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PROCEEDINGS

Panel II—Merger and Acquisition Issues

The second panel discussed partial and two-tier tender offers, their social and economic purpose and utility, and the necessity and proper focus of tender offer regulation. Digests of these presentations follow.

Panelists: (l to r) Frank H. Easterbrook, Professor, University of Chicago Law School; Dean LeBaron, President, Batterymarch Financial Management; Martin Lipton, Partner, Wachtell, Lipton, Rosen & Katz; Bevis Longstreth, Partner, Debevoise & Plimpton; (not pictured) Robert E. Rubin, Partner, Goldman Sachs & Company.

Moderator: Charles C. Cox
SEC Commissioner

Staff Coordinator: Linda C. Quinn
Executive Assistant to the SEC Chairman

Introduction—Charles C. Cox

Recommendations of the Advisory Committee on Tender Offers addressed perceived problems in two broad areas—tactics of target managements and tactics of bidders. While defensive tactics have received considerable attention and regulatory scrutiny, relatively little attention has been paid to bidder tactics, particularly partial and two-tier tender offers. Scope of discussions today will be primarily limited to those.

The frequent use of partial, front-end-loaded tender offers has raised concerns that regulation may be necessary to protect investors from the "coercive" effect of such offers, but the economic consequences of regulation must be examined first.

The Advisory Committee's proposals relating to partial tender offers might have undesirable consequences for capital formation and corporate governance. Tender offers generally serve a useful economic purpose by reallocating resources to more valued uses; restricting partial tender offers could result in fewer tender offers. Accordingly, regulation should neither encourage nor discourage tender offers, but instead should be neutral. The decision to make a tender offer should be committed to the bidder's business judgment.

Neutral regulation probably would not harm investors, because shareholders do not receive a lower premium in two-tier tender offers according to a recent analysis of 148 tender offers by the Commission's Office of the Chief Economist. Second-tier premiums typically are substantial even though they are less than in the first tier. In no case included in the study, moreover, did a partial or two-tier offer defeat an any-or-all offer involving greater total compensation. Thus, regulation designed to eliminate differences between first- and second-tier premiums likely would not benefit investors.

Remarks of Panelists

Dean LeBaron

Three elements of the current corporate environment contribute to the need for regulation of tender offers:

- managements have engaged in actual or perceived abuses of power by allocating shareholder assets less on the basis of business need than on management's desire to protect their positions with the company;
- directors of public companies have committed a breach of trust by making decisions in the interests of the persons responsible for nominating them to the board rather than in the interests of shareholders, to whom they are primarily responsible; and
- confidence in the prevailing system of corporate governance has been undermined by a perceived increase in the risk associated with ownership of securities, the allocation of assets for non-earning purposes, and a generally higher cost of capital.

The emergence of a cleavage between shareholders and managements in the corporate takeover area is clear. Managements now propose antitakeover measures with full awareness that the measures are beneficial to management but typically are not in the best interests of shareholders. This development evidences the failure of directors to recognize the primacy of their duty to shareholders.

Much of the criticism of two-tier offers and partial ownership is based on the notion that all shareholders should share in the control premium paid by the bidder. However, of more concern is the fact that securities frequently sell at a price substantially below the market value of their underlying assets; they do not command their true value in the marketplace because of barriers to a change of control. If these barriers were reduced or eliminated, the market price of securities would more nearly approximate the value of the assets they represent. As a consequence, the "control premium" would be reflected in the market price of stock and would not be an element of a tender offer.

Management decisions must further shareholder interests if securities are to reflect their true value. If the present cleavage between managements and shareholders continues, institutional investors will become more militant and more vocal. Institutional investors do not analyze companies based on short term prospects without regard for the long term plans of managements. Institutional investors seek only the optimum price for their securities, and they are likely, in the future, to challenge management decisions on takeovers that undermine this goal. The rising concern of institutional investors may result in litigation, investigations of conflicts of interests, and other efforts to hold directors more accountable for their actions.

Martin Lipton

Two-tier tender offers have been used abusively; Congress and the Securities and Exchange Commission should move decisively to eliminate the abuses. By borrowing the money necessary to implement the first tier of an offer, and then issuing securities in the second tier, bidders have been able to take over substantial companies without placing their own assets at risk. In such cases, the bidder may have neither the capital nor the ability to manage the acquired company.

