SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-23486; S7-18-86]

Concept Release on Takeovers and Contests for Corporate Control

Advance Notice of Possible Commission Actions

AGENCY: Securities and Exchange Commission

ACTION: Request for Public Comment

SUMMARY: The Commission is seeking public comment on three topics relating to takeovers and contests for corporate control: (1) whether the Williams Act should apply whenever a person acquires a substantial percentage of a target company's securities during or shortly after a tender offer; (2) whether there should be a governmental response to the proliferation of "poison pill" plans; and (3) whether the Commission should adopt a self-governance exemption to its "all holders" rule, as well as to other provisions of its tender offer rules. The Commission will review comments received in response to this release with a view towards determining whether future rulemaking or legislative proposals are appropriate.

DATE: Comments should be received by September 30, 1986.

ADDRESS: Comment letters should refer to File S7-18-86 and be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. The Commission will make all comments available for public inspection and copying in its Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Joseph G. Connolly, Jr. or Gregory E. Struxness ((202) 272-3097), Office of Tender Offers, Division of Corporation Finance.

SUPPLEMENTARY INFORMATION:

In this concept release, the Commission requests public comment on three topics related to takeovers and contests for corporate control. The Commission has determined that these topics deserve further inquiry because of developments in the market for corporate control, recent court decisions, and comments made during public roundtable meetings with representatives of investor groups, experts in the legal and financial aspects of takeovers, and participants in contests for corporate control.

INTRODUCTION

1. Substantial Share Acquisitions Outside the Williams Act. Two Courts of Appeals have held that the tender offer provisions of the Williams Act and Commission rules adopted thereunder did not apply to certain substantial acquisitions of shares that occurred during a tender offer or immediately after termination of a tender offer. The Ninth Circuit's decision in Carter Hawley Hale allowed a target company to purchase a majority of its own shares in the open market in six days without complying with the Williams Act. The Second Circuit's decision in Hanson Trust allowed a tender offer bidder to terminate its tender offer and immediately purchase almost a third of a target company's shares in open-market and privately negotiated transactions, without complying further with the Williams Act.

The Commission seeks comment as to whether investors require the protections provided by the Williams Act and Commission rules adopted thereunder in the case of certain substantial share acquisitions made during or shortly after termination of a conventional tender offer, and the benefits and costs of applying the Williams Act to these acquisitions. The Commission specifically requests comment on a proposal that would subject to Williams Act requirements all substantial acquisitions of a target company's securities either during or shortly after termination of a conventional tender offer.

2. "Poison Pills." "Poison pill" plans place impediments in the path of any person who seeks to acquire substantial shareholdings directly from a target's shareholders without obtaining the prior approval of the target's board. Delaware's Supreme Court upheld one such plan in November of 1985. Currently, more than 190 publicly-traded corporations have poison pill plans in place, and there are indications that more publicly-held corporations may adopt them.

Generally, "poison pill" plans are adopted by a corporation's board of directors without shareholder approval. Proponents of these plans contend that they allow managements to negotiate more effectively on behalf of stockholders. In particular, it is said that these plans protect shareholders from tender offers at unreasonably low prices as well as from partial offers, two-tier offers, open-market purchase programs, and other allegedly abusive takeover practices.

Opponents of these plans argue that they deter takeovers and proxy contests, can entrench management to the detriment of stockholders, and are tantamount to recapitalizations of the issuer effected without shareholder approval. Recent research suggests that poison pills can, under some circumstances, cause a statistically significant decline in the price of a company's shares. There are also indications that some boards of directors may have adopted poison pill plans despite suggestions that the corporation's shareholders would have opposed such plans, had the matter been put to a vote. Because of these and other concerns, it has been suggested that poison pill plans should, at a minimum, be subject to shareholder approval.

The Commission seeks information regarding the extent to which the incidence of poison pill plans is increasing, the costs and benefits of such plans, and the investor protection issues raised by these plans. The Commission also seeks comment as to whether a governmental response is appropriate; whether a governmental response, if appropriate, should be at the state or federal level; and, if at the federal level, the nature of the most appropriate response.

3. Self-Governance. State corporation codes and portions of the federal securities laws permit corporations to modify the application of certain regulations to suit their individual circumstances, provided that the corporation acts in accordance with principles of corporate self-governance. The Commission seeks comment on the advisability of adopting a self-governance exemption to its "all holders" rule, as well as to other provisions of its tender offer regulations.

The Williams Act and the Commission's tender offer rules currently operate as rules of general applicability with no provision for modification by stockholder or director action. Tender offers are thus conducted according to uniform rules, and all participants are equally subject to regulations that Congress and the Commission have judged to be in the public interest.

The Commission is interested in exploring whether the public interest might be better served if individual corporations are permitted to craft safeguards suited to the specific circumstances of the corporation and its shareholders rather than be unconditionally subject to the provisions of the Williams Act. Should stockholders and directors be permitted jointly to determine that certain provisions of the tender offer rules are less effective than alternative protections they can craft and implement for themselves? Would a self-governance exemption that permits stockholders and directors to design protections suitable for an individual corporation be a beneficial supplement to regulations that would otherwise have general applicability?

The Commission seeks comment as to whether principles of self-governance can contribute to the efficient and equitable operation of tender offer regulations. In particular, the

Commission seeks comment as to the probable costs and benefits of self-governance exemptions to tender offer regulations; the investor protection issues raised by such exemptions; the form and workability of self-governance exemptions; and the specific provisions of the tender offer regulations that are most appropriate candidates for self-governance exemptions.

