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*/ See Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

**/ See Flordia Lime & Avacado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963).

***/ See, e.g., Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978), rev'd sub nom on venue grounds, Leroy v. Great Western Corp., 443 U.S. 173 (1979); Kennecott Corp. v. Smith, 637 F.2d 181 (3d Cir. 1980); Crane Co. v. Lam, 509 F. Supp. 782 (E.D. Pa. 1981); Canadian Pacific Enterprises (U.S.), Inc. v. Krouse, 506 F. Supp. 1192 (S.D. Ohio 1981). See also Edgar v. MITE, 457 U.S. at 630-40 (portion of Justice White's opinion in which Chief Justice Burger and Justice Blackmun concurred).

****/ Portions of the Adivsory Committee Report strongly express approval of state corporate law. For example, Recommendation 9(b) states that "[e]xcept to the extent necessary to eliminate abuses of interference with the intended functions of federal takeover regulation, federal takeover regulation should not preempt or override state corporation law. Essentially the business judgment rule should continue to govern most such activity." However, the recommendations of the Advisory Committee also reflect a rejection of state law obstacles to national tender offers.

The Committee concluded in Recommendation 4 that "[r]egulation of takeovers should recognize that such transactions take place in a national securities market." Moreover, Recommendation 34 provided:

> State laws and regulations, regardless of their form, that restrict the ability of a company to make a tender offer should not be permitted because they constitute an undue burden on interstate comerce. Included in this category should be statutes that prohibit completion of a tender offer without target company shareholder approval and broad polilcy legislation written so as to impose the ability to transfer corporate control in a manner and time frame consistent with the federal tender offer process.

Recommendation 34 recognizes only two exceptions to this broad federal preemption of state takeover statutes -- "local companies and regulated industries." */

In testimony before Chairman Wirth's Telecommunications Subcommittee on March 28, 1984, the

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*/ The Advisory Committee indicated in Recommendation 9 that the permissible scope of state tender offer regulation extended only to "local companies" and "public interest businesses" such as banks, utilities, and insurance companies. Even in those areas, Recommendation 9 provides that state regulation should only be permitted if it is justified in relation to the overall objectives of the industry, does not conflict with procedural provisions of federal takeover regulations, and relates to a significant portion of the issuer's business. Recommendation 9 also strongly supports state corporate law in general and the business judgment rule in particular.

Commission expressed general agreement with these recommendations. The Commission's testimony was based on its continuing belief that regulation of takeovers should be federal, since these transactions take place in the national securities market, and regulation by the states must neither unduly burden interstate commerce nor conflict with the Williams Act. */ The Commission expressed its intent to continue to implement its policy on state takeover statutes through _amicus curiae_ participation in private litigation to challenge state statutes which impede the operation of the federal tender offer process. **/

11. What is the impact of the increasing number of companies adopting charter and by-law amendments to make corporate tender offers more difficult?

Answer: From 1979 through 1984, shareholders of over 450 companies approved supermajority, fair price and

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*/ One economist concluded that "state statutes increased the likelihood that tender offers would fail, and provided a measurable and statistical significant deterrance to tender offer activity." Smiley, _The Effect of State Securities Statutes on Tender Offer Activity_, 19 Econ. Inquiry 426, 433 (1981).

**/ The Commission proposed legislation in 1980 to specifically preempt state laws governing tender offers. _See_ Tender Offer Report at 123. Because of the success of the Commission's _amicus curiae_ program in this area, the Commission does not believe that such legislation is now necessary.

other charter and by-law amendments which make it more difficult for changes in corporate control to take place. In fiscal 1985, as of June 21, 1985, the Commission has received definitive proxy statements containing such anti-takeover proposals for 305 companies.

The ultimate impact of such amendments may vary according to the particular type of amendment adopted. Supermajority provisions typically permit the holders of 20% of the shares to block a statutory merger. Fair price provisions, which have accounted for over 80% of proposed antitakeover amendments in the last two years, require bidders to pay all shareholders the highest price paid for any shares purchased during a specified period of time. Typically, the adoption of supermajority or fair price provisions requires shareholder approval.

