



# Federal Register

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**Thursday,  
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**Part II**

## **Securities and Exchange Commission**

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**17 CFR Part 240**

**Amendments to the Tender Offer Best-  
Price Rule; Proposed Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release Nos. 34-52968; IC-27193; File No. S7-11-05]

RIN 3235-AJ50

### Amendments to the Tender Offer Best-Price Rule

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** We are proposing amendments to the tender offer best-price rule to clarify that the rule applies only with respect to the consideration offered and paid for securities tendered in an issuer or third-party tender offer and should not apply to consideration offered and paid according to employment compensation, severance or other employee benefit arrangements entered into with employees or directors of the subject company. The proposed rule also would provide a safe harbor in the context of third-party tender offers that would allow the compensation committee or a committee performing similar functions of the subject company's or bidder's board of directors, depending on whether the subject company or the bidder is the party to the arrangement, to approve an employment compensation, severance or other employee benefit arrangement and thereby deem it to be such an arrangement within the meaning of the proposed exemption.

**DATES:** Comments should be received on or before February 21, 2006.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-11-05 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303. All submissions should refer to File Number S7-11-05. This file number should be included on the subject line

if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Brian V. Breheny, Chief, or Mara L. Ransom, Special Counsel, Office of Mergers & Acquisitions, Division of Corporation Finance, at (202) 551-3440.

**SUPPLEMENTARY INFORMATION:** We are proposing amendments to Rule 13e-4<sup>1</sup> and Rule 14d-10<sup>2</sup> under the Securities Exchange Act of 1934.<sup>3</sup>

### I. Executive Summary and Background

#### A. Reasons for the Proposed Amendments to the Best-Price Rule

The tender offer best-price rule<sup>4</sup> was adopted, as discussed in more detail below, to assure fair and equal treatment of all security holders of the class of securities that are the subject of a tender offer by requiring that the consideration paid to any security holder is the highest paid to any other security holder in the tender offer.<sup>5</sup> We are proposing amendments to the best-price rule for three reasons. First, we want to make it clear that compensatory arrangements between subject company employees or directors and the bidder<sup>6</sup> or subject company<sup>7</sup> are not captured by the application of the best-price rule. Second, we would like to alleviate the uncertainty that the various interpretations of the best-price rule by courts have produced. Finally, we want

<sup>1</sup> 17 CFR 240.13e-4.

<sup>2</sup> 17 CFR 240.14d-10.

<sup>3</sup> 15 U.S.C. 78a *et seq.*

<sup>4</sup> For purposes of this release, unless otherwise indicated, our references to the "tender offer best-price rule" or the "best-price rule" are intended to refer to both Exchange Act Rule 13e-4(f)(8)(ii) and Exchange Act Rule 14d-10(a)(2).

<sup>5</sup> See Amendments to Tender Offer Rules: All-Holders and Best-Price, Release No. 34-23421 (July 11, 1986) [51 FR 25873] (the "Rule 14d-10 Adopting Release").

<sup>6</sup> The term "bidder" is used throughout this release to refer to the offeror or purchaser in a tender offer.

<sup>7</sup> The term "subject company" is used throughout this release to refer to the company to be acquired in a business combination transaction or the company whose securities are the subject of the transaction, whether the transaction is agreed upon or unsolicited.

to remove any unwarranted incentive to structure transactions as statutory mergers, to which the best-price rule does not apply, instead of tender offers, to which it does apply.

Briefly, we propose to:

- Amend the language of Rules 13e-4(f)(8)(ii) and 14d-10(a)(2) to clarify that the best-price rule applies only with respect to the consideration offered and paid for securities tendered in a tender offer;

- Add a new provision to Rule 14d-10(c) to provide an exemption from the third-party best-price rule for the negotiation,<sup>8</sup> execution or amendment of payments made or to be made or benefits granted or to be granted according to employment compensation, severance or other employee benefit arrangements that are entered into by the bidder or the subject company with current or future employees or directors of the subject company; and

- For purposes of the exemption, add a new provision to Rule 14d-10(c) to include a safe harbor provision that provides that the compensation committee of the board of directors (or a committee performing similar functions) comprised solely of independent directors of the bidder or subject company, depending on which entity is party to the arrangement, may approve the employment compensation, severance or employee benefit arrangement and thereby deem it to be such an arrangement for purposes of the exemption.

#### B. History of the Adoption of the Best-Price Rule

Congress adopted the Williams Act in 1968 to address potentially abusive tactics such as "Saturday Night Specials" and "First-Come, First Served" offers.<sup>9</sup> The Williams Act amended the Exchange Act by adding the requirement for beneficial ownership reporting (Section 13(d)),<sup>10</sup> the procedural and disclosure requirements for purchases of securities by the issuer thereof (Section 13(e)),<sup>11</sup> and the procedural and disclosure requirements for third-party tender offers (Sections 14(d)-(f)).<sup>12</sup> With respect to tender offers, the Williams

<sup>8</sup> We do not believe that an analogous exemption is needed in the issuer best-price rule, Rule 13e-4(f)(8), although we solicit comment on whether that rule should be changed as well in this respect. See Section II.B. below.

<sup>9</sup> Hearings, Subcommittee on Securities, 90th Congress, First Session on S.510, March 21, 1967 at page 17.

<sup>10</sup> 15 U.S.C. 78m(d).

<sup>11</sup> 15 U.S.C. 78m(e).

<sup>12</sup> 15 U.S.C. 78n(d)-(f).

Act was designed to achieve two main purposes: assure that public security holders of the target company are provided with adequate disclosure, and eliminate practices in connection with tender offers that may result in unfair discrimination among, and pressure on, tendering security holders.<sup>13</sup> The second purpose was achieved through Congress's adoption of the substantive provisions of Section 14(d) of the Exchange Act<sup>14</sup> and the Commission's adoption of Regulation 14D.<sup>15</sup>

Based on the objectives of the Williams Act and the substantive protections afforded by Section 14(d)(7) of the Exchange Act,<sup>16</sup> which requires equal treatment of security holders, the staff of the Commission had taken the position that there were implicit requirements that a bidder make a tender offer to all holders of the subject securities and that the bidder make the offer to all holders on the same terms.<sup>17</sup> After questions arose regarding the applicability of this implicit all-holders requirement to issuer tender offers,<sup>18</sup> we adopted Rule 13e-4(f)(8) and Rule 14d-10 to codify the position that both an issuer tender offer and a third-party tender offer must be open to all holders of the class of securities subject to the tender offer (commonly referred to as the "all-holders rule"), and that all security holders must be paid the highest consideration paid to any security holder (commonly referred to as the "best-price rule"). The rules provide that no bidder shall "make a tender offer unless: (1) [t]he tender offer is open to all security holders of the class of securities subject to the tender offer; and (2) [t]he consideration paid to any security holder pursuant to the tender offer is the highest consideration

paid to any other security holder during such tender offer."<sup>19</sup>

### C. History of the Various Interpretations of the Best-Price Rule

Since the adoption of the best-price and all-holders rules, the best-price rule has been the basis for litigation brought in connection with tender offers in which it is claimed that the best-price rule was violated as a result of the bidder entering into new agreements or arrangements, or adopting the subject company's pre-existing agreements or arrangements, with security holders of the subject company.<sup>20</sup> The agreements or arrangements with security holders that most frequently are the subject of best-price rule litigation have involved employment compensation, severance or other employee benefit arrangements with employees or directors of the subject company—although certain commercial agreements also have been the basis for these actions.<sup>21</sup> When ruling on these best-price rule claims, courts generally have interpreted the best-price rule in two different ways—employing either an "integral-part test" or a "bright-line test" to determine whether the arrangement violates the best-price rule.