SPECIFIC REQUESTS FOR COMMENT

I. Share Acquisitions in Conjunction with Tender Offers

The Commission seeks to determine whether acquisition programs for a target company's shares effected during or shortly after termination of a tender offer for the target's securities present investor protection concerns. In the event investor protection issues are present, the Commission seeks comment as to whether a regulatory response is required and, if so, the nature of an appropriate response.

A. Issues Presented

Announcement of a control contest generally builds a premium into the price of the target company's stock. This premium reflects the market's response to the expected increase in security value that will accrue in the event the takeover is completed on the announced terms. Also reflected in the market price is the market's assessment of the probability that the offer will be defeated, or that a takeover may take place on terms and conditions materially different from those initially announced.

After the announcement of a tender offer, shares of the target company often become concentrated in the hands of a smaller number of investors. This concentration represents an allocation of the risk created by uncertainty over the outcome of the takeover process. Shareholders who wish to receive some portion of the tender offer premium but who are unwilling to assume the risk that the tender offer will not be consummated frequently sell into the market. These shares are often purchased by professionals, who assume the risk and provide liquidity to the market.[1]

The Williams Act and tender offer rules are designed to provide shareholders with sufficient time and information to make an informed decision whether to sell into the market, tender, or hold the securities. They also establish substantive protections, including a minimum offering period, and withdrawal and proration rights. These substantive protections prohibit a bidder from purchasing shares under the

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[1]For an analysis of the relationship between market price prior to completion of a takeover transaction and the probability that the transaction will be successfully completed, see Samuelson & Rosenthal, Price Movement as Indicators of Tender Offer Success, 41 J. Fin. 481 (1986).

tender offer until the expiration of the offer. A bidder also is prohibited from purchasing securities outside of its tender offer once the tender offer is announced and during the time that the offer is open.[2] This prohibition prevents bidders from acquiring shares through open market purchases, including purchases from investors who have acquired substantial holdings after announcement of the takeover bid. This and related prohibitions ensure that all target shareholders will be treated equally by a bidder during the tender offer.

Restrictions on the acquisition of securities during a tender offer currently apply only to a tender offer bidder. Other purchasers of a target company's securities are free to engage in open market and privately negotiated transactions at any time during the course of a tender offer,[3] sometimes in competition with or to defeat the original bidder. For example, the Ninth Circuit permitted a target company to defeat a third party tender offer through unregulated, large scale open market purchases of its own securities.[4] Similarly, the Second Circuit permitted a third party bidder, faced with a

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[2]Rule 10b-13, 17 C.F.R. § 240.10b-13.

[3]This assumes that those acquisitions are not themselves deemed to be an unconventional tender offer.

[4]See SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985). The Commission sued Carter Hawley on the grounds that the purchase program constituted an unconventional tender offer that should have complied with the Williams Act and the regulations thereunder. The court rejected the Commission's position.

hostile response by the target company, to terminate its tender offer and immediately effect substantial acquisitions of target company securities through unregulated open market purchases and privately negotiated transactions.[5]

The Commission seeks comment on the consequences of such acquisitions, and their associated costs and benefits. Commentators are requested to address both the shareholder protection and market efficiency issues presented by such acquisitions. Specifically, with respect to investor protection interests, the Commission seeks comment as to whether shareholders have adequate time and information upon which to act in the face of such unregulated acquisition programs, and whether some groups of shareholders are unfairly disadvantaged in such transactions because of the speed with which the transactions occur, the lack of adequate information concerning the transaction, or the inability to participate on the same basis as other shareholders.

The Commission also seeks comment as to the consequences of regulating timing and disclosure in conventional tender offers while permitting other large acquisitions to compete

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[5]See Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985). The Commission, at the request of the Second Circuit Court of Appeals, filed an amicus brief in which it expressed the view that the bid termination and immediate purchases raised sufficiently substantial questions under the Williams Act to justify the District Court's issuance of a preliminary injunction. The Second Circuit did not agree.

with such offers, unfettered by such restrictions. In particular, the Commission seeks comment as to whether the possibility of an unregulated competing acquisition by the target or a third party deters or disadvantages the initial bidder or encourages initial takeover attempts to proceed other than by way of conventional tender offers.[6] The Commission also seeks comment as to whether the ability to abandon a conventional tender offer and commence unregulated purchases, as permitted in Hanson Trust PLC v. SCM Corporation,[7] offsets the possible deterrence of initial bids.

The Commission further seeks comment on the differences, if any, (1) between concerns raised by acquisitions effected during a tender offer and acquisitions effected shortly after termination of a tender offer, and (2) between acquisitions effected by an issuer in the context of a third party offer and acquisitions effected by a third party in the context of either an issuer or third party offer. With respect to any identified effects, commentators are requested to discuss whether such effects are adequately addressed through existing regulation and/or market forces and if not, what response, if any, is warranted. Commentators are requested to provide factual support for their views.

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[6]For a related analysis, see Bradley & Rosenzweig, Defensive Stock Repurchases, 99 Harv. L. Rev. 1377 (1986).

[7]774 F.2d at 47.