Poison pills may become one of the most effective defenses to tender offers devised to date. A poison pill is a stock, warrant, or right issued by a company to its shareholders. Generally, a poison pill may be exercised if a tender offer for the company is made, a specified percentage of the company's stock is acquired or a group of investors holding a specified amount of the company's stock is formed. In the event of a merger or other combination, poison pills typically permit target company shareholders to purchase shares in the acquiring company at a substantial discount from the market or to acquire securities of the target company at a low price. */ Poison pills typically do not require shareholder approval. The board of directors of a company may simply issue, as did the board of Household International Inc., the "poison pill" security to its shareholders as a dividend. **/

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*/ Poison pills are recent innovations. The first was apparently used in the 1983 takeover battle between Lenox, Inc. and Brown-Forman Distillers Corp. See Lewin, Tactics That's 'Poison' to Bids, N.Y. Times Feb. 22, 1985 p. D-1 Col. 1.

**/ A poignant example of the Board's authority to dispense with shareholder involvement in this area recently occurred in connection with Rorer Group, Inc. Shareholders approved a recommendation to eliminate the company's poison pill. The vote, however, was non-binding. See Rorer Holders Vote to Rescind Firm's 'Poison Pill' Rule, Wall St. J. (May 9, 1985). Notwithstanding the vote, however, the board of directors unanimously voted to retain the poison pill provision. See Rorer Group Retains Measure Against Takeovers, Wall St. J. (May 29, 1985).

Some have questioned the impact of anti-takeover provisions on both individual companies and on the governance and structure of corporations. With respect to the impact of anti-takeover amendments on individual companies, the Commission's Office of the Chief Economist, as well as others, has begun to quantify the available data in this area. The data indicates that these provisions both impede takeovers and cause declines in stock prices.

The Investor Responsibility Research Center, Inc. ("IRRC") recently conducted a study of the impact of anti-takeover charter amendments on takeovers. The study reached the following conclusions:

"° Firms with anti takeover amendments are the targets of takeover attempts less frequently than firms without the amendments.

° Takeover premiums are lower by one measure, and unchanged by another measure, in the presence of the amendments.

° Takeover targets with anti takeover amendments resist takeovers more frequently than targets without the amendments.

- Targets with the amendments are more successful in resisting takeover than targets without the amendments." */

The study concluded that "these facts suggest both that anti-takeover amendments endow firms with additional power to resist takeovers, and that firms with the amendments behave differently from those without the amendments when confronted with a takeover attempt. * * * The analysis suggests that the amendments appear to be contrary to the interests of shareholders." The study cautioned, however, that "this evidence is of an inferential nature and should not be considered definitive." **/ It is particularly significant to note that currently available data does not support the argument frequently advanced to justify these provisions, *i.e.*, that management will be able to negotiate higher premiums.

As to the impact of anti-takeover provisions on stock prices, the Commission's Office of the Chief Economist has studied the economic impact of

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*/ IRRC report at 20.

**/ *Id*.

supermajority and fair price amendments and poison pills. OCE found a 4% average decrease in stock price from 20 trading days before the announcement of a supermajority provision through 10 trading days after the announcement. */ The study also found that fair price amendments have no significant impact on share price. **/ OCE also studied 15 poison pill issuers, finding that their stock prices decreased by an average of 2% upon announcement; and that based on the prices 10 trading days before the announcement of the poison pill and 40 trading days after the announcement, the stock prices declined an average of 3%. ***/

Another study of anti-takeover amendments concluded, consistent with the Chief Economist's study, that "[a]lthough inconclusive, the evidence provides weak preliminary support for the hypothesis

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*/ *See* Exhibit C.

**/ *Id.*

***/ *See* Exhibit D.

that anti-takeover amendments are best explained as a device for management entrenchment." */ In contrast, however, at least one other study has concluded that "[a]lthough the results are not unambiguous, the overall impression yielded by the analysis is that the introduction and adoption of anti-takeover amendments is associated with an increase in common stock prices * * * [and] there is no evidence that anti-takeover amendments have a negative impact on stock prices." **/

In addition to the impact of anti-takeover amendments on individual companies, some have echoed concerns reflected in the 1984 House Report and in recent testimony before the Congress about their long-term impact on the governance and

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*/ DeAngelo and Rice, Anti-takeover Charter Amendments and Shareholder Wealth, 11 Journal of Financial Economics 329 (April 1983). This study utilizes several different event dates.