#### 1. The integral-part test

The integral-part test states that the best-price rule applies to all integral elements of a tender offer, including employment compensation, severance and other employee benefit arrangements or commercial arrangements that are deemed to be part of the tender offer, regardless of whether the arrangements are executed and performed outside of the time that the tender offer formally commences and expires.<sup>22</sup> In 1995, in *Epstein v. MCA Inc.*,<sup>23</sup> the United States Court of

Appeals for the Ninth Circuit was the first court to apply the integral-part test to an action brought pursuant to, *inter alia*, the best-price rule. The *Epstein* court rejected the defendants' argument that no liability existed pursuant to the best-price rule because a transaction between the bidder and one of the security holders of the subject company in a tender offer closed after the tender offer period expired. Instead, the Court held that "[a]n inquiry more in keeping with the language and purposes of Rule 14d-10 focuses not on when [the individual shareholder] was paid but on whether the [individual shareholder transaction] was an integral part of [the bidder's] tender offer."<sup>24</sup> Analyzing the transaction based on this test, the *Epstein* court held that "[b]ecause the terms of the [individual shareholder transaction] were in several material respects conditioned on the terms of the public tender offer, we can only conclude that the [individual shareholder transaction] was an integral part of the offer and subject to Rule 14d-10's requirements."<sup>25</sup> Courts following the integral-part test have ruled that agreements or arrangements made with security holders that constituted what they determined to be an integral part of the tender offer violate the best-price rule.<sup>26</sup>

#### 2. The Bright-Line Test

The bright-line test, on the other hand, states that the best-price rule applies only to agreements and arrangements executed and performed between the time a tender offer formally commences<sup>27</sup> and expires.<sup>28</sup> Both before and after the *Epstein* decision, jurisdictions following the bright-line test have held that agreements or arrangements with security holders of the subject company do not violate the best-price rule if they are not executed and performed "during the tender

<sup>13</sup> Hearings, Subcommittee on Securities, 90th Congress, First Session on S.510, April 4, 1967 at page 203.

<sup>14</sup> Hearings, Subcommittee on Securities, 90th Congress, First Session on S.510, March 21, 1967 at page 36.

<sup>15</sup> See the Rule 14d-10 Adopting Release.

<sup>16</sup> 15 U.S.C. 78n(d)(7).

<sup>17</sup> See Proposed Amendments to Tender Offer Rules, Release No. 34-22198 (July 1, 1985) [50 FR 27976] (stating that " \* \* \* implicit in these provisions, and necessary for the functioning of the Williams Act, are the requirements that a bidder make a tender offer to all security holders of the class of securities which is the subject of the offer and that the offer be made to all holders on the same terms.").

<sup>18</sup> *Id.* at 27977 (" \* \* \* questions have arisen recently regarding the applicability of the all-holders requirement \* \* \*" in referring to *Unocal Corp. v. Pickens*, 608 F. Supp. 1081 (C.D. Cal. 1985), in which the court held that a defensive issuer tender offer that excluded the hostile bidder who was also a shareholder of the issuer was lawful).

<sup>19</sup> Exchange Act Rule 13e-4(f)(8) (17 CFR 240.13e-4(f)(8)) and Exchange Act Rule 14d-10(a) (17 CFR 240.14d-10(a)).

<sup>20</sup> See, e.g., *Epstein v. MCA*, 50 F.3d 644 (9th Cir. 1995), *rev'd on other grounds sub nom. Matsushita Electrical Industrial Co. v. Epstein*, 516 U.S. 367 (1996); *Lerro v. Quaker Oats*, 84 F.3d 239 (7th Cir. 1996); *Walker v. Shield Acquisition Corp.*, 145 F. Supp.2d 1360 (N.D. GA 2001).

<sup>21</sup> *Id.*

<sup>22</sup> See *Epstein*, 50 F.3d 644; *Perera v. Chiron Corp.*, 1996 U.S. Dist. LEXIS 22503 (N.D. CA 1996); *Padilla v. MedPartners*, 1998 U.S. Dist. LEXIS 22839 (C.D. CA 1998); *Millionerros Investment Club v. General Electric*, 2000 U.S. Dist. LEXIS 4778 (W.D. CA 2000); *Maxick v. Cadence Design Systems*, 2000 U.S. Dist. LEXIS 14099 (N.D. CA 2000); *McMichael v. United States Filter Corp.*, 2001 U.S. Dist. LEXIS 3918 (C.D. CA 2001); *Karlin v. Alcatel, S.A.*, 2001 U.S. Dist. LEXIS 12349 (C.D. CA 2001); *Harris v. Intel Corp.*, 2002 WL 1759817 (N.D. CA 2002); *Cummings v. Koninklijke Philips Electronics, N.V.*, 2002 U.S. Dist. LEXIS 23383 (N.D. CA 2002); *In re: Luxottica Group S.p.A.*, 2003 U.S. Dist. LEXIS 21389 (E.D. N.Y. 2003).

<sup>23</sup> 50 F.3d 644.

<sup>24</sup> *Id.* at 655.

<sup>25</sup> *Id.*

<sup>26</sup> Although originally adopted by the Ninth Circuit in the *Epstein* case, decisions rendered by district courts in the Second and Third Circuits also have applied the integral-part test when addressing best-price rule claims. See, e.g., *Millionerros*, 2000 U.S. Dist. LEXIS 4778; *Luxottica*, 2003 U.S. Dist. LEXIS 21389.

<sup>27</sup> See Exchange Act Rule 13e-4(a)(4) (17 CFR 240.13e-4(a)(4)) and Exchange Act Rule 14d-2 (17 CFR 240.14d-2) (relating to procedures for formal commencement of tender offers).

<sup>28</sup> *Kramer v. Time Warner Inc.*, 937 F.2d 767 (2d Cir. 1991); *Lerro*, 84 F.3d 239; *Gerber v. Computer Associates Int'l*, 303 F.3d 126 (2d Cir. 2002); *In re Digital Island Securities Litigation*, 357 F.3d 322 (3d Cir. 2004); *Walker v. Shield Acquisition Corp.*, 145 F. Supp.2d 1360 (N.D. GA 2001); *Susquehanna Capital Group v. Rite Aid Corp.*, 2002 U.S. Dist. LEXIS 18290 (E.D. PA 2002); *Katt v. Titan Acquisitions, Inc.*, 244 F. Supp.2d 841 (M.D. TN 2003).

offer.”<sup>29</sup> In this regard, the United States Court of Appeals for the Seventh Circuit stated in *Lerro v. Quaker Oats Company*<sup>30</sup> that “[b]efore the offer is not ‘during’ the offer,” “[t]he difference between ‘during’ and ‘before’ (or ‘after’) is not just linguistic” and “\* \* \* the point of Rules 10b-13, 14d-10, and their cousins is to demark clearly the periods during which the special Williams Act rules apply.”<sup>31</sup>

### 3. Impact of Split in Court Interpretations

The resulting uncertainty regarding the interpretation of the best-price rule has made parties that are considering commencing a tender offer and intend to enter into or amend any agreements or arrangements with employees or directors of the subject company reluctant to engage in a tender offer.<sup>32</sup> We understand that this reluctance is present even if the negotiation, execution or amendment of any agreement or arrangement, or related payments, has no relation to the securities tendered by such employees or directors in a tender offer. Because the retention of key employees or directors, or the execution of definitive severance arrangements, can be such an important aspect of a merger or acquisition, the bidder and subject company are not likely to forgo entering into or modifying employment compensation, severance or other employee benefit arrangements in favor of retaining the tender offer structure. Instead, even where a tender offer may be the most attractive method of acquiring another company, the resulting uncertainty and the drastic consequences of a violation (payment of the per share value of the other arrangements to all security holders) have caused bidders to refrain from conducting tender offers, in favor of structuring extraordinary transactions as statutory mergers<sup>33</sup> where the best-price rule is inapplicable.<sup>34</sup> This disfavoring

of tender offers in favor of statutory mergers is contrary to our goals articulated in the adoption of Regulation M-A.<sup>35</sup>

#### *D. Proposed Approach to Addressing Split in Court Interpretations*

We do not believe that the best-price rule should be subject to a strict temporal test. We also do not believe that all payments that are conditioned on or otherwise somehow related to a tender offer, including payments under compensatory or commercial arrangements that are made to persons who happen to be security holders, whether made before, during or after the tender offer period, should be subject to the best-price rule. Accordingly, we are proposing amendments to the best-price rule that do not follow the approach of either the integral-part or the bright-line test. Instead, the proposed amendments would refocus the determination as to potential violations of the best-price rule on whether any consideration paid to security holders for securities tendered into an offer is the highest consideration paid to any other security holder for securities tendered into the tender offer.

The proposed amendments are premised on the view that the best-price rule was not intended to apply to consideration paid pursuant to arrangements, including employment compensation, severance or other employee benefit arrangements, entered into by the bidder or the subject company with the employees or directors of the subject company, so long as the consideration paid pursuant to such arrangements to persons that happen to be security holders was not to acquire their securities. As such, we are proposing amendments that establish that the best-price rule applies only to consideration paid for securities tendered. In light of the particular difficulties that have arisen under the existing rules regarding compensatory arrangements, we also are proposing an exemption and safe harbor regarding these arrangements in the context of

third-party tender offers. The fact that we are proposing a safe harbor for compensatory arrangements in third-party tender offers would not affect the impact of the proposed rule change on payments made pursuant to other arrangements, such as commercial arrangements, provided that the consideration paid is not for securities tendered.