B. A Possible Approach to Regulation of Acquisitions During or Shortly After Tender Offers

One approach to the regulation of such acquisitions involves amending the tender offer rules promulgated under the Securities Exchange Act of 1934 (the "Exchange Act") to provide that a substantial acquisition of a target company's securities by any person after commencement of a formal tender offer for such securities, and until the expiration of a specified period after termination of the tender offer, would be deemed a "tender offer" required to be made in compliance with the tender offer rules. Under this approach, upon the commencement of a tender offer, by either an issuer or a third party, any person seeking to acquire a substantial amount of target company securities (e.g., 10 percent) would be required to effect that acquisition through a conventional tender offer. This requirement would apply to the acquisition of securities by the target company itself as well as to acquisitions by any third party. The establishment of a threshold level, such as 10 percent, is intended to avoid interference with the activities of most arbitrageurs and other market professionals. Commentators are specifically requested to address the need for such a threshold and the appropriate level thereof.

The establishment of a "cooling off" period after the termination of a tender offer would ensure that neither the initial bidder nor any other person could take advantage of the market activity generated by an offer to effect a rapid acquisition of securities.[8] Commentators are specifically requested to address the need for such a "cooling off" period and, if considered necessary, the appropriate amount of time that should be allotted to permit the impact of the offer on the market to subside.

Commentators are also requested to identify characteristics of acquisitions that occur during or shortly after tender offers that, in their view, should be exempted from the requirements of the regulations discussed above because the transactions do not raise investor protection or other concerns. Commentators are specifically requested to address the appropriateness of exempting acquisitions effected through "lock-up" options granted by the issuer.

II. "Poison Pill" Plans

"Poison pill" plans place impediments in the path of any person who seeks to acquire substantial shareholdings directly from a target's stockholders without first obtaining

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[8] Rule 13e-4(f)(6), 17 C.F.R. § 240.13e-4, currently prohibits purchases of securities for a period of ten business days after the expiration of an issuer tender offer.

the approval of the target's board.[9] Proponents of these plans state that they are designed to protect shareholders by giving their boards of directors the power to ensure that shareholders receive a fair price for their shares.[10] These plans are generally adopted without the approval of the corporation's stockholders.[11]

Poison pills were adopted as early as June of 1983.[12] On November 19, 1985, in Moran v. Household International, the Delaware Supreme Court ruled that a board's adoption of a poison pill plan without shareholder approval did not necessarily violate Delaware's corporation law or the

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[9]It has been said that poison pills typically "serve[] no conceivable business purpose other than deterring takeovers." Bogen, More Legal Tests Likely on Stockholder Rights Plans, Nat'l L.J., June 30, 1986, at 26. See also Letter from D.C. Clark, Chairman and CEO of Household International to Household's shareholders (Aug. 14, 1984) (The poison pill's warrants "should deter any attempts to acquire your company in a manner or on terms not approved by the Board.").

[10]E.g., Letter from M. Lipton to the clients of Wachtell, Lipton, Rosen & Katz (Feb. 4, 1985) (Poison pill plans help "to preserve the option of the board of directors of a target company to make the ultimate decision as to its destiny.").

[11]See, e.g., Moran v. Household Int'l, Inc., 500 A.2d 1346, 1348 (Del. 1985). See also Note, Internal Transfers of Control Under Poison Pill Preferred Issuances to Shareholders: Toward A Shareholder Approval Rule, 60 St. John's L. Rev. 94 (1985) [hereinafter Internal Transfers].

[12]Lenox, Inc. adopted a poison pill in its battle with Brown, Forman Distillers Corp. See Wall St. J., June 16, 1983, at 2, col. 2.

business judgment rule.[13] Approximately 37 companies had poison pills in place as of the date of the Household decision.[14] Today, at least 190 companies have poison pills in place, and market observers believe this number will increase substantially.[15]

The term "poison pill" refers generally to preferred stock, rights, warrants, options, or debt instruments that an actual or potential target company distributes to its security holders.[16] These instruments are designed to deter nonnegotiated takeovers by conferring certain rights to

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[13]Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

[14]Office of the Chief Economist, Securities and Exchange Commission, The Economics of Poison Pills, at Table 2 (March 5, 1986).

[15]Investor Responsibility Research Center, Ongoing Survey of Antitakeover Developments (May, 1986); Kidder, Peabody & Co., Impact of Adoption of Stockholder Rights Plan on Stock Price (June 9, 1986); Corporate Control Alert, June 1986 (and preceding issues).

[16]For a general description of the operation of poison pill plans see Internal Transfers, supra note 13; Note, Delaware's Attempt to Swallow a New Takeover Defense: The Poison Pill Preferred Stock, 10 Del. J. Corp. L. 569 (1985); Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred, 97 Harv. L. Rev. 1964 (1984); Fleischer & Golden, "Poison Pill," Nat'l L.J., Feb. 24, 1986, at 17.

shareholders upon the occurrence of a "triggering event," such as a tender offer or third party acquisition of a specified percentage of stock.[17] These rights usually have little value until the triggering event occurs, but may subsequently become quite expensive for any party to redeem or purchase.[18] "Flip over" and "flip in" plans are the most

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[17] See, e.g., Dynamics Corp. of America v. CTS Corp., No. 86-1601, slip op. at 14 (7th Cir. May 28, 1986) (plan is triggered when one shareholder owns 15% or more of CTS's stock); Moran v. Household Int'l, Inc., 500 A.2d at 1348-49 (plan is triggered by tender offer for 30% of shares or acquisition of 20% of shares); Horwitz v. Southwest Forest Indus., 604 F. Supp. 1130, 1132 (D. Nev. 1985) (same).