Widespread negative reaction to tender offers of this nature is evidenced by:

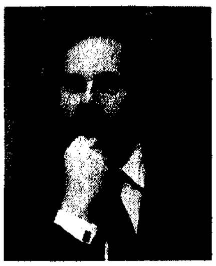
- the large number of corporations that have amended their charters to protect against two-tier offers;

- the number of states that have enacted or are considering legislation to regulate two-tier offers; and
- the introduction of legislation in the Congress designed to regulate takeover activity.

Two-tier tender offers not only enable persons with little or no cash to acquire substantial companies, but also result in highly leveraged companies that are vulnerable to serious financial and business problems, particularly to a downturn in earnings or an increase in interest rates.

American management has lost confidence in institutional investors. Management views institutional investors as effectively controlling the price of securities through their market activity with no regard for the long term needs of corporations and their managements. Long term profitability may require measures that will reduce earnings in the short term, but institutional investors are too concerned with quarter-to-quarter performance of their managed assets and will sell any securities that do not have immediate prospects for high yields. This depresses the value of a farsighted company's securities and makes the company an attractive takeover target. Thus, management may be forced to choose between prudent management and avoiding a takeover battle.

Frank H. Easterbrook



The fundamental premise underlying each panelist's position was that regulation of partial and two-tier tender offers has predictable consequences. More specifically each panelist recognized that regulation intended to make two-tier bids more difficult would reduce the number of initial tender offers, with the consequence that fewer takeovers would occur. In deciding whether and how to regulate two-tier offers, therefore, it must first be determined whether tender offer activity should be discouraged.

This requires an analysis of the purposes served by tender offers. A number of reasons have been advanced by both proponents and opponents, explaining why tender offers occur:

- Acquisitions represent "paper entrepreneurialism" (asset shuffling without economic gain) impelled by the large ego of persons trying to increase the assets subject to their control.
- Acquisitions are a form of corporate raiding that serve only to damage morale and the productivity of the target.
- Tender offers evidence the bidder's belief that the securities are undervalued by the market.
- Acquisitions create real economic benefits resulting from synergy (the productive combination of assets) or the replacement of ineffective managers.

Evidence shows that stock prices reflect the future profits and prospects of a company. Tender offers, regardless of their purpose, raise stock prices. The increase shows that investors anticipate higher profits and better prospects. Thus, acquisitions through tender offers transfer assets to those who place a higher value on them and give shareholders of the target company a better price for their shares.

Partial ownership of stock (ownership of more than 10 percent but less than 50 percent of a company's stock) also has a beneficial effect; the value of the stock is generally higher. The reason is that corporate managers are more likely to manage the company effectively and profitably if they know that their activity is being scrutinized by someone with both a large economic interest and the wherewithal to take action against management.

In view of the benefits to shareholders resulting from tender offers and partial ownership, legislation designed to make such activity more difficult or more expensive should be studied carefully. In view of the study by the Commission's Office of the Chief Economist showing that two-tier offers do not cause shareholders to sell to a bidder offering a lower price than is offered by an any-or-all bidder, it is questionable whether legislation should discourage two-tier tender offers. Instead, regulation should accommodate whatever form of tender offer enables a potential bidder to commence a tender offer.

Bevis Longstreth

Disagreement over how and whether to regulate changes in corporate control and ownership results from disagreement regarding the underlying problem. Identifying the underlying problem depends, in turn, on one's view of the social and economic utility of corporate takeovers. One view holds that hostile tender offerors displace competent management, misuse the target corporation, and injure its shareholders. Another view is that tender offers benefit shareholders by optimizing the value of their shares, and benefit society by assuring optimum efficiency in the deployment of assets.

The Advisory Committee on Tender Offers rejected both positions on the ground that there was inadequate evidence to support either view. The Advisory Committee's recommendations were thus designed to achieve a reasonable balance between the bidder and the target in a takeover attempt. But neither the bidder nor the target should be accorded regulatory protection or advantage until a conclusion is reached regarding the social and economic utility of tender offers.