The commercial realities of merger and acquisition transactions are that key employees (without any regard to their holdings of securities) may represent a significant portion of the value that inheres in a continuing business enterprise. Alternatively, it may be advantageous for those employees (again, without any regard to their holdings of securities) to be replaced or otherwise terminated after the transaction. To ensure that key employees remain with the subject company, or to ensure a smooth transition for employees who will not remain with the subject company after the transaction is complete, critical personnel decisions often are required to be made concurrently with decisions regarding whether to pursue a transaction with the subject company. While these decisions may be an “integral part” of the transaction of which the tender offer is a part, they also may have nothing to do with the consideration paid for securities tendered in the tender offer. Indeed, we believe that the fact that most recipients of such payments are security holders is pure happenstance insofar as these payments are concerned and that such payments would be made to the recipients whether or not they were security holders. We therefore believe that the proposed specific exemption from the third-party best-price rule for employment compensation, severance or other employee benefit arrangements strikes the proper balance between these realities and the statutory purpose of the best-price rule.

## II. The Current Proposals

### *A. Proposed Amendments to Rules 13e-4(f)(8)(ii) and 14d-10(a)(2)*

The premise of the best-price rule is that bidders must pay consideration of equal value to all security holders for the securities that they tender in a tender offer.<sup>36</sup> Accordingly, an analysis of the best-price rule must include a consideration of whether any security

<sup>29</sup> *Kramer*, 937 F.2d 767; *Gerber*, 303 F.3d 126; *Priddy v. Edelman*, 679 F. Supp. 1425 (E.D. Mich. 1988), *aff'd on other grounds*, 833 F.2d 438 (6th Cir. 1989).

<sup>30</sup> *Lerro*, 84 F.3d 239.

<sup>31</sup> *Id.* at 242.

<sup>32</sup> See, e.g., Dennis J. Block and Jonathan M. Hoff, *Developments Concerning SEC All Holders, Best Price Rules*, N.Y. L.J., June 28, 2001, at 5; Clifford E. Neimeth, *Inconsistent Application of the SEC's “All Holders-Best Price” Rule Continues to Chill Tender Offers*, *The Journal of Investment Compliance*, Winter 2002/2003, at 43.

<sup>33</sup> Statutory mergers are also known as “long-form” or “unitary” mergers, the requirements of which generally are governed by applicable state law.

<sup>34</sup> See, e.g., Stephen I. Glover, *Applying the Best Price Rule to Employee Retention Bonuses*, *The M & A Lawyer*, April 2001, at 26.

<sup>35</sup> 17 CFR 229.1000—229.1016. See Regulation of Takeovers and Security Holder Communications, Release No. 34-42055 (Oct. 22, 1999) [64 FR 61408] (“We also noted unnecessary differences in regulatory requirements between tender offers and other types of extraordinary transactions, such as mergers \* \* \*. Our goals in proposing and adopting these changes are to \* \* \* harmonize inconsistent disclosure requirements and alleviate unnecessary burdens associated with the compliance process \* \* \*.”). We acknowledge, however, that other factors, including the adoption of poison pills and staggered boards by companies and the passage of anti-takeover legislation by states, may otherwise have caused, and may continue to cause, bidders to refrain from conducting tender offers.

<sup>36</sup> “The objective of the \* \* \* best-price provision is to make explicit the requirements that issuers and bidders alike \* \* \* must pay every tendering security holder the highest consideration paid to any other security holder.” See the Rule 14d-10 Adopting Release at 25881.

holders have been paid additional or different consideration for the securities they tendered in the offer.<sup>37</sup>

Our proposed amendments recognize that if purchases of securities are deemed to be made as part of a tender offer, then the consideration paid for all securities tendered in the offer must satisfy the best-price rule. We propose to amend the best-price rule to establish clearly that it applies with respect to the consideration offered and paid for securities tendered in the tender offer. Specifically, we propose to revise the best-price rule to state that a bidder shall not make a tender offer unless “[t]he consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer.” In doing so, the clause “for securities tendered in the tender offer” would replace the current clauses “pursuant to the tender offer” and “during such tender offer” to clarify the intent of the best-price rule.

Congress and the Commission<sup>38</sup> have declined to define the term “tender offer” in consideration of the complex structure of acquisitions, the constant changes affecting tender offers and, most importantly, to avoid compromising substantive protections as a result of a narrowly construed definition.<sup>39</sup> The best-price rule was not intended to presuppose a bright-line standard such that a tender offer is always deemed to commence and expire as of a formal stated date.<sup>40</sup> The flexible

concept of a tender offer is consistent with the purpose of the best-price rule, in that it prevents bidders from impermissibly circumventing the rule. We do not intend to change this approach, and the elimination of the words “during the tender offer” would not do so.

The proposed revisions also would remove the potentially expansive concept of consideration paid “pursuant to” the tender offer in order to focus the analysis as to whether the consideration to which the best-price rule would apply was paid “for securities tendered in” the tender offer. While we believe that the best-price rule was not intended in all cases to be limited to formal stated dates, we also believe that the best-price rule was not intended to apply to all payments made to persons who happen to be security holders of a subject company, whether made before, during or after the formal tender offer period. After concluding that a tender offer exists, a proper analysis of whether the best-price rule has been violated must address whether each security holder was paid consideration equal to the consideration paid to all other security holders for securities tendered in the offer. The proposed language “for securities tendered in” would result in a narrower scope of consideration falling within the best-price rule than would potentially be the case if the integral-part test were applied.<sup>41</sup> Consideration paid under other arrangements, including compensatory and commercial arrangements, that is not consideration for securities tendered in the tender offer, also would fall outside the scope of the best-price rule.

It has been suggested that it would be appropriate to adopt a specific time frame during which the best-price rule would apply.<sup>42</sup> Certain of the

the procedural protections of Regulation 14E and, if the securities are registered pursuant to section 12 of the Exchange Act, Regulation 14D or, if the issuer has a class of equity securities registered pursuant to section 12 of the Exchange Act, or is required to file periodic reports pursuant to section 15(d) of the Exchange Act, or which is a closed-end investment company registered under the Investment Company Act of 1940, Rule 13e-4, including the best-price rule.

<sup>41</sup> We recognize that neither the integral-part test nor the bright-line test precedent specifically relies on the “pursuant to” provisions of Rule 13e-4(f)(8)(ii) or Rule 14d-10(a)(2) when deciding best-price rule actions. Most bright-line opinions focus on the “during” such tender offer provisions. We are proposing this amendment and providing this interpretive guidance to clarify for practitioners and the courts the proposed rule’s application.

<sup>42</sup> See, e.g., American Bar Association comment letter in response to changes to the regulations governing tender offers, mergers, going-private transactions and security holder communications proposed in Regulation of Takeovers and Security Holder Communications, Release No. 33-7607

Commission’s rules include such specific time frames during which those rules apply. For instance, the prohibitions contained in Rule 14e-5 apply “from the time of public announcement of the tender offer until the tender offer expires,”<sup>43</sup> and Rule 10b-18’s safe harbor generally is not available for purchases “[e]ffected during the period from the time of public announcement \* \* \* of a merger, acquisition, or similar transaction involving a recapitalization, until the earlier of the completion of such transaction or the completion of the vote by target shareholders.”<sup>44</sup> We believe, however, that it would be inappropriate to limit the application of the best-price rule to a specific time frame, as the abuses at which the best-price rule is aimed are not triggered by particular time frames.

*Request for comment:*

- What effect would the removal of “during” from the best-price rule have on the bright-line case law precedent? Would the change in this language broaden the scope of potential future claims to include allegations that payments made at any time violate the best-price rule?

- If the “for securities tendered” language is added to the best-price rule, would employees and directors who enter into arrangements with the bidder or subject company, and who do not tender their securities into a tender offer, avoid the strictures of the best-price rule? Is this the appropriate outcome of the proposed amendment? Would a similar outcome result under the current language of the best-price rule? If this outcome is a possibility, should we revise the proposed language of the best-price rule so that the best-price rule would apply to arrangements entered into by employees and directors with the bidder or subject company regardless of whether they tender their securities in the offer?

- If officers or directors recommend that security holders tender into the transaction but, in order to avoid

(Nov. 3, 1998) in File No. S7-28-98, Apr. 30, 1999, which states “[i]t is important that there be a “bright line” test to measure the time period during which the restrictions under Rule 14e-5 (as well as Rule 14d-10) are applicable;” Michael D. Ebert, “During the Tender Offer” (or some other time near it): *Insider Transactions Under the All Holders/Best Price Rule*, 47 Vill. L. Rev. 677 (2002); Jason K. Zachary, *Love Me Tender, Love Me True: Compensating Management and Shareholders under the “All-Holders/Best-Price” Rule*, 31 Sec. Reg. L.J. 81 (2003).