[18] See, e.g., Dynamics Corp. v. CTS, slip op. at 14 (holders of rights can buy stock and debentures at 25% of the then market price of the package); Household, 500 A.2d at 1349 (holders of 1/100 of a share of preferred stock able to purchase $200 of acquirer's stock for $100). See generally Ferrara & Phillips, Opposition to Poison Pill Warrants is Mounting, 7 Legal Times 13 (Oct. 15, 1984).

frequently used forms of poison pills,[19] but a large number of securities issuance plans could conceivably be crafted to have the same effect as currently popular poison pill plans.[20]

Tender offers can benefit shareholders by offering them an opportunity to sell their shares at a premium and by guarding against management entrenchment.[21] However, because

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[19]Both of these variations involve the distribution of "rights" that are nondetachable from the common stock until the triggering event occurs. Under "flip-over" plans, if the acquiring firm consummates a merger, substantial asset sale, or other combination, the shareholder can present the rights to the acquirer in exchange for a fixed dollar amount of securities of the acquiring firm at a price far below (usually half) the market price. See, e.g., Household, 500 A.2d at 1349; Horwitz v. Southwest Forest Indus., 604 F. Supp. at 1132. Under "flip in" plans, the occurrence of a triggering event permits shareholders, except the bidder, to return their rights to the issuer in exchange for cash or short-term senior notes in amounts often well in excess of the market value of the pre-rights shares. See, e.g., Dynamics Co. of America v. CTS Corp., No. 86-1601, slip op. at 14 (7th Cir. May 28, 1986).

[20]"Back end" plans are a particular type of "flip in" pill that require that the target's shares be tendered along with the rights, and provide that the person causing the rights to be triggered may not exercise those rights. See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 177 (Del. 1986); Dynamics Corp. of America v. CTS Corp., No. 86C1624, slip op. at 5-6 (N.D. Ill. May 3, 1986), aff'd on rehearing, 86C1624 (N.D. Ill. June 20, 1986). The net financial effect of such a plan may be similar to exclusionary self-tenders that are prohibited by Commission regulation. See part III, infra. Other varieties of poison pills can also have the same financial effect. For a discussion of recent variations of poison pill plans see Corporate Control Alert, June 1986, at 1.

[21]See, e.g., Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983) and authorities cited therein; Ginsburg & Robinson, The Case

poison pills are intended to deter nonnegotiated tender offers, and because they have this potential effect without stockholder consent, poison pill plans can effectively prevent shareholders from even considering the merits of a takeover that is opposed by the board.[22] Accordingly, in an amicus brief submitted to the Court in Household International, the Commission expressed its concern over these plans. The Commission argued that poison pills may harm shareholders by restricting their opportunity to consider hostile tender offers and by limiting their ability to wage proxy contests.[23]

Against Federal Intervention in the Market for Corporate Control, Brookings Rev. (Winter/Spring 1986), at 9.

[22]Judges of a Federal Court of Appeals have echoed many of the reservations expressed in this release:

> Personally, we are rather skeptical about the arguments for defensive measures. They strike us as giving too little weight to the effect of "defensive" measures in rendering shareholders defenseless against their own managements. (The shareholders of CTS were not asked to approve the poison pill.) We are especially skeptical about the arguments used to defend poison pills. If the present case is representative, the poison pill seems (as we shall see) more a reflex device of a management determined to hold on to power at all costs than a considered measure for maximizing shareholder wealth.

Dynamics Corp. of America v. CTS Corp., No. 86-1601, slip op. at 9 (7th Cir. May 28, 1986) (Posner, J.).

[23]Brief of the Securities and Exchange Commission, Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) (poison pills raise the cost of forming a control block and

In at least two instances, corporations have adopted poison pill plans despite indications that there would be a substantial question as to whether a majority of the corporation's stockholders would support adoption of a poison pill, if given the opportunity to vote on the plan.[24] A "Shareholder Bill of Rights" recently adopted by the Council of Institutional Investors, whose members manage over $160 billion in assets, proclaims that "shareholders have a right to vote on . . . poison pills."[25] Members of Congress have similarly considered requiring shareholder approval of poison pills.[26]

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evidence shows that control blocks increase the likelihood of a successful proxy contest). See also Household, 500 A.2d at 1355.

[24]See Moran v. Household Int'l, Inc., 490 A.2d 1059, 1064 (Del. Ch.), aff'd, 500 A.2d 1346 (1985) (Proxy consultant predicted that shareholder approval of a fair price amendment, an antitakeover measure less inhibiting than a poison pill, would result in a close vote. Management elected to pursue the poison pill route, which does not require a vote, "in view of the predicted closeness of the [fair price] vote."); Rorer Group, Inc. Retains Measure Against Takeovers, Wall St. J., at 8 (May 29, 1985); Rorer Holders Vote to Rescind Firm's 'Poison Pill' Rule, Wall St. J., at 20 (May 9, 1985).

[25]Vise, "Bill of Rights" Seeks to Boost Power of Shareholders, Washington Post, April 13, 1986, p. F1.

[26]See H.R. 5693, 98th Cong., 2d Sess. (1984). See also, Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison-Pill" Preferred, supra note 16, at 1964 n.2.