Until such a conclusion is reached, regulation should be designed only to ensure fairness to shareholders in situations where the competitive marketplace does not serve that end. The question thus is not whether two-tier acquisitions and partial ownership should be encouraged or discouraged, but whether such transactions are fair to shareholders. In this regard, the major issue that needs to be resolved by the Congress and the Securities and Exchange Commission is whether such transactions involve payment of a control premium and, if so, whether that control premium should be shared by all shareholders.

Robert Rubin

Because of the complexity of the question of whether takeovers are good or bad for the economy, the Advisory Committee on Tender Offers appropriately decided to strive for fairness among the participants in a takeover situation rather than to make tender offers more or less difficult. As an investment banker and arbitrageur, I have sensed no unfairness to myself or to other shareholders in two-tier or partial tender offers. Professional investors had an advantage over small investors prior to the Commission's adoption of rules making the proration period coterminous with the period for accepting tenders. Now all shareholders benefit equally from two-tier tender offers.

Two-tier tender offers occasionally involve an average price less than may have been obtained by shareholders in an any-or-all tender offer or merger. However, discouraging two-tier bids for this reason would result in fewer tender offers, with a resulting loss to shareholders. On balance, shareholders derive greater benefit from a system permitting two-tier and partial offers than from a system that discourages or prohibits such offers. Allowing partial and two-tier offers has the added benefit of allowing smaller companies to acquire target entities.

Some believe that the opposition of a number of groups to tender offers evidences a widely held view that tender offers are a significant and undesirable phenomenon. My opinion is that the Congress has been active only because, when viewed on a simplistic basis, tender offers are an attractive political issue, and that state legislatures have been motivated primarily by a desire to protect local companies. As a result, efforts to regulate tender offers probably do not evidence a widespread view that tender offers are detrimental to shareholders or the economy, and in any event the subject should be carefully studied to identify all ramifications and effects of discouraging or encouraging tenders before regulation in either direction is adopted.

Two-tier offers may result in highly leveraged companies. However, creation of liabilities for the acquiring company results in the creation of corresponding assets for the shareholders of the acquired entity. Interference with this free market allocation of assets may be detrimental unless it is first determined that the use of credit in these transactions is harmful to the economy or shareholders.

Discussion

Are institutional investors opposing antitakeover proposals to the same extent as during the 1983 proxy season?

Mr. LeBaron responded that, although he had not seen any statistics, he had heard that institutions are more frequently voting in favor of antitakeover proposals. Mr. LeBaron stated that he believed that opposition to antitakeover proposals is continuing, but that institutional investors may sometimes decline to express their opposition when they feel that their efforts would be unsuccessful and would result in a loss of research contacts within the company.

Will the recent proposal to require that anyone acquiring 10 percent or more of a public company make a tender offer for the remainder of the company unduly restrict investors in their allocation of assets and their efforts to obtain a certain level of voting power in a company?

Mr. Lipton responded that his proposal contained a number of exceptions, including an exception to permit large acquisitions that are approved by the company. He said that his proposal would not, therefore, restrict venture capital investments or transfers among family members. Instead, it would serve to prevent raiders from acquiring toehold positions for the purpose of "greenmailing" the company.

In response to the comment that institutional investors depress stock prices by failing to support managements with long term goals, Mr. LeBaron observed that such companies may take advantage of the underpricing by repurchasing their own stock. He suggested that a company's failure to engage in stock repurchases may reflect basic problems with the company rather than a failure by institutional investors to appreciate management's long term plans. Mr. Lipton replied that an extensive stock repurchase plan by a company would result in the same leveraging that has been widely criticized in two-tier and partial tender offers.

In response to Mr. Longstreth's suggestion that regulation should be designed to achieve fairness, Professor Easterbrook stated that regulation on this basis is difficult unless fairness is defined. He said that fairness can mean the receipt by each shareholder of the same price for his stock, or it can mean equal opportunity to respond to a two-tier tender offer. He suggested that regulation is not always necessary to ensure fairness, observing that investors have long been free to gain or lose in the stock market based on personal investment choices without anyone suggesting that the result is unfair. Protection from the vagaries of the marketplace lies in voluntary diversification of investments, he said, not in governmental regulation.

Why are a disproportionate number of hostile bids structured as two-tier bids?