**/ Linn and McConnell, Anti-takeover Charter Amendments, 11 Journal of Financial Economics 397 (April 1983). This study examined stock prices on and between several event dates on which information regarding such amendments was released, such as the date on which the proxy statement describing the amendments were mailed and the dates on which shareholders and boards of directors voted on these proposals.

structure of corporations. */ Since the widespread adoption of anti-takeover amendments is a relatively recent phenomenon, however, their long term effect is uncertain.

Some have contended that certain anti-takeover provisions, particularly supermajority provisions, disenfranchise shareholders by allowing a minority of shareholders to thwart the will of the majority. **/ The Commission shares this serious shareholder democracy concern. Nonetheless, it is also true that such supermajority amendments typically require shareholder approval for their adoption. To this extent, therefore, existing shareholders vote on whether they wish to permit a minority "veto." When shareholder approval of such provisions is required, the proxy rules require full disclosure, including the reasons for the proposal; the

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*/ See, e.g., Statement of Jesse M. Unruh, California State Treasurer, Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary (April 24, 1985); Statement of William Norris, Chairman and CEO of Control Data Corp., Before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee (April 22, 1985).

**/ See, e.g., Hochman and Folger, Deflecting Takeovers: Charter and By-Law Techniques, 34 Business Lawyer 537 (1979).

advantages and disadvantages to incumbent management and to shareholders generally; any existing anti-tender offer measures; how the proposal will operate; and its overall effects. If a proposal would make the consummation of a hostile tender offer more difficult, this must be disclosed. */ In addition, persons who contemplate becoming shareholders after such provisions are adopted have the opportunity to inform themselves about the nature of the voting and other rights that attach to the company's shares prior to making their investment.

Poison pills, because of their operation and because they typically do not require shareholder approval, appear to raise the most serious concerns. The Commission's concerns about such plans are reflected in its recent amicus brief in Moran v. Household International, Inc., discussed in the Commission's response to Question 12.

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*/ See Securities Exchange Act Rel. No. 15230 (October 13, 1978), 43 Fed. Reg. 49863.

12. Does the business judgment rule adequately protect shareholders and the fairness of the tender offer process?

Answer: As noted earlier, the Commission's Tender Offer Advisory Committee endorsed the role of state corporation law in general and the business judgment rule in particular. The Commission, as discussed earlier, has noted that, in the change of control context, shareholders would be better served if the courts gave greater recognition to potential conflicts of interest between management and shareholders.

The Commission, */ like the House Committee on Energy and Commerce, **/ had hoped that Norlin Corp. v. Rooney, Pace Inc., et al., ***/ indicated a trend toward modification of the business judgment rule in the tender offer context, at least insofar as it suggested that board of directors' decision in this context would be subjected to heightened judicial scrutiny. ****/ Another

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*/ See Memorandum of Securities and Exchange Commission In Opposition To H.R. 5972 and H.R. 5693, As Amended (July 25, 1982).

**/ See 1984 House Report at 15-16.

***/ 744 F.2d 255 (2d Cir. 1984).

****/ In Norlin, the United States Court of Appeals for the Second Circuit, in upholding a preliminary injunction against several defensive tactics, emphasized that the business judgment rule governs only situations in which the directors are not shown to have a self-interest in the transaction.

(footnote continued)

recent Delaware case may evidence somewhat greater scrutiny in the change of control area. In Smith v. Van Gorkom, */ the Delaware Supreme Court held that the business judgment rule did not insulate a board's decision to approve a merger, where the directors "lack[ed] valuable information adequate to reach an informed business judgment." **/

On the other hand, other recent decisions not only do not reflect a heightened degree of scrutiny in judicial review of change of control transactions, but indeed reflect greater judicial tolerance of many defensive actions. The Delaware Chancery Court, in Moran v. Household International, Inc.,

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(footnote continued from previous page)

The court found that the defensive tactics of Norlin's board of directors created "a strong inference that the purpose was * * * to solidify management's control of the company. * * * Where * * * directors amass voting control of close to a majority of * * * shares in their own hands * * * it strains credulity to suggest that the retention of control * * * played no part in their plans." 744 F.2d at 265.

*/ No. 255 (Del., January 29, 1985).

**/ Id. at 37. The court found that the directors of Trans Union Corporation (1) did not conduct a formal study of the company's worth; (2) were not adequately informed as to the chief executive officer's role in arranging Trans Union's sale and setting the purchase price; (3) did not call in their investment bankers to render a fairness opinion; (4) were not informed that the purpose of the special board meeting was to propose a sale of the company; and (5) were "grossly negligent" in approving the sale of the company without prior notice and without the existence of a crisis or emergency.