In Household International, the Delaware Supreme Court determined that poison pills do not necessarily harm shareholders.[27] The court concluded that poison pills do not necessarily prevent stockholders from entertaining all tender offers, and may not change the structure of a company as much as other antitakeover measures that a board could legally implement without stockholder approval. The court also observed that these plans may deter partial and two-tier tender offers and ward off open market purchase programs that could deprive shareholders of larger control premiums. Accordingly, the court concluded that poison pills give a board of directors bargaining power that can be helpful in assuring that target shareholders receive a higher price for their shares. The court stressed, however, that a board of directors has a fiduciary duty to the corporation's shareholders when it is presented with a request to redeem the poison pill, and that the decision not to redeem a poison pill could be subject to further judicial scrutiny.[28] Other

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[27]500 A.2d at 1354.

[28]"While we conclude for present purposes that the Household Directors are protected by the business judgment rule [in adopting the plan] that does not end the matter. The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders. Their use of the plan will be evaluated when and if the issue arises." Id. at 1357 (citations omitted). At that time, the Delaware court is likely to consider whether the application of the pill is "'reasonable in relation to the threat posed.'" Id. at 1356

courts have upheld the issuance of poison pills under circumstances and on grounds similar to those of Household International.[29]

Not all applications of poison pills have, however, withstood challenge in the courts. In Dynamics Corp. of America v. CTS Corp., a federal district court applying Indiana law enjoined CTS's first poison pill because it was "unreasonable in relation to the particular threat posed."[30] The Seventh Circuit affirmed that decision and indicated that managements adopting poison pills might not be able to satisfy their burden under the business judgment rule[31] unless the triggering event requires that a shareholder own

(citing Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985)).

[29]See, e.g., Horwitz v. Southwest Forest Indus., 604 F. Supp. 1130 (D. Nev. 1985); MacAndrews & Forbes Holding, Inc. v. Revlon, Inc., 501 A.2d 1239, 1251 (Del. Ch. 1985), aff'd, 506 A.2d 173 (Del. 1985).

[30]Dynamics Co. of America v. CTS Corp., No. 86C1624, slip op. at 32 (N.D. Ill. April 17, 1986), aff'd, No. 86-1601 (7th Cir. May 28, 1986). On appeal, the court found that the pill "effectively preclude[d] a hostile takeover, and thus allow[ed] management to take the shareholders hostage." No. 86-1601, slip op. at 16 (7th Cir. May 28, 1986). The district court has since refused to enjoin a second CTS poison pill, No. 86C1624 (N.D. Ill. June 20, 1986) (appeal pending). Unlike the initial rights plan, the second plan did not contain a "flip-in" provision which precluded the insurgent from conducting a proxy contest. Furthermore, the District Court noted that the second plan was the result of a more considered deliberative process by the Board of Directors.

[31]No. 86-1601, slip op. at 10-11 (7th Cir. May 28, 1986).

more than 50% of the target's shares and the rights give shareholders no more for their shares than the highest price the majority shareholder paid for its shares.[32] In Asarco, Inc. v. M.R.H. Holmes A Court, a federal district court held that New Jersey law prohibited adoption of poison pill plans that caused unequal voting rights among holders of a single class of shares.[33] Similarly, courts have enjoined poison pill plans that created rights that could not be transferred with the underlying shares.[34]

Because poison pill plans are relatively new, there has been little research as to their consequences. One study of early plans suggests that poison pills harm stockholder interests and lead to management entrenchment.[35] A more recent study conducted by the Commission's Office of the Chief Economist ("OCE") examines the effects on share price of a larger and more recent set of poison pills and finds that the effect of these pills depends on the circumstances

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[32] Id., slip op. at 16.

[33] 611 F. Supp. 468 (D.N.J. 1985).

[34] Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985) (New Jersey law); Unilever Acquisitions Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (Delaware law).

[35] Malatesta & Walkling, The Impact of "Poison Pill" Securities on Shareholder Wealth (Dec. 1985) (unpublished manuscript).

under which they are adopted.[36] For certain firms that were the subject of serious takeover speculation at the time their poison pill plans were adopted, the poison pills caused statistically significant price declines of about 2.4 percent. Poison pills adopted under other circumstances showed no statistically significant effect on share price. All of these findings should be interpreted in light of other research suggesting, in general, that antitakeover measures either reduce shareholder wealth or leave it unchanged.[37] At least one study, however, suggests that antitakeover measures approved by shareholders may increase shareholder wealth.[38]

There has also been substantial controversy as to the effectiveness of poison pills in deterring takeovers. Some commentators claim that poison pills erect virtually insurmountable obstacles to takeovers,[39] but there have been

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[36]Office of the Chief Economist, Securities and Exchange Commission, The Economics of Poison Pills (Mar. 5, 1986).

[37]See, e.g., Bradley & Wakeman, The Wealth Effects of Targeted Share Repurchases, 11 J. Fin. Econ. 301 (1983); Dann & DeAngelo, Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control, 11 J. Fin. Econ. 275 (1983).

[38]See Linn & McConnell, An Empirical Investigation of the Impact of "Antitakeover Amendments" on Common Stock Prices, 11 J. Fin. Econ. 361 (1983). But see DeAngelo & Rice, Antitakeover Charter Amendments and Stockholder Wealth, 11 J. Fin. Econ. 329 (1983).