Mr. Rubin cited two reasons. First, many hostile tender offers are made by small companies that do not have the resources to finance any-or-all offers. Second, a properly structured two-tier tender offer involving a high premium in the first tier gives the offeror an advantage in the event of a subsequent competing any-or-all bid, even if the premium in the any-or-all offer is higher than the blended premium in the two-tier offer. Mr. Rubin explained that a shareholder is likely to tender to the two-tier offeror where the two-tier offer expires prior to the expiration date of the any-or-all offer, out of fear that the any-or-all offer will fail.

Commissioner Treadway addressed the panel concerning the Commission's recently proposed revisions to registration statements under the Securities Act of 1933. The changes were designed to place tender offers in which the consideration is the bidder's securities on equal footing with cash tender offers. He asked whether these amendments would result in more any-or-all offers by eliminating the need for a delayed second-tier offer, or would instead merely give the bidder more flexibility in structuring the first tier of a two-tier offer. Mr. Lipton responded that the amendments would give two-tier offerors more flexibility in structuring the first tier. He also noted, however, that the amendments might encourage competing offers because potential bidders would be able to enter the competition without having to arrange financing.

Commissioner Cox noted that approximately 20 percent of publicly held companies have a holder of a block of stock exceeding 10 percent. He asked Mr. LeBaron what legitimate business purposes, other than control, are served by holding such large blocks. Mr. LeBaron responded that "significant minority holdings" are common, especially in foreign countries. He said the practice is also common in the United States, and often is intended to lend stability to companies with which the holder has a significant business relationship. He noted as examples a major retailer's practice of owning a significant interest in its key suppliers and a computer company's recent purchase of a 20 percent interest in one of its major suppliers.

Secretary Regan's Remarks

When I was a youngster, growing up in Cambridge, the marketplace was an open-air series of fruit and vegetable stands, fish vendors, and an array of other merchants.

As I entered my professional career, the marketplace, to me, was the sometimes frenetic activity of the exchanges and dealers' trading pits.

In modern economics, the marketplace is our entire, dynamic system of commerce—from the same open-air markets that still flourish in Boston's North End to the multi-million-dollar transactions of the New York Stock Exchange.

Our American system of commerce—enterprise in freedom—has served us, as well as much of the world, spectacularly. The free markets of America have produced technologies, advancements and a standard of living unrivaled in history.

They have produced an economy that exceeds any other. And they have fostered a uniquely American entrepreneurial spirit that offers the means, the faith, and the drive for maintaining and even bettering the standards we enjoy.

There can be no comparison of achievement between our free market system and those systems around the world where democratic capitalism has been shunned. And, to be fully candid, even among some of the other western democracies, marketplace rigidities—in labor and capital—have caused some of our allies and trading partners to lag far behind the United States.

Yet, this afternoon I must inject a note of caution—perhaps, more accurately, a warning. For the past two decades our society has experienced an explosion of government regulation. And make no mistake, we have not been spared the results of our actions.

Yes, as I said, we have still outpaced other nations. And we maintain, in America, the most desirable society on earth. But, there *have* been unfortunate repercussions of our recent propensity for regulation and government involvement in the private sector.

The fallout? Higher prices, less efficiency, higher unemployment and lower productivity growth.

To continue to tamper and interfere with free market forces promises only more detrimental effects for our economy and our people.

Let me make clear here that I do not favor dismantling those regulatory agencies, laws and regulations that are truly necessary—for example, certain environmental protections and those dealing with public safety and health — nor the SEC.

But we can and need to do something about the inefficient, burdensome and in many cases worthless regulations that impede the economy and, in the final analysis, hurt the consumer.

One of the cornerstones of President Reagan's comprehensive economic program is deregulation—to scrap what we can and make better what we must keep. In my opinion much progress has been made. But there's more to be done.

As Treasury Secretary, I am very deeply involved in our efforts towards financial deregulation. I would like to share with you what we have found and what we can do about it.

As you all know, regulation of the financial services industry dates back further than two decades. Much, perhaps most of it, stems from the tumultuous and chaotic economic times of more than 50 years ago—the after-effects of the crash of the stock and money markets in 1929, and the next few years.

Well, 50 years ago was another era for most industries, including the financial industry. The social and economic conditions that bred those "reform" regulations are behind us, and we now approach the 21st century.