<sup>43</sup> Exchange Act Rule 14e-5(a) (17 CFR 240.14e-5(a)).

<sup>44</sup> Exchange Act Rule 10b-18(a)(13) (17 CFR 240.10b-18(a)(13)). See *Purchases of Certain Equity Securities by the Issuer and Others*, Release No. 34-48766 (Nov. 17, 2003) [68 FR 64952].

<sup>37</sup> This analysis assumes, of course, that the transaction is a tender offer. For purposes of this release, we assume the presence of a tender offer and, therefore, the application of the best-price rule.

<sup>38</sup> Although the Commission proposed to define the term “tender offer” in 1979, no such definition has been adopted. See *Proposing Release Regarding Amendments to Tender Offer Rules*, Release No. 34-16385 (Nov. 29, 1979) [44 FR 70349].

<sup>39</sup> *Id.* at page 70349 (“This position has been premised upon the dynamic nature of these transactions and the need for the Williams Act to be interpreted flexibly in a manner consistent with its purposes to protect investors. Consequently, the Commission specifically declined to define the term \* \* \*”).

<sup>40</sup> We recognize that certain courts have wrestled with the concept of “whether” a tender offer exists as opposed to “when” a tender offer begins and ends. See, e.g., *Epstein*, 50 F.3d at 656 (“Rule 14d-10 does not prohibit transactions entered into or effected before, or after, a tender offer—provided that all material terms of the transaction stand independent of the tender offer.”) Often, however, these questions cannot be determined independently of each other. Depending on the facts, multiple purchases of a subject company’s securities over an extended period of time may be determined to be private transactions or open market purchases or, alternatively, multiple purchases may be deemed to be a tender offer. If the purchases are deemed a tender offer, then, beginning with the first purchase, the security holders who sold their securities should have had

implicating the best-price rule, the same officers or directors opted to withhold tendering their own securities, what would be the outcome? Could this result in an alleged breach of fiduciary duty? What effect or impact is this type of behavior likely to have on tender offers? Would it discourage officers or directors from recommending that security holders tender into the offer?

#### B. Proposed Amendments to Rule 14d-10(c)

We propose to revise Rule 14d-10 to include not only the general provision that the best-price rule applies solely to payments in consideration for securities tendered in a tender offer, but also a specific exemption from the third-party best-price rule for the following:

The negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such arrangements, with respect to employees and directors of the subject company, where the amount payable under the arrangement: (i) Relates solely to past services performed or future services to be performed or refrained from performing, by the employee or director (and matters incidental thereto), and (ii) is not based on the number of securities the employee or director owns or tenders.<sup>45</sup>

We believe that amounts paid pursuant to employment compensation, severance or other employee benefit arrangements should not be considered when calculating the price paid for tendered securities. These payments are made for a different purpose.

We are not proposing an analogous exemption to the issuer best-price rule. We do not believe that issuers generally have the same need to negotiate, execute or amend compensatory arrangements when they structure and commence tender offers and, thus, the additional clarification afforded by such an exemption is unnecessary. We solicit comment, however, on whether adopting a similar exemption from the issuer best-price rule is necessary or would be practical.

#### 1. Requirements of the Exemption

For purposes of the exemption included in proposed Rule 14d-10(c), the amounts to be paid pursuant to such an arrangement must:

- Relate solely to past services performed or future services to be performed or refrained from performing (e.g., covenants not to compete), by the employee or director, and matters incidental thereto; and

- Not be based on the number of securities the employee or director owns in the subject company.<sup>46</sup> We have included these additional requirements to ensure that the amounts paid pursuant to employment compensation, severance or other employee benefit arrangements are based on legitimate compensatory reasons. Under our proposed amendments to the third-party best-price rule, part of the consideration required for the exemption must be past or future services, or refraining from performing such services.

The requirement in the proposed amendments to the third-party best-price rule that the amounts payable under the employment compensation, severance or other employee benefit arrangement must not be based on the number of securities the employee or director owns is intended to exclude from the exemption those types of arrangements to which the best-price rule is intended to apply. Specifically, if the payments to be made pursuant to an arrangement are proportional to or otherwise based on the number of securities held by the employee or director, then this relationship between the payment and the securities would defeat the purpose of the exemption and would, accordingly, subject the payments to the application of the third-party best-price rule.

While the exemption that we have proposed specifically covers employment compensation, severance and other employee benefit arrangements and thus does not specifically extend to other arrangements, such as commercial arrangements, the fact that an arrangement does not fall within the exemption would not raise any inference that the arrangement constitutes consideration paid for securities tendered in a tender offer. We have proposed a new instruction to Rule 14d-10 to that effect.

#### Request for comment:

- The proposed rule does not specifically define or refer to examples of employment compensation, severance or other employee benefit

<sup>46</sup> Our proposals do not address whether the employment compensation, severance or other employee benefit arrangements need always be for the purpose of incentivizing an individual with respect to future performance. We recognize that there are instances in which the issuance of additional consideration may be necessary to serve a contrary purpose, such as to persuade departing employees to relinquish or renegotiate long-term employment contracts, golden parachutes and other arrangements that the bidder would prefer not to honor upon successful consummation of the tender offer. These arrangements also can fall within the exemption under the proposed amendments.

arrangements that would be captured in the exemption. Should we define these arrangements? If so, would a definition similar to Instruction 7(ii) to Item 402(a)(3) of Regulation S-K<sup>47</sup> be helpful? Alternatively, or perhaps in addition to providing a definition, would it be more helpful if we gave examples? If so, what examples of employment compensation, severance and employee benefit arrangements should be included? Are we risking making the exemption too broad by providing a list of examples (e.g., would parties simply call the arrangement something in the list, even where it is some other arrangement entirely, in the hopes of triggering application of the exemption)?

- Should we include a list of non-exclusive factors in our proposed amendments to Rule 14d-10(c) to assist bidders and subject companies in making a determination as to whether an employment compensation, severance or employee benefit arrangement falls within the exemption? Such factors could include: Timing of the execution of the arrangements; timing of payments to be made pursuant to the arrangements; the reasonable and customary nature of the arrangements; endorsement or recommendation of the tender offer; and whether the arrangement is conditioned on tendering into the tender offer. Should we include additional factors or modify or exclude some of these proposed factors? Is there a certain factor or combination of factors that should always be present to conclude that an arrangement falls within the exemption? Should a certain factor or combination of factors be deemed dispositive as to whether an arrangement falls within the exemption? Would the inclusion of the non-exclusive factors be helpful in determining what arrangements fall within the exemption? Would some or all of these factors currently be considered by boards of directors and courts when deciding whether an arrangement falls within the exemption? If the non-exclusive factors were not included in the proposed rule, would it be helpful if a discussion of certain non-exclusive factors were included in the adopting release?

- What would be the impact on the proposed rule if an exemption for commercial arrangements also was included in the best-price rule? Should we expand the proposed amendment to Rule 14d-10(c) to cover any commercial arrangement (e.g. distribution rights arrangements) where the party received an economic benefit beyond the price

<sup>47</sup> 17 CFR 229.402(a)(3).

<sup>45</sup> See proposed Exchange Act Rule 14d-10(c)(2).

paid for the securities? Some commenters have raised this issue in their analysis of the judicial precedent to date. Are the proposed amendments to Rule 14d-10(a)(2) broad enough to provide commercial arrangements protection from the potential application of the best-price rule?

- The proposed exemption would require that the arrangement relate to past or future services and matters incidental thereto. We solicit comment on the appropriateness of this requirement. Specifically, should we give guidance as to what evidence would be necessary to prove that the agreement or arrangement relates to past or future services? Is it clear what the clause "matters incidental thereto" would capture? Should we give guidance as to what this was intended to cover?

- The proposed exemption would require that the payments made pursuant to an arrangement not be based on the number of securities the employee or director owns or tenders. We solicit comment on the appropriateness of this requirement. For example, would it be helpful if we included the word "specifically" in front of the requirement "based on the number of securities the employee or director owns or tenders?" Should we give guidance as to what standard would be applied to avoid having payments be based on the number of securities owned or tendered?

- The proposed exemption would cover arrangements or agreements entered into with employees and directors of the subject company. Should the exemption be restricted to only such employees and directors? Is it possible that these types of arrangements or agreements would be entered into with employees and directors of the bidder?

- Would the proposed exemption help alleviate the litigation risk currently posed by the best-price rule? Would it make it less likely that cases involving a violation of the best-price rule survive a summary judgment motion, and, if so, is this preferable?