[39]A "Poison Pill" That's Super-Lethal, Business Week, at 93 (Oct. 1, 1984); Ferrara & Phillips, Opposition to Poison Pills Is Mounting, 7 Legal Times 13 (Oct. 15, 1984).

at least two takeovers completed despite the presence of poison pills.[40] An alternative measure of the effectiveness of poison pills is the number of takeovers that would have occurred but for the presence of these plans, or any changes in takeover premiums resulting from poison pill plans. The Commission invites comment as to whether and how the effectiveness of these plans can be measured.

The Commission also observes that the regulation of poison pills has to date been a subject of state, not federal, oversight. Because federal regulation of poison pills could intrude on traditional state functions and preempt state corporation law, the benefits of state involvement in this area must be considered when weighing the appropriateness of any federal action.

In light of the quick evolution, rapid spread, and deep debate over the consequences of poison pill plans, the Commission seeks comment as to the extent to which the incidence of poison pill plans is increasing, the circumstances under which corporations adopt and exercise such plans, the number of corporations that can be expected

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[40] Pantry Pride commenced and succeeded with a tender offer for Revlon despite the existence of a poison pill. Similarly, Sir James Goldsmith commenced a tender offer for Crown Zellerbach even though the company had adopted a poison pill plan. Although Goldsmith terminated his tender offer, he proceeded to acquire control of the company through open market purchases.

to adopt poison pills in the future, and the types of pills likely to be adopted. The Commission also seeks comment as to the effectiveness of poison pills in deterring takeovers, and the strategies that bidders can use to circumvent current and future poison pill plans.

The Commission further seeks comment regarding the investor protection issues that poison pills raise and their costs and benefits in general. Because poison pill plans are adopted without stockholder approval, the Commission seeks comment regarding the possibility that these plans are used to entrench management, and the effectiveness of state law fiduciary obligations imposed on directors to consider redemption of the poison pills.[41] The Commission also seeks comment on the consequences of poison pills on contests for corporate control that do not otherwise involve tender offers, including, in particular, proxy contests.

Many concerns regarding poison pill plans might be resolved if these plans are subject to stockholder approval.[42] Such a requirement could be imposed at either a state or federal level. The Commission requests comment as to the appropriateness of federal intervention into the area

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[41] See Note, Protecting Shareholders Against Two-Tiered and Partial Takeovers: The "Poison Pill" Preferred, supra note 16, at 1968-72.

[42] See Internal Transfers, supra note 11.

of poison pills, an area that has to date been the province of state corporation law. In the event that federal action is warranted, the Commission seeks comment as to the appropriate form of the response. In light of the market's ability to evolve new instruments designed to avoid the restraints imposed by regulation, the Commission also seeks comment on the probable effectiveness of any suggested federal action, and the likely market response to such regulatory initiatives.

III. Self-Governance Exemptions

Self-governance exemptions are found in both state and federal law. They are particularly common in state law where corporation codes frequently establish general rules from which corporations can exempt themselves by appropriate stockholder and/or director action.[43] Certain state antitakeover statutes

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[43]Self-governance exemptions are found in the Model Business Corporation Act, Delaware's General Corporation Law, and New York's and California's corporation codes, as well as in the corporation codes of all other states. See, e.g., Model Business Corp. Act Ann. §§ 6.30(a), 8.03(b)-(c) (3d ed. 1985) (shareholders have no preemptive rights unless provided in articles of incorporation; after shares are issued, board may not change range for size of board or from fixed to variable sized board without shareholder approval); Del. Code Ann. tit. viii, § 102(b)(4) (1974) (stockholders may, by amendment to articles of incorporation, impose supermajority provisions for taking corporate or board actions); N.Y. Bus. Corp. Law § 908 (McKinney 1986) (corporation may give guarantee not in furtherance of a corporate purpose if approved by two-thirds of outstanding shares); Cal. Corp. Code § 700(a) (West 1977) (each share, regardless of class, entitled to one vote unless otherwise provided in articles).

also contain self-governance exemptions.[44] Self-governance exemptions are also found in the federal securities laws, where regulated entities can, by appropriate stockholder or director action, exempt themselves from certain provisions of the Investment Company Act.[45] The Trust Indenture Act contains a

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In addition, in response to a perceived "insurance crisis" that has made directors and officers liability insurance either unobtainable or relatively expensive, Delaware has recently added a new section 102(b)(7) to its General Corporation Law. See S. Bill No. 533 (June 10, 1986). Section 102(b)(7) authorizes charter amendments that would relieve directors of monetary liability for certain breaches of the duty of care. Because section 102(b)(7) is an enabling statute, Delaware corporations must obtain board and shareholder approval before such relief can be made available.

[44]See, e.g., Ohio Rev. Code Ann. § 1701.831(a) (Page 1983); Pa. Stat. Ann. tit. 15, § 1910a (Purdon 1984); 1983-85 Wis. Legis. Serv. 200, § 7 (West); N.Y. Bus. Corp. Law § 912(d)(3) (McKinney 1986).