Why, in the last few years alone, the face of the financial services industry has changed tremendously, almost at an exponential rate. There's been a proliferation of new products, new services and new methods of conducting financial transactions. Financial institutions and consumers must be able to effectively deal with these changes.

At present, their ability to do so is greatly hindered. But, if we dismantle the outmoded and now obsolete regulations in a carefully organized manner, we will allow the market to operate as it should. And when the market is allowed to follow its course, the results are efficiency and responsiveness, from which industry and all Americans benefit.

Until we set the market free, the inefficiency and unresponsiveness remain. Large segments of the financial services industry will continue to struggle, attempting to remain competitive in a rapidly evolving marketplace, fighting regulations that once served a purpose, and now merely suppress innovation and entrepreneurial spirit.

It's true that some of the impediments have been removed already.

Just yesterday, as you know, Congress sent to the President a spending cut/revenue package that contained among other things repeal of the 30 percent withholding tax on securities held by foreigners.

This gives Treasury an opportunity to distribute issues to a class of international investors who heretofore declined to purchase those securities because of the withholding requirement. The prospect of broadening the investor base for Treasury securities should have a salutary effect on the domestic credit markets, and contribute to a freer flow of credit internationally.

As we always do, Treasury is evaluating alternative debt management techniques to minimize the cost of debt issuance in light of changing market developments.

The creativity of financial markets is evidenced by the constant emergence of new financing techniques. For instance, issuers have recently been offering "zero-coupon" securities which are discounted instruments that have characteristics favorable to certain long-term investors and to foreigners.

In fact, the Government securities market has been creating its own version of these securities by stripping coupons from bonds, which has benefited Treasury indirectly. Treasury is currently studying whether direct offering of such a security would bring more of the benefit directly to the Treasury. And we are studying other techniques as well.

It is the creativity and imagination, combined with responsible tax policy and debt management, which broadens the financial markets and makes them ultimately more efficient.

We actually started whittling away at the cumbersome and inefficient financial regulations several years ago.

The Depository Institutions Deregulation Committee (DIDC), established in 1980, began the process of loosening the ties that bind depository institutions during this Administration. The mandate was clear: Phase out interest rate controls, controls that were preventing consumers from obtaining a true return on their savings, and controls that were making it difficult for banks and thrifts to attract and hold deposits.

Among the benefits are more encouragment for saving, equity among depositors and the basis for a steadier flow of funds for home mortgage lending.

In 1982, we took another step with the Garn-St Germain Depository Institutions Act. This provided depository institutions with the very popular money market accounts, allowed thrifts to diversify their assets and strengthened insurance provisions to ease the assistance given to failing institutions.

That certainly moved the financial services industry in the right direction. But, it wasn't enough.

Since passage of Garn-St Germain, the Administration has been primarily concerned with fully opening the industry's competitive forces, while protecting the integrity and soundness of our banking system.

We have recommended that Congress promote competitive equity in the financial services industry in three fundamental ways. First, by increasing the products and services of depository institution holding companies so that they may compete with less regulated firms.

Second, by closing the nonbank bank loophole which allows diversified financial services firms to capture the centerpiece of today's banking—Federally insured deposits—while avoiding restrictions on interstate banking and nonbanking powers that are otherwise imposed on bank holding companies.

Third, by placing unitary thrift holding companies on substantially the same footing as bank holding companies.

All of these concerns are addressed in a balanced approach by the Administration's proposed Financial Institutions Deregulation Act, with which you are probably familiar.

I'm certain you are also aware of Senate Bill 2181—the Financial Services Competitive Equity Act—which was introduced by Senator Jake Garn.

The Garn bill basically is consistent with the Administration proposal, and represents policy that we would support in general.

Yesterday, Senator Garn's committee marked up a final bill which authorized substantial new securities powers for bank holding companies—including revenue bond underwriting and mortgage-backed securities.

Our view, pending the development of final language, is that the enactment of the Garn Bill in its current form would be worthwhile.

I am also happy to report that, today, the Supreme Court unanimously endorsed the authority of bank holding companies to acquire affiliates that are engaged principally in retail securities brokerage. This is clearly a victory for consumers and in full conformity with what the Senate Banking Committee did yesterday.