- Should we amend the issuer tender offer rules contained in Rule 13e-4 to provide a similar exemption? Are similar issues present in issuer tender offers, particularly where a going-private transaction is involved? Would the failure to include a similar exemption with respect to the issuer tender offer rules contained in Rule 13e-4 create a negative implication that employment compensation, severance and other employee benefit arrangements would or should be covered by the issuer best-price rule?

## 2. The Compensation Committee Safe Harbor

To provide increased certainty to bidders and subject companies in connection with the application of the third-party best-price rule to employment compensation, severance and other employee benefit arrangements, we propose to amend Rule 14d-10(c) to include a non-exclusive safe harbor provision. The safe harbor provision would allow the compensation committee or a committee performing similar functions of the subject company's or bidder's board of directors, depending on whether the subject company or the bidder is the party to the arrangement, to approve an employment compensation, severance or other employee benefit arrangement and thus have it deemed to be an arrangement within the exemption of the proposed rule.<sup>48</sup> The proposed safe harbor would require that the compensation committee or the committee performing similar functions be comprised solely of independent directors. Specifically, the proposals would add the following sentence to new proposed Rule 14d-10(c)(3):

For purposes of paragraph (c)(2) of this section, pursuant to this non-exclusive safe harbor, an arrangement shall be deemed an employment compensation, severance or other employee benefit arrangement if it is approved as meeting the requirements of paragraphs (c)(2)(i) and (ii) of this section by the compensation committee of the subject company's or bidder's (depending on whether the subject company or bidder is a party to the arrangement) board of directors. If that company's board of directors does not have a compensation committee, the arrangement shall be deemed an employment compensation, severance or other employee benefit arrangement if it is so approved by the committee of that board of directors that performs functions similar to a compensation committee. In each circumstance, the arrangement shall be deemed an employment compensation, severance or other employee benefit arrangement only if the approving compensation committee or the committee performing similar functions is comprised solely of independent directors.<sup>49</sup>

We believe that this proposed non-exclusive safe harbor provision strikes a proper balance between the need for certainty in planning and structuring proposed acquisitions and the statutory purposes of the third-party best-price rule. The fiduciary duty requirements of board committee members, coupled

<sup>48</sup> Where the bidder or subject company does not have an established compensation committee, one or more directors who have been selected to form a committee that conducts similar functions as a compensation committee may be used for purposes of this safe harbor.

<sup>49</sup> See proposed Exchange Act Rule 14d-10(c)(3).

with significant advances in the independence requirements for compensation committee members<sup>50</sup> and recent advances in corporate governance, suggest that independent compensation committee members and groups of independent board members provide the necessary safeguards to approve as employment compensation, severance or other employee benefit arrangements only arrangements that fall within those categories, and would be thus subject to the exemption.

Any action by a compensation committee or other group of directors that violates a fiduciary duty generally would be an issue of state law.<sup>51</sup> An approval in accordance with the proposed rule that comprised such a violation would, as a result, be subject to state law remedies but would not necessarily result in a violation of the third-party best-price rule.

We recognize that, under certain circumstances, security holders of the subject company may not be able to make a successful claim of a breach of fiduciary duty for actions taken by the bidder's compensation committee or other group of directors because fiduciary duties generally are not owed to prospective security holders.<sup>52</sup> We do not believe that this eliminates the utility of the safe harbor because the bidder's directors are obligated to act in the best interests of the security holders of the bidder, who likely will remain security holders of the combined company. Further, security holders of the subject company may have breach of fiduciary duty remedies available where members of the subject company board of directors recommend that security

<sup>50</sup> See e.g., Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc. Order Approving Proposed Rule Changes, Release No. 34-48745 (Nov. 4, 2003) [68 FR 64154]. See also 303A.05 of the New York Stock Exchange's Listed Company Manual (requiring the compensation committee to be comprised solely of independent directors); Rule 4350(c) of the NASDAQ's Marketplace Rules for Listed Companies (requiring compensation to be approved by independent directors). While the NASD listing standards do not mandate the establishment of a compensation committee, they do require that the compensation of the CEO of a listed company be determined or recommended to the board by either a majority of the independent directors or a compensation committee comprised solely of independent directors.

<sup>51</sup> See e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003). See generally, Dennis J. Block, Stephen A. Radin and Nancy E. Barton, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (5th ed.).

<sup>52</sup> See e.g., *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A. 2d 1171 (Del. 1988), *Sanders v. Devine*, 1997 Del. Ch. LEXIS 131 (Del. Ch. Sept. 24, 1997).

holders tender into a tender offer that contemplates employment compensation, severance or other employee benefit arrangements to be granted to employees or directors.

For purposes of determining whether the members of the bidder's or the subject company's compensation committee or the committee performing similar functions are independent, we propose to include an instruction to Rule 14d-10(c)(3) providing that if the bidder or the subject company, as the case may be, is a listed issuer whose securities are listed on a registered national securities exchange or in an automated inter-dealer quotation system of a national securities association that has independence requirements for compensation committee members, the independence standards for compensation committee members as defined in the listing standards applicable to listed issuers should be used. Alternatively, if the bidder or the subject company is not a listed issuer, in determining whether a member of the compensation committee is independent, the bidder or subject company would use a definition of independence of a national securities exchange or a national securities association, so long as whatever definition is chosen is used consistently for all members of the compensation committee.<sup>53</sup>

*Request for comment:*

- We have proposed that either the bidder's or the subject company's (depending which entity is a party) compensation committee or similar committee would be allowed to approve the arrangement. Will the respective state law fiduciary duties protect security holders' interests in these arrangements? For example, is it clear that the compensation committee members of the entity approving an arrangement will owe fiduciary duties to the security holders of that entity? If the compensation committee of the bidder does not owe fiduciary duties to subject company shareholders, are there alternative remedies available to protect their interests? What if the arrangement that is entered into between the subject company and the employee or director provides for payment over an extended period of time? Would that implicate a fiduciary duty of the bidder to its security holders for future obligations? Are there other state law protections apart from those arising from fiduciary duties? Can the safe harbor be modified

to work better with state law protections?

- Could the proposed safe harbor be relied on in both negotiated or "friendly" tender offers and unsolicited or "hostile" tender offers? Should changes be made to the language of the proposed safe harbor to make it clear that the safe harbor can or cannot be relied on in hostile transactions? Would the hostile nature of a takeover preclude the ability to negotiate arrangements that would involve additional consideration that would violate the best-price rule?

- For those companies, such as small business issuers, that may not have established a compensation committee or a committee performing similar functions, would full board approval provide an equally useful standard in establishing that the arrangement falls within the safe harbor? If so, would it matter whether or not the full board was comprised of at least a majority of independent directors, utilizing the independence standard provided in the instruction to the proposed safe harbor?

- The proposed safe harbor benefits are available only if the arrangements are approved by the compensation committee or a committee performing similar functions. Should the language of the safe harbor require, as a basis for reliance on the safe harbor, approval of specific arrangements? Are there circumstances under which approval for entire plans or arrangements would be sufficient? Do bidders in a tender offer enter into employment compensation, severance or other employee benefit arrangements with officers or directors of the subject company without first obtaining compensation committee approval? Do compensation committees generally set broad parameters that the officers of the company use when negotiating and entering into compensation arrangements?

- Should we address specifically the timing of the approval of the compensation committee (or the committee performing similar functions) of arrangements for purposes of the safe harbor? Should benefits granted or to be granted to an employee or director in connection with a tender offer pursuant to existing employment compensation, severance or other employee benefit arrangements that were approved by the compensation committee or the full board of directors when adopted be eligible for the safe harbor protections? If the proposal is adopted, should the safe harbor have retroactive applicability? If so, should the safe harbor be available for arrangements approved not sooner than, for example, the date the changes to the listing

standards of the New York Stock Exchange requiring that the compensation committee be comprised solely of independent directors were adopted, or is some other date appropriate?

- If a member of the compensation committee or a committee performing similar functions is a party to the employment compensation, severance or other employee benefit arrangement, should the safe harbor still be available? Should the safe harbor address recusal or leave it to the committee members to determine how to handle this or similar situations that may arise?

- Is the independence test that is tied to the listing standards sufficient? Should we define "independent" by some other standard? Should the subject company directors also be independent from the bidder? Should we consider using the Non-Employee Director standard used in Rule 16b-3(d)?<sup>54</sup>

- How would the independence test affect bidders that are foreign private issuers? Should we consider an alternative standard for foreign private issuers? Will the fiduciary duties of the members of the compensation committee of a foreign private issuer adequately serve to ensure that the agreement or arrangement falls within the exemption?

- Should we consider allowing the compensation committee or the committee performing similar functions to rely exclusively on the opinion of a compensation consultant in making its determination that an agreement or arrangement falls within the exemption for purposes of the proposed best-price rule amendments?