[45]Section 13(a) of the Act provides that a registered investment company may not change from a diversified to a non-diversified company, deviate from its stated investment policy, or change its business so as to cease to be a registered investment company, "unless authorized by the vote of a majority of its outstanding voting securities." 15 U.S.C. § 80a-13. Section 23(b) permits the sale of common stock of a closed-end investment company at less than current net asset value only "with the consent of a majority of its common stockholders." 15 U.S.C. § 80a-23(b). Section 61(a)(3)(A) requires a majority of directors and shareholders to authorize the issuance of certain debt accompanied by warrants, options, or rights to convert. 15 U.S.C. § 80a-61(3)(A).

The Investment Advisers Act contains statutory provisions that can be waived by client consent. Section 205(2) of the Act provides, in substance, that an investment adviser may not assign an investment advisory contract without the consent of the party being advised. 15 U.S.C. § 80b-5(2). Section 206(3) of the Act provides that an investment adviser, without obtaining the informed prior consent of his client, may not sell securities to or purchase securities from the client as principal for the adviser's own account, or as agent for another client. 15 U.S.C. § 80b-6(3).

prohibition that may be waived by debt holder action.[46] The Commission has also proposed and adopted rules that rely on principles of corporate self-governance to exempt regulated persons from various statutory or regulatory proscriptions.[47]

The Commission seeks public comment on the advisability of a rule whereby stockholders and directors would be permitted to decide for themselves whether they require certain protections of the Williams Act. The Commission seeks public comment on

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[46]Section 316 of the Act provides that trust indentures qualified under the Act may authorize a simple majority of the indenture security holders to consent to a waiver of a past default, and a 75 percent majority to consent to a postponement of interest payments for a period of three years from their due date. 15 U.S.C. § 77ppp(a).

[47]Rule 16b-3 under the Securities Exchange Act of 1934 provides an exemption for directors, officers, and principal stockholders from liability for short swing profits under section 16(b) of the Act if their transactions occur pursuant to a plan approved by the company's security holders that otherwise meets the requirements of the rule. 15 C.F.R. § 240.16b-3. Rule 12b-1 under the Investment Company Act of 1940 provides that mutual funds may act as distributors of their own securities if they do so pursuant to a plan approved by a majority of their security holders that otherwise meets the requirements of the rule. 15 C.F.R. § 270.12b-1(b)(1). One of the alternatives proposed by the Commission for Rule 14a-8 under the Securities Exchange Act of 1934 would have allowed issuers and their security holders to adopt their own procedures governing access to the issuer's proxy statement, subject to certain minimums prescribed by the Commission. See SEC Release No. 34-20091, 48 Fed. Reg. 38218 (1983). There was some support, mostly from issuers, for this self-governance alternative, but many commentators were concerned that it would create problems of administration in that there would not necessarily be uniformity or consistency among different issuers in determining whether security holder proposals would be included in the issuer's proxy materials. Id. The Commission decided not to adopt this self-governance proposal in part because of overwhelming support for an alternative that was subsequently adopted. Id.

this concept in two contexts: (1) as applied to the "all holders" rule, and (2) as applied to other provisions of the tender offer rules.

A. The "All Holders" Requirement

The recently adopted "all holders" rule prohibits exclusionary issuer and third-party tender offers. It requires that tender offers of issuers and third-party bidders must be open to all holders of the class of securities subject to the tender offer.[48]

As applied to the "all holders" rule, a self-governance provision could, for example, provide that corporations may exempt themselves from the rule if their charters are amended, in accordance with state law, expressly to authorize exclusionary tender offers. A charter provision authorizing such an exemption could cover either issuer or third-party tender offers for such issuer, or it could apply to both issuer and third-party tender offers. The charter provision could also define particular circumstances under which issuer or third-party exclusionary offers would continue to be prohibited.

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[48]Release No.34-23421 (July 11, 1986) [51 Fed. Reg. 25873] (announcing adoption of Rule 14d-10 and amendments to Rules 13e-4, 14d-7, and 14e-1(b)). Although the "all holders" principle is incorporated in more than one rule, for ease of reference this release refers to an "all holders" rule.

The Williams Act and the Commission's tender offer rules currently operate as rules of general applicability with no provision for exemptions or modifications by stockholder or director action. Tender offers are thus conducted in accordance with uniform rules, and all participants are equally subject to regulations that Congress and the Commission have determined to be in the public interest.

A self-governance exemption would alter the current structure of the Commission's tender offer rules by allowing individual corporations, within bounds set by the Commission, to modify the protections of the rules to suit their particular circumstances. The Commission requests comment on whether the public interest would be well served if stockholders and directors of individual corporations are permitted, under certain circumstances, to craft safeguards designed to suit the specific circumstances of individual corporations. A body of recent research suggests that self-determination in matters related to corporate governance yields benefits that may not be as readily attainable under rules of general applicability.[49]

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[49] See, e.g., Baysinger & Butler, Antitakeover Amendments, Managerial Entrenchment and the Contractual Theory of the Corporation, 71 Va. L. Rev. 1257, 1290 ff. (1985); Baysinger & Butler, The Role of Corporate Law in the Theory of the Firm, 28 J.L. & Econ. 179 (1985); Butler, Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges, 14 J. Legal Stud. 129 (1985); Coase, The Problem of Social Cost, 3 J.L. & Econ. 1 (1960); Dodd & Leftwich, The Market for Corporate Charters: Unhealthy Competition vs.

Thus, without a self-governance exemption, there is a possibility that the "all holders" rule might impose protections on certain corporate investors who neither desire nor benefit from safeguards that might be reasonable for investors in other corporations that are subject to the "all holders" rule. A self-governance exemption might thus help minimize whatever ancillary burdens are imposed by an "all holders" rule without diminishing the rule's general protections.