In another decision released today, the Court disapproved the underwriting of commercial paper by banks, but this decision will have little long-term effect if the Senate Banking Committee's action yesterday—in authorizing commercial paper underwriting for bank holding companies—remains in the bill through final passage.

I should point out that the two Supreme Court decisions, taken together, fully endorse the Administration's strongly held view that the deregulation of banking should occur through new powers for holding companies rather than banks.

We are unhappy, however, that the committee did not include insurance and real estate authority among the newly permitted activities for bank holding companies. These changes, we believe would be highly beneficial for consumers and would contribute to the future health of depository institutions.

The Administration will make every effort to get a bill passed before Congress adjourns. But only if such a bill incorporates most of the new financial services powers for the holding companies of depository institutions included now in the Garn bill.

We believe the public policy arguments underlying the Garn bill are compelling. Consumers would benefit from a wider variety of financial services and greater shopping convenience at competitively lower prices.

Financial service firms could compete under rules that are fairer to all. Depository institutions would be able to maintain their financial health by diversifying into other areas of financial services.

But this will only come about if Congress exercises its responsibility to oversee the deregulation and evolution of the financial system rather than acquiesce to its occurrence by court interpretations of obsolete laws, competition in laxity among the states, and the cross-purposes of Federal regulators.

I can tell you this from 35 years of experience on Wall Street: The market will not acquiesce. Ways will be found. Whatever is necessary will be done within the legal framework, as it is now being done. The market will always move forward.

It is a matter of survival and no series of laws can be drawn tightly enough to prevent a determined industry from expanding its franchises.

The only problem with this is that change will occur in a haphazard and chaotic manner, presenting substantial risk to the soundness of the entire industry.

We'll see more disarray, more fragmentation, more inequity and a growing threat to our system of depository institutions.

Instead of attempting to repeal the laws of economics and competition, Congress should set the rules to apply for the real world of today and provide a framework that will accommodate market dynamics in the future.

And, I must point out that I am quite a bit less than overjoyed with other bills being considered in the House. H.R. 5734, approved by Chairman St Germain's Banking Committee, while slightly better than the bill originally introduced, still offers no constructive contribution to the problems that Congress must address this year, and ignores the interest of consumers almost entirely.

The bill adopted by Congressman Wirth's subcommittee is even worse in both respects.

In essence, these proposals divide the financial services industry into sectors—largely determined by whether each firm involved is affiliated with a depository institution.

If such an affiliation exists, a firm is restricted to a narrow range of activities, insufficient over time—in my opinion—to maintain its health in the current and future competitive environments.

If a firm is not affiliated with a depository institution, it is free to respond to the demands of consumers, to compete and to grow in any line of business and anywhere in the country.

This distinction makes no sense as a matter of policy. Contrary to enhancing the safety and soundness of depository institutions, such legislation will weaken their long-term financial health and force these institutions to further contort themselves in attempts to get around the proposal's unrealistic distinctions.

It will also harm the interests of consumers by reducing the financial services available and increasing the price of those services that are offered.

What's most upsetting about H.R. 5734, and other thinking along the same lines, is that it refuses to face up to today's marketplace realities. It's a futile attempt to seek ways of stemming an incoming tide.

And it's risky to continue lingering with this issue. The longer Congress delays comprehensive action based on free market principles, the more the problem is compounded. We are courting the very real peril of allowing a new and undesirable industry structure to become so entrenched as to be practically, as well as politically, irreversible.

I know that some in the industry, including some in this audience, may consider the Administration's request inimical to their short-term interest. But we must remember that eventually everyone pays the price for an over-regulated and a poorly regulated environment.

I admonish your industry. Being too protective of your turf can cause the opposite effect. It's better to compete and help set the rules of competition, than to attempt to close your doors and risk more government regulation and interference.

As I've been saying for all of my professional career, competition is the best regulator.

It's time to unite behind sound and necessary public policy.

It's time for Congress to sort out the system we use for delivering financial services in this country and ensure that the consumers' interests are protected.

And it's time to trust in the marketplace. I think Ronald Reagan put it best: "The system of free enterprise has never failed us once. But we have failed the system every time we lose faith in the magic of the marketplace."

Thank you.

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