- If a bidder or subject company intended to rely on the proposed safe harbor, is it clear, based on existing rules and regulations, whether such reliance would be required to be disclosed in the tender offer documents? If not, should a specific requirement be adopted to ensure that adequate disclosure would be made to the security holders? Should reliance on the safe harbor be conditioned on corresponding disclosure by the bidder or subject company, as appropriate, about how the safe harbor was satisfied, including what factors were used in determining that the arrangement was deemed an employment compensation, severance or other employee benefit arrangement?

- If we were to include a list of non-exclusive factors in our proposed amendments to Rule 14d-10(c) to assist bidders and subject companies in making a determination as to whether

<sup>53</sup>This approach is consistent with the disclosure requirements regarding nominating committee member independence contained in Item 7 of Schedule 14A (17 CFR 240.14a-101).

<sup>54</sup>17 CFR 240.16b-3(d).



an employee compensation, severance or employee benefit arrangement falls within the exemption, should we require that the compensation committee, or a committee performing similar functions, examine the non-exclusive factors in connection with its determination as to what arrangements fall within the exemption for purposes of the safe harbor?

- To what extent would the proposed safe harbor provide bidders and subject companies with an adequate means to avoid implicating the best-price rule when it comes to employment compensation, severance and other employee benefit arrangements? Is there a risk that the proposed safe harbor would merely shift scrutiny by the courts to the determination as to whether the compensation committee has properly exercised its duties? Is that an appropriate outcome? Should approval that a court determines violates a fiduciary duty result in loss of the safe harbor? Will the fiduciary duties of the members of the compensation committee or a committee performing similar functions adequately serve to ensure that the agreement or arrangement falls within the exemption? Are there impediments to seeking judicial review of a determination that the agreement or arrangement falls within the exemption? Will the bidder's incentive to consummate a transaction impede the compensation committee members' exercise of their fiduciary duties? Will the fact that the members of the subject company's compensation committee may not be part of the ongoing business operation after the consummation of the transaction impede the exercise of their fiduciary duties?

*General request for comment:*

- Would the proposed amendments accomplish the goal of clarifying the scope of Rule 14d-10? If not, what other or additional language would accomplish this goal more effectively?

- Should we amend the issuer best-price rules as well as the third-party best-price rules? Are there issues that differ in issuer tender offers such that we should not consider making uniform changes to both sets of best-price rules? Would the failure to make uniform changes to both sets of best-price rules create any implication that employment compensation, severance and other employee benefit arrangements, as well as other commercial arrangements, would or should be covered by the issuer best-price rule? How should we address any such implication?

- Would it be appropriate to also include a *de minimis* exclusion to the best-price rule? For example, would it

be appropriate to carve out of the application of Rule 14d-10 the negotiation or execution of any employment compensation, severance or other employee benefit arrangement with an employee or director of the subject company who, together with any affiliates, beneficially owns less than a nominal threshold amount (e.g., 1% of the class of securities that is the subject of the tender offer)?

### III. Request for Comment

Any interested persons wishing to submit written comments on the proposals, as well as on other matters that might have an impact on the proposals, are requested to do so. We solicit comments from the point of view of bidders, subject companies, other participants in transactions, security holders of bidders and subject companies and other investors.

### IV. Paperwork Reduction Act

We have not prepared a submission to the Office of Management and Budget under the Paperwork Reduction Act of 1995 because the proposals do not impose recordkeeping or information collection requirements, or other collections of information requiring the approval of the Office of Management and Budget.

### V. Cost-Benefit Analysis

The overall objective of the proposed reforms is to make it clear that employment compensation, severance and other employee benefit arrangements between subject company employees or directors and the subject company or bidder are not captured by the application of the best-price rule. We also seek to alleviate the uncertainty bidders and subject companies face in planning and structuring third-party and issuer tender offers due to varying judicial interpretations of the best-price rule. Finally, we want to remove any unwarranted incentive to structure transactions as statutory mergers, to which the best-price rule does not apply, instead of tender offers, to which it does apply.

#### A. Benefits

We believe that the proposed rules would benefit bidders because the amendments would have the effect of correcting unintended consequences of the present regulatory scheme, which has been interpreted by certain courts to include compensation merely due to the time in which the compensation was offered or paid. Further, the proposed safe harbor would provide bidders and subject companies with the ability to ensure that the compensation being

awarded to employees and directors of the subject company does not run afoul of the best-price rule by providing greater certainty as to the situations in which the compensation being granted is outside the rule. Finally, these amendments also would provide parties that are in the process of negotiating mergers and acquisitions with greater flexibility in determining which structure they choose to effectuate the transaction.

Presently, a split by courts in their interpretation of the best-price rule has left bidders with uncertainty as to the application of the best-price rule. Because the proposed amendments to the best-price rule are intended to clarify the application of the best-price rule, thereby mitigating the uncertainty of potential litigation risk, the costs of litigation being avoided could be significant. We believe that this serves as the primary benefit of the proposed amendment as the costs of litigation borne by security holders of bidders choosing to engage in tender offers where the best-price rule is applicable could be avoided.

The proposed amendments also would benefit security holders in that the proposed changes accomplish the aforementioned purposes without undermining the statutory objective of ensuring that all tendering security holders are paid the highest consideration paid to any other security holder tendering into the offer. Without the proposed amendments, bidders, subject companies and security holders may have difficulty determining what constitutes the "highest consideration" when bidders conduct a tender offer at the same time employees or directors of the subject company enter into employment compensation, severance or other employee benefit arrangements with the bidder or subject company.

We do not believe that clarification of the best-price rule by virtue of the proposed amendments is likely to result in a modification of behavior on the part of bidders or subject companies in entering into employment compensation, severance or other employee benefit arrangements with employees or directors. We do, however, believe that the proposed amendments may provide bidders and subject companies with more options when they are determining a means to accomplish mergers and acquisitions. Absent the changes being proposed to the best-price rule, we understand that some bidders have avoided engaging in tender offers for fear of being subject to litigation regarding the application of the best-price rule.

We solicit quantitative data to assist our assessment of the benefits of the amendments to the best-price rule.

#### B. Costs

We note that the conduct the proposed rule prohibits already is prohibited by the existing rule and related statute. Therefore, the amended best-price rule does not add any additional requirements. Rather, it more clearly prohibits certain conduct by clarifying the language of the best-price rule and adds a means by which bidders can ensure, via a safe harbor, that they are complying with the rule. In that regard, compliance with the best-price rule could be achieved in the same manner and by the same persons responsible for compliance under the current rule. We understand that, to take advantage of the safe harbor, bidders and subject companies may need to take extra steps to ensure compliance with the rule, but such compliance could entail a relatively small burden. Most bidders and subject companies already are required to have a compensation committee or a committee performing similar functions, so the cost of forming, organizing and convening a committee should be a cost that already is being incurred by the bidder or subject company. Further, it may be likely that many bidders or subject companies already ensure that their compensation committee or a committee performing similar functions approve employment compensation, severance or other employee benefit arrangements. Such bidders or subject companies likely would not incur additional costs to comply with the best-price rule and, for those that are not already engaging their compensation committee to perform this function, the cost should be limited to the time and expense associated with reviewing the specific arrangement and holding a meeting of the committee.

While we believe that the proposed changes to the best-price rule and, more specifically, the safe harbor, would provide increased certainty to bidders and subject companies in structuring tender offers, the proposed rule does not eliminate the potential costs of litigation entirely, including those that arise under state law. Security holders may claim that members of the compensation committee or a committee performing similar functions have breached their state fiduciary duties owed to security holders in approving employment compensation, severance or employee benefit arrangements entered in connection with a tender offer. Whether such behavior will be identifiable on the part of potential plaintiffs such that a successful claim can be made against

members of the board of directors for breach of their fiduciary duties in approving the arrangement is uncertain. As a result, the potential costs associated with identifying the alleged illegal behavior and bringing a claim of liability could be imposed on potential plaintiffs. However, such costs currently would exist to the extent transactions are structured not to be tender offers.

Overall, we believe that the proposed amendments to the rule would impose minimal costs, if any, on bidders and subject companies and would support investor protection.

- What are the direct and indirect costs associated with the proposed rules?
  - Would there be increased costs for compliance with the best-price rule in order to take advantage of the proposed safe harbor or are companies already implementing the steps necessary to take advantage of the proposed safe harbor, such that no additional costs would be applicable to the proposed amendment to the rule?
  - Would there be increased costs associated with shifting the litigation from claims of violations of the best-price rule under federal law as compared to claims of breach of fiduciary duties under state law? What is the implication for such costs given that such litigation currently arises under state law for transactions that are structured not to be tender offers?
- We solicit quantitative data to assist our assessment of the costs associated with compliance with the best-price rule.