C.A. No. 7730 (Del. Ch., January 29, 1985), upheld the adoption of a "poison pill" plan by Household International's directors. In Moran, the court stated that the poison pill plan

> had been properly adopted under Delaware law, is not intended primarily for entrenchment of management and serves a rational corporate purpose * * * [W]hile the plan indirectly limits alienation of shares and the conduct of proxy contests those features are sustainable, within the parameters of the business judgment rule, as necessary to protect the corporation and all its constituencies from the coercive nature of certain partial tender offers.

This case is currently on appeal, and the Commission has filed a brief, amicus curiae, urging that the decision of the court below be reversed. In its brief, the Commission does not argue that this case directly involves application of the federal securities laws, but rather that it involves securities activities regulated by those laws. The Commission's brief argues that the "poison pill" rights plan adopted by Household as an anti-tender offer defense would bar all hostile tender offers for Household, would deter proxy contests by Household shareholders, would entrench Household management, and thus was not in the interests of

Household's shareholders and should not be sustained by the court. */

Unocal Corp. v. Mesa Petroleum Co. **/ evidences a similar reluctance by state courts to subject business decisions reached in the charge of control context to greater scrutiny. In Unocal, the Delaware Supreme Court, reversing the Chancery Court, upheld Unocal's decision not to allow Mesa and its affiliates to participate in Unocal's exchange offer. The court stated in rendering its decision that,

> there was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise. Further, the selective stock repurchase plan chosen by Unocal is reasonable in relation to the threat that the board rationally and reasonably believed was posed by Mesa's inadequate and coercive two-tier tender offer. Under those circumstances the board's action is entitled to be measured by the standards of the business judgment rule. Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some

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*/ Judicial reluctance to look more closely at change of control transactions was also seen in Lowenschuss v. Options Clearing Corp. No. 7972 (Del. Ch., March 26, 1985). In Lowenschuss, the plaintiff's attempt to enjoin an issuer self-tender initiated by Phillips Petroleum Corporation was rejected, with the court upholding the directors' exercise of business judgment.

**/ No. 152 (Del., May 17, 1985).

> other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board. */

Unocal and Household, of course, are not binding on other state courts. **/ However, Delaware is a critically important jurisdiction in the development of state corporate law. Looking in the aggregate at the recent change of control state law cases, the Commission does not believe that it is possible to identify any consistent trend toward heightened judicial scrutiny of change of control related transactions.

13. What is the appropriate scope of Section 14(e) in tender offers and other contests for control of a corporation?

Answer: Section 14(e) of the Exchange Act provides that it "shall be unlawful for any person to make any

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*/ Id. at 25.

**/ One recent decision, disagreeing with Unocal, invalidated a plan which, the court found, violated New Jersey law because it discriminated between holders of a class of securities by creating certain "rights" which were non-transferable by post-May 20, 1985 shareholders. Minstar v. AMF, Inc., 85 Civ. 3800 (S.D.N.Y. June 6, 1985). While these rights were not attributes of a typical poison pill plan, the court and the parties in the case described the plan as a "poison pill." In other decisions, more typical "poison pill" plans have been upheld. See, e.g., APL Corp. v. Johnson Controls, Inc., No. 85-C-990 (E.D.N.Y. March 25, 1985); Horwitz v. Southwest Forest Industries, No. CV-R-84-467 (D. Nev. March 19, 1985).

untrue statement of a material fact or to omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer * * *." */ Section 14(e) further provides that the Commission shall by rules and regulations "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

The Supreme Court recently construed the scope of Section 14(e). In Schreiber v. Burlington Northern **/ the Court considered whether withdrawal of a hostile tender offer after shares had been tendered, and the substitution of a friendly tender offer for a smaller number of shares, constituted "manipulative" conduct in violation of Section 14(e). The Court rejected the argument that the phrase "fraudulent, deceptive or manipulative acts or practices" in Section 14(e) of the Exchange Act is directed at purposes broader than providing

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*/ 15 U.S.C. 78n(e).