The Commission seeks comment as to the advisability, costs, and benefits of a self-governance exemption to the "all holders" rule. The Commission also seeks comment regarding the extent to which experience with self-governance exemptions at the state or federal level provides guidance relevant to the adoption of such a self-governance exemption. Empirical evidence related to the costs and benefits of self-governance exemptions will be particularly useful.[50]

Federal Regulation, 53 J. Bus. 259 (1980); Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. Law 540 (1984); Fischel, The Corporate Governance Movement, 35 Vand. L. Rev. 1259 (1982); Fischel, The Race to the Bottom Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw.U.L. Rev. 913 (1982); Oesterle, Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis, 71 Corn. L. Rev. 53, 65 ff. (1985); Romano, Some Pieces of the Incorporation Puzzle, 1 J.L., Econ. & Org. 225 (1985).

[50]For examples of such research, see Dodd & Leftwich and Romano, supra note 49.

The Commission also seeks comment regarding the mechanics involved in the implementation of a self-governance exemption, as well as comment regarding alternative formulations of a rule that might implement a self-governance exemption. In particular, the Commission seeks comment as to whether it should rely on the rules for charter amendments in the issuer's corporate domicile, whether it should condition the exemption on subsequent enactment by the legislature of the issuer's corporate domicile of rules for charter amendments that are specifically addressed to the proposed self-governance exemption, or whether the Commission should provide separate criteria for the adoption of any exemption. Examples of such criteria include supermajority requirements, requirements for periodic shareholder reaffirmation, or provisions that allow for exemptions to be approved by stockholder action without prior board approval.

B. Self-Governance Provisions Applied to Other Tender Offer Regulations

The Commission also seeks comment on the concept of adopting self-governance exemptions to tender offer rules other than the "all holders" provision. The Commission has not determined which, if any, tender offer rules are appropriate candidates for self-governance exemptions, and seeks comment identifying rules that are either particularly appropriate or inappropriate candidates for self-governance exemptions. The Commission requests that comments address the costs and benefits of providing self-governance exemptions to specific tender offer rules and, as in the case of the "all holders" rule, address: (1) relevant analogues and empirical evidence; (2) specific language for suggested exemptions; and (3) whether the exemption should rely on the charter amendment provisions of the issuer's domicile, or on some other rule of corporate self-governance.

In connection with such proposals, the Commission observes that members of Congress have introduced numerous amendments to the Williams Act.[51] Some of these proposals suggest congressional support for time deadlines and thresholds different than those currently found in the statute.[52]

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[51] E.g., S.286, 99th Cong., 1st Sess. (1985) (Sen. Riegle); S.631, 99th Cong., 1st Sess. (1985); (Sen. Chafee); S.706, 99th Cong., 1st Sess. (1985) (Sen. Proxmire); S.860, 99th Cong., 1st Sess. (1985) (Sen. Metzenbaum); S.1882, 99th Cong., 1st Sess. (1985) (Sen. Metzenbaum); S.1907, 99th Cong., 1st Sess. (1985) (Sens. D'Amato & Cranston); H.R. 1480, 99th Cong., 1st Sess. (1985) (Rep. Markey). Cf. S.1695, 99th Cong., 1st Sess. (1985) (Sen. Specter) (to prohibit enforcement of all holders rule).

[52] For example, Congressman Markey's bill, H.R. 1480, would require that all tender offers (other than issuer offers not made in response to an outside offer) remain open for 60 business days. See H.R. 1480, § 104(d), 99th Cong., 1st Sess. (1985). The legislation introduced by Senators D'Amato and Cranston would extend the minimum offering period for tender offers, now 20 days, to 30 days for "any-and-all" offers and to 40 days for partial and two-tiered offers. S.1907, §§ 2(a)(1), 4(a)(4), 99th Cong., 1st Sess. (1985).

Corporate self-governance exemptions could allow issuers to elect deadlines and thresholds within ranges defined by currently pending legislation.[53] In addition, some business organizations and academics have proposed takeover rules that are incompatible with the Williams Act, but that could potentially be adopted in the form of self-governance exemptions.[54] The Commission invites comment regarding the advisability of adopting or recommending to Congress self-governance exemptions that would permit corporations to adopt

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[53]Self-governance provisions could, for example, allow directors to recommend and stockholders to approve minimum offering periods for tender offers for their corporation's shares, provided that those periods were no shorter than the current 20-day period and no longer than the 30-day "any-and-all" and 40-day partial and two-tier periods proposed in the D'Amato-Cranston bill.

[54]See, e.g., Bebchuck, Toward an Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1695 (1985) (proposing that the fate of all offers aimed at acquiring a controlling interest (e.g., above 20 percent) be decided upon a poll of shareholders, regardless of whether they tender their shares, and that nontendering shareholders be given certain immediate takeout or redemption rights); Business Roundtable, Statement of Principles on Hostile Takeover Abuses (undated) (proposing that no one may purchase more than 15 percent of the voting securities of a company without board or shareholder approval and that all purchasers of more than 15 percent must offer to purchase all voting securities in a tender offer).

these or other takeover rules to govern contests for corporate control.

By the Commission.

Jonathan G. Katz

Secretary

July 31, 1986