#### C. Small Business Issuers

Although the proposed rules apply to small business issuers, we do not anticipate any disproportionate impact on small business issuers. Like other issuers, small business issuers should incur relatively minor compliance costs, and should find it unnecessary to hire extra personnel. The issues of equal treatment among security holders in the context of tender offers affect small companies as much as they affect large companies. Thus, we do not believe that applying the proposed rules to small business issuers would be inconsistent with the policies underlying the small business issuer disclosure system.

### VI. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act<sup>55</sup> and Section 2(c)<sup>56</sup> of the Investment

Company Act of 1940<sup>57</sup> require the Commission, whenever it engages in rulemaking, to consider or determine if an action is necessary or appropriate in the public interest and to consider whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>58</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed amendments to the best-price rule are intended to improve on market efficiency by providing greater clarity to bidders, subject companies and security holders as to the situations in which compliance with the best-price rule has been met. This would facilitate the planning and negotiation of tender offers by clarifying the application of the best-price rule when an employment compensation, severance or other employee benefit arrangement is expected to be entered into.

As to the impact on competition, the proposed amendments to the best-price rule are intended to have a positive impact on competition for the same reasons that the proposed amendments would have a positive impact on market efficiency—companies desiring to merge with or acquire another company by conducting a tender offer would have the benefit of the amendments to the best-price rule that more clearly delineate the instances in which the negotiation or execution of employment compensation, severance or other employee benefit arrangements would not run afoul of the requirements of the best-price rule. It is possible, however, that because bidders and subject companies may desire to take advantage of the amendment to the best-price rule that provides for a safe harbor where the compensation committee, or committee performing similar functions, approves the arrangement, bidders and subject companies may need to reevaluate whether they have adequate policies and procedures in place for their compensation committee. Bidders and subject companies that do not consider using the safe harbor may be at a competitive disadvantage as compared to those bidders and subject companies that do because, absent the safe harbor, bidders and subject companies are

<sup>55</sup> 15 U.S.C. 78c(f).

<sup>56</sup> 5 U.S.C. 80a-2(c).

<sup>57</sup> 15 U.S.C. 80a-1 *et. seq.*

<sup>58</sup> 15 U.S.C. 78w(a)(2).

potentially subject to lawsuits alleging a violation of the best-price rule if they negotiate or execute employment compensation, severance or other employee benefit arrangements that are outside the terms of the safe harbor.

In this regard, we request comment regarding the degree to which our proposed changes to the best-price rule would create competitively harmful effects on public companies, and how to minimize those effects.

The proposed amendments should promote capital formation since the amendments seek to eliminate the uncertainty caused by the varying judicial interpretations of the best-price rule, which would remove any disincentive to the use of tender offers as a means to accomplish mergers and acquisitions. The clarifications to the best-price rule would have the added effect of leveling the regulatory playing field between statutory mergers and tenders offers, which we understand has been disfavored recently in favor of statutory mergers because the best-price rule is not applicable to statutory mergers. Further, for similar reasons, these proposed amendments would promote investor confidence in the tender offer context, as well as in the market as a whole, which would further contribute to capital formation. Nevertheless, it is possible that the safe harbor exclusion from the amended best-price rule may serve to impede capital formation because of the additional time that may need to be spent in ensuring that the compensation committee or committee performing similar functions approves the employment compensation, severance or employee benefit arrangement. We believe, however, that any additional time and effort that may be expended in order to take advantage of the safe harbor from the best-price rule would be appropriate in order to ensure that the best-price rule continues to serve its purpose in ensuring equal treatment among security holders.

The possibility of these effects, their magnitude, if they were to occur, and the extent to which they would be offset by the costs of the proposals are difficult to quantify, and we request comment on how the proposed amendments to the best-price rule, if adopted, would affect efficiency and capital formation. Where empirical data or other factual support is available, we encourage commenters to provide it.

## VII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates

to proposed revisions to the best-price rule under the Exchange Act to clarify that the rule applies only with respect to the consideration offered and paid for securities tendered in an issuer or third-party tender offer and should not apply to consideration offered and paid according to employment compensation, severance or other employee benefit arrangements entered into with employees or directors of the subject company.

### A. Reasons for the Proposed Action

The best-price rule was adopted originally to assure fair and equal treatment of all security holders of the class of securities that are the subject of a tender offer by requiring that the consideration paid to any security holder is the highest paid to any other security holder in the tender offer. We are proposing amendments to the best-price rule for three reasons.

First, we want to make it clear that compensatory arrangements between employees and directors and the subject company or bidder are not captured by the application of the best-price rule. We believe that amounts paid pursuant to employment compensation, severance or other employee benefit arrangements should not be deemed included in the consideration paid for tendered securities. These payments are made for a different purpose that is compensatory in nature in exchange for services rendered or that is related to severance or similar events.

Second, since the adoption of the best-price rule, it has been the basis for litigation brought in connection with tender offers in which it is claimed that the best-price rule was violated as a result of the bidder in a tender offer entering into new, or adopting the subject company's pre-existing, employment compensation, severance or other employee benefit arrangements with security holders of the subject company. In the process of resolving these claims, courts have interpreted the best-price rule in different ways. We are proposing changes to the rule to alleviate the uncertainty that the various interpretations of the best-price rule by courts have produced.

Finally, we want to reduce any unwarranted incentive to structure transactions as statutory mergers, to which the best-price rule does not apply, instead of tender offers, to which it does apply. We understand that the uncertainty regarding the application of the best-price rule has made parties reluctant to utilize tender offers as a means to accomplish extraordinary transactions, and we believe the

proposed changes to the rule would alleviate the need for this reluctance.

### B. Objectives

The overall objective of the proposed reforms is to make it clear that employment compensation, severance or other employee benefit arrangements between employees and directors of the subject company or bidder are not captured by the application of the best-price rule. We also seek to alleviate the uncertainty bidders and subject companies face in planning and structuring third-party and issuer tender offers due to varying judicial interpretations of the best-price rule. Finally, we want to remove any unwarranted incentive to structure transactions as statutory mergers, to which the best-price rule does not apply, instead of tender offers, to which it does apply.

First, we propose to clarify that the best-price rule applies only with respect to the consideration offered and paid for securities tendered in a tender offer. Second, we propose amending the rule in the context of third-party tender offers to make it clear that the negotiation, execution or amendment of payments made or to be made or benefits granted or to be granted according to employment compensation, severance or other employee benefit arrangements that are entered into by the bidder or the subject company with current or future employees or directors of the subject company were never intended to trigger the best-price rule. Lastly, to give additional comfort to parties entering into employment compensation, severance or other employee benefit arrangements, we propose to add a safe harbor to assist parties in the determination of whether such arrangements are outside the best-price rule. These modifications to the best-price rule would provide greater certainty to the parties in structuring the terms of tender offers and would also give security holders greater confidence that the best-price rule is continuing to ensure equal treatment among security holders.

### C. Legal Basis

We are proposing amendments to the best-price rule under Sections 3(b), 10, 13, 14, 23(a) and 36 of the Exchange Act, as amended, and Section 23(c) of the Investment Company Act of 1940, as amended.

### D. Small Entities Subject to the Proposed Rules

The proposed changes to the best-price rule would affect issuers that are

small entities. Exchange Act Rule 0-10(a)<sup>59</sup> defines an issuer, other than an investment company, to be a "small business" or "small organization" for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year. An investment company is considered to be a "small business" or "small organization" if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>60</sup> We estimate that there were approximately 3,500 public issuers, other than investment companies, that may be considered small entities. We estimate that there are approximately 240 investment companies that may be considered small entities. Of these 240 investment companies that may be considered small entities, we estimate that 97 are closed-end investment companies, including closed-end investment companies electing to be treated as business development companies, as defined in Section 2(a)(48) of the Investment Company Act of 1940,<sup>61</sup> that may be affected by these proposed amendments.

The Commission received a total of 362 issuer and 110 third-party tender offer schedules in its 2005 fiscal year. We estimate that 13 of the issuer tender offer schedules were issuer tender offers that were filed by subject companies that were small entities, including investment companies. We further estimate that 41 of those tender offer schedules were third-party tender offers where the subject companies were small entities, including investment companies. Therefore, as discussed below, we believe that the proposals would affect a limited number of small entities that are reporting companies. However, we request comment on the number of small entities that would be impacted by our proposals, including any available empirical data.