**/ No. 83-2129 (June 4, 1985).

"full and true information to investors." */ Rather, the Court held, "[a]ll three species of misconduct, i.e., 'fraudulent, deceptive or manipulative' listed by Congress [in 14(e)] are directed at failure to disclose." **/ The Court emphasized that

> [n]owhere in the legislative history is there the slightest suggestion that § 14(e) serves any purpose other than disclosure, or that the term 'manipulative' should be read as an invitation to the courts to oversee the substantive fairness of tender offers; the quality of any offer is a matter for the marketplace. ***/

The Court, in discussing the 1970 amendment to Section 14(e) which granted the Commission rule-making authority, stated that "[i]n adding the 1970 amendment, Congress simply provided a mechanism for defining and guarding against those acts and practices which involve material misrepresentation or nondisclosure. The amendment gives the Securities and Exchange Commission latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself." ****/

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*/ Id. at 4.

**/ Id. at 6.

***/ Id. at 10 [footnote omitted].

****/ Id. at 10, n.11.

II. Questions Relating to the Commission's Comments on H.R. 5693

The legislative proposal on tender offers submitted to Congress by the Commission in 1984, which was introduced in the 98th Congress as H.R. 5693, was intended to respond to problems the Commission perceived in the tender offer process at that time. As discussed in Chairman Wirth's letter, the Commission objected to H.R. 5693 as amended and ordered reported by the House Energy and Commerce Committee, based on three aspects of the bill.

These were (1) the amendment to the disclosure provisions of Section 13(d), which would have required disclosure of the impact of the purchaser's plans on the issuer's community; (2) the statutory mandate of a minimum offering period of 40 days for a tender offer; and (3) the absence of any limitation on the kind of tender offer that would have triggered restrictions on defensive tactics.

At a public Commission meeting on May 20, 1985, the Commission heard presentations from a number of experts in the tender offer area. After listening to and questioning these experts, the Commission voted on each major portion of its 1984 legislative proposal on tender offers. The Commission voted unanimously to continue to support its proposal to close the 10-day filing window in Section 13(d) of the Exchange Act. */ The Commission also voted unanimously not to support the remaining elements of its 1984 legislative package. These dealt with golden parachutes, greenmail, issuer self-tenders, and issuances of securities or voting rights during certain tender offers and proxy contests.

The Commission's decision not to reintroduce the major elements of its 1984 legislative proposal was reached in light of the continuing evolution in practices in this area since May 1984. During the current proxy season, at least 35 issuers have proposed or adopted corporate charter amendments restricting greenmail payments. Also, it appears that greenmail transactions may be declining because issuers are concerned that, by purchasing the shares held by one potential bidder, they will become the target of others.

The Deficit Reduction Act of 1984 (Public Law No. 98-369), enacted in July 1984, may also affect the practice of greenmail. Prior to the enactment of the DRA, a corporation could deduct both

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*/ The details of this proposal are described in the Commission's response to Question 6, *supra*.

the interest paid on a loan used to secure a "toe-hold" position in a company and 85% of any dividends received from the target. Under the DRA, the 85% corporate dividends-received deduction is reduced by a percentage related to the amount of debt incurred to purchase the stock. This may have the effect of making greenmail and other "toe-hold" acquisitions that utilize borrowed funds more expensive.

Also, portions of the DRA clearly address golden parachutes by imposing a 20% excise tax on their recipients and eliminating of the corresponding tax deduction previously enjoyed by the employer.

Chairman Wirth also raised a number of specific points relating to H.R. 5693. These points, dealing with community impact disclosure, the minimum offering period, the use of trigger mechanisms, and the "balance" of H.R. 5693, are discussed below.

1. <u>Community impact disclosure</u>

The Commission continues to oppose amendment of Section 13(d) of the Exchange Act to require disclosure of the impact of the purchaser's plans on the issuer's community. The Commission believes that such disclosure is unrelated to the objectives of the federal securities laws and outside its expertise.

The Commission believes that current disclosure requirements are adequate to elicit the information concerning changes in an issuer's business that shareholders would deem material in making investment or voting decisions. Expansion of disclosure requirements to reflect social concerns may result in information material to shareholders' investment and voting decisons being obscured. The Commission believes that "boilerplate" responses will quickly develop. Such "boilerplate" disclosure will provide little hard information and may tend to confuse rather than inform shareholders.