#### *E. Reporting, Recordkeeping and Other Compliance Requirements*

The proposed changes to the best-price rule are expected to result in minimal additional costs to all bidders and subject companies, large or small. Because the current best-price rule already requires bidders to ensure that the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer, the proposed changes to the best-price

rule should not impose significant additional costs, if any, and should not require any additional professional skills. Thus, the task of complying with the proposed changes could be performed by the same person or group of persons responsible for compliance under the current rules at a minimal incremental cost.

We understand that one aspect of the proposed changes, the safe harbor, may impose extra steps on the bidder and/or subject company to ensure compliance with the safe harbor, and such compliance could entail new costs. Most bidders and subject companies already are required to have a compensation committee or a committee performing similar functions, so the cost of forming and organizing a committee should be a cost that is already being incurred by the bidder or subject company. This is particularly the case where the bidder or subject company either has a class of securities listed on a registered national securities exchange or on an automated inter-dealer quotation system of a national securities association because the listing standards of each generally impose certain requirements regarding the formation and composition of the members of the board of directors and its committees.

Small entities or organizations might be less likely to have a class of securities listed on a registered national securities exchange or on an automated inter-dealer quotation system of a national securities association. As a result, it is possible that small entities or organizations would be less likely to have the pre-existing infrastructure in place for compensation committees or a committee performing similar functions to approve employment compensation, severance or other employee benefit arrangements. Such small entities or organizations would likely incur additional costs to take advantage of the safe harbor. The cost, however, should be limited to the expense of organizing a committee, reviewing the specific arrangement and holding a meeting of the committee. Further, bidders and subject companies that are small entities or organizations would not be required to take advantage of the safe harbor, so any additional expenses that may be incurred, if any, would be optional on the part of the small entity or organization. Therefore, the proposed rule would likely have virtually no adverse impact upon small entities.

We encourage written comments regarding this analysis. We solicit comments as to whether the proposed changes could have an effect that we have not considered. We request that commenters describe the nature of any

impact on small entities and provide empirical data to support the extent of the impact.

#### *F. Duplicative, Overlapping or Conflicting Federal Rules*

We believe that there are no rules that conflict with or completely duplicate the proposed changes to the best-price rule.

#### *G. Significant Alternatives*

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposals, we considered the following alternatives:

1. Establishing different compliance or reporting requirements or timetables that take into account the resources of small entities;
2. The clarification, consolidation, or simplification of the compliance or reporting requirements for small entities;
3. The use of performance rather than design standards; and
4. An exemption for small entities from coverage of the best-price rule, or any part thereof, for small entities.

We have considered a variety of reforms to achieve our regulatory objectives. However, we believe that the original intent of the best-price rule, to require equal treatment of security holders, would not be served by a best-price rule that applied only to bidders and subject companies of a certain size. Further, we believe that in order to alleviate the uncertainty that the parties to tender offers face, uniform rules applicable to all bidders and subject companies, regardless of size, is necessary. Therefore, the establishment of different requirements for small entities would not be practicable, nor would it be in the public interest. For similar reasons, the clarification, consolidation or simplification of the compliance and reporting requirements for small entities also would not be practicable.

Although the best-price rule generally employs performance standards rather than design standards, the proposed changes to the rule would implement certain design standards in order to clarify that the rule should not apply where employment compensation, severance or other employee benefit arrangements are made or will be made or have been granted or will be granted. The implementation of design standards in this case, however, would be more useful to bidders and subject companies because the circumstances in which the

<sup>59</sup> 17 CFR 240.0-10(a).

<sup>60</sup> 17 CFR 270.0-10.

<sup>61</sup> 15 U.S.C. 80a-2(a)(48).

best-price rule is applicable would be delineated more clearly. This would provide greater certainty in the application of the rule and the enforcement of the application of the rule. Therefore, implementing design rather than performance standards in the application of the rule appears to be more effective in ensuring compliance with the proposed rule.

The majority of bidders and subject companies that engage in tender offers and are subject to the best-price rule are not small entities. Further, where small entities are bidders and/or subject companies in the tender offer, the proposed changes to the best-price rule, in general, and the invocation of the safe harbor, in particular, impose minimal additional costs or burdens so exempting small entities from the best-price rule altogether would not be justified in this context.

#### H. Solicitation of comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

1. The number of small entities that may be affected by the proposals;
2. The existence or nature of the potential impact of the proposed changes on small entities discussed in the analysis; and
3. How to quantify the impact of the proposed revisions.

Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, or in the alternative, a certification under Section 605(b) of the Regulatory Flexibility Act, if the proposed changes are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

#### VIII. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or (SBREFA),<sup>62</sup> we must advise the Office of Management and Budget as to whether the proposed amendments constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on the potential impact of the proposed amendments on the U.S. economy on an annual basis, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

#### IX. Statutory Basis

The amendments to the best-price rule are proposed pursuant to Sections 3(b), 10, 13, 14, 23(a) and 36 of the Exchange Act, as amended, and Section 23(c) of the Investment Company Act of 1940, as amended.

#### X. Text of the Proposed Amendments

##### List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Securities and Exchange Commission proposes to amend Title 17, chapter II of the Code of Federal Regulations as follows:

#### PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

2. Amend § 240.13e-4 by revising paragraph (f)(8)(ii) to read as follows:

##### § 240.13e-4 Tender offers by issuers.

\* \* \* \* \*

(f) \* \* \*

(8) \* \* \*

(ii) The consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer.

\* \* \* \* \*

3. Amend § 240.14d-10 by revising paragraphs (a)(2), (c) and (d)(2) to read as follows:

##### § 240.14d-10 Equal treatment of security holders.

(a) \* \* \*

(2) The consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security

holder for securities tendered in the tender offer.

\* \* \* \* \*

(c) Paragraph (a)(2) of this section shall not prohibit:

(1) The offer of more than one type of consideration in a tender offer, where:

(i) Security holders are afforded equal right to elect among each of the types of consideration offered; and

(ii) The highest consideration of each type paid to any security holder is paid to any other security holder receiving that type of consideration.

(2) The negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such arrangements, with respect to employees and directors of the subject company, where the amount payable under the arrangement:

(i) Relates solely to past services performed or future services to be performed or refrained from performing, by the employee or director (and matters incidental thereto); and

(ii) Is not based on the number of securities the employee or director owns or tenders.

*Instruction to paragraph (c)(2):* The fact that the exemption in paragraph (c)(2) of this section extends only to employment compensation, severance and other employee benefit arrangements and not to other arrangements, such as commercial arrangements, does not raise any inference that a payment under any such other arrangement constitutes consideration paid for securities in a tender offer.

(3) For purposes of paragraph (c)(2) of this section, pursuant to this non-exclusive safe harbor, an arrangement shall be deemed an employment compensation, severance or other employee benefit arrangement if it is approved as meeting the requirements of paragraphs (c)(2)(i) and (ii) of this section by the compensation committee of the subject company's or bidder's (depending on whether the subject company or bidder is a party to the arrangement) board of directors. If that company's board of directors does not have a compensation committee, the arrangement shall be deemed an employment compensation, severance or other employee benefit arrangement if it is so approved by the committee of that board of directors that performs functions similar to a compensation committee. In each circumstance, the arrangement shall be deemed an employment compensation, severance or other employee benefit arrangement only if the approving compensation committee or the committee performing

<sup>62</sup> Pub. L. 104-121, Title II, 110 Stat. 857 (1996).

similar functions is comprised solely of independent directors.

*Instruction to paragraph (c)(3):* For purposes of determining whether the members of the bidder's or subject company's compensation committee or the committee performing similar functions are independent, the following provisions shall apply:

1. If the bidder or subject company, as applicable, is a listed issuer (as defined in § 240.10A-3) whose securities are listed on a national securities exchange registered pursuant to section 6(a) of the Act or in an automated inter-dealer quotation system of a national securities association registered pursuant to section 15A(a) of the Act that has independence requirements for

compensation committee members, apply the independence standards for compensation committee members as defined in the listing standards applicable to listed issuers; or

2. If the bidder or subject company, as applicable, is not a listed issuer (as defined in § 240.10A-3), in determining whether a member of the compensation committee is independent, the bidder or subject company, as applicable, shall use a definition of independence of a national securities exchange registered pursuant to section 6(a) of the Act or a national securities association registered pursuant to section 15A(a) of the Act that has been approved by the Commission (as that definition may be modified or supplemented). Whatever definition the bidder or subject company, as applicable, chooses, it must apply that

definition consistently to all members of the compensation committee or the committee performing similar functions.

(d) \* \* \*

(2) Paragraph (c)(1) of this section shall not operate to require the bidder to offer or pay the alternative form of consideration to security holders in any other state.

\* \* \* \* \*

Dated: December 16, 2005.

By the Commission.

**Jonathan G. Katz,**  
*Secretary.*

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