2. Minimum offering period

The 20 business day minimum offering period for tender offers was set by the Commission in 1979, following public comment and analysis over a three-year period. The Commission has, since 1976, considered over 200 letters of comment on the subject. */ The Commission determined that the 20 business day period strikes an appropriate balance under the Williams Act between maintaining neutrality in a tender offer, and providing sufficient time for shareholders to receive, analyze and react to a tender offer. By design, it neither encourages nor discourages tender offers. **/

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*/ See Securities Exchange Act Rel. No. 15548 (February 15, 1979), 44 Fed. Reg. 9956.

**/ See S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967).

The Commission's first proposal in this area was made in 1976. */ The Commission then proposed a 15 business day minimum offering period. The Commission believed that a 15 business day period would facilitate communications during a tender offer and provide a realistic time frame for security holders to evaluate a bid, and certain changes in an offer, before making an investment decision.

In response to the 1976 proposal, the Commission received 111 letters of comment, which expressed divergent views. Some commentators thought the period too long; some considered it too short. Other commentators, including the American Bar Association, questioned the Commission's authority to promulgate any rule establishing a minimum offering period. These commentators believed the seven and ten business day periods implicit in the Williams Act to be adequate.

In 1979, the Commission proposed a 30 business day minimum offering period, to be extended for an additional 10 business days following a price increase or an increase in the dealer's soliciting fees. **/ The Commission solicited public comment on

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*/ Securities Exchange Act Rel. No. 12676 (August 2, 1976), 41 Fed. Reg. 33004.

**/ Securities Exchange Act Rel. No. 15548 (February 5, 1979), 34 Fed. Reg. 9956.

whether the 30 business day minimum offering period ought to be longer or shorter and, if so, what period should be adopted. In response to its 1979 release, the Commission received 105 letters of comment. As in 1976, these comments reflected divergent views on the question of the length of the minimum offering period and the Commission's authority to adopt such a rule. */

In 1979, the Commission's Directorate of Economic and Policy Analysis conducted a study of 153 tender offers made during the years 1974 through 1978. This study concluded that,

> given that the proposed rules are designed to correct past abuses and not to fundamentally alter current tender offer practice, it would seem advisable to set minimum initial offer and extension periods which do not significantly affect more than half of the tender offers. This suggests that the median initial offer and extension periods would be good upper bounds on the minimum offer periods to be established by the proposed rules.

The study found the median initial offer period of tender offers during that period to be 15 business days. The median extension of an offer during that period was six business days. The study found that 75% of all offers had an initial offer period

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*/ See Summary of Comments Relating to Proposal Tender Offer Rules and Schedule, Securities Exchange Act Rel. No. 15548 (February 5, 1979), File No. S7-770.

of less than 24 business days. The study also showed that the median duration of a tender offer had increased from 13 business days in 1974 to 20 business days in 1978.

Both the Commission and Congress recognized that delays substantially increase expenses for a bidder and tendering shareholders, and reduce the chances for success of a tender offer. The 20 business day minimum offering period, determined after extensive public comment and-analysis, strikes a balance under the Williams Act between maintaining neutrality, and provides sufficient time for the tender offer to be published and for shareholders to receive, digest and respond to the offer, while favoring neither bidders nor managements. In case of an increase in the consideration or broker's fees, the period is extended 10 days. Moreover, the 20 business day period avoids tying-up securities tendered by shareholders any longer than necessary.

With respect to the ability of management to respond to a tender offer, the 20 business day minimum offering period is more than adequate. In fact, under Rule 14e-2, management's response must occur within 10 business days from the publication of a third-party offer. As this is routinely accomplished under the current rule, the Commission sees no reason to doubt the adequacy of the 10 business day period under Rule 14e-2, much less the 20 business day minimum offering period.

3. Trigger mechanism

The Commission advised the House Energy and Commerce Committee that specific triggers should be included in any tender offer legislation to provide for additional clarity and certainty. The Commission expressed a preference that the triggers be incorporated in the statute itself, not in Commission rules. Of course, the Commission regrets any misunderstandings that may have arisen last year with respect to the Commission's continued support of statutory triggers.

4. "Balance" of the legislation

The Commission's original proposal, while it restricted specific defensive tactics, also proposed closing the 13D ten-day window, thereby providing management with additional time to consider its alternatives prior to the commencement of a tender offer.

As noted above, while the Commission has voted not to reintroduce most elements of its 1984 legislative package, it continues to support its proposal to close the 10-day window in Section 13(d) of the Exchange Act. Of course, the Commission stands ready to assist the Subcommittee in examining various approaches to regulating current tender offer practices.