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STATE VERSUS FEDERAL REGULATION: BALANCING THE INTERESTS

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

I. Introduction

My remarks 1/ this evening concern three corporate governance issues which the Securities and Exchange Commission is currently considering. These issues, which I think should be of concern to any director or prospective director of a publicly-held company, all involve consideration of the proper balance between federal and state power.

The shared responsibility between the federal and state governments for regulation of the securities industry and the capital-raising process adds a special dimension to the resolution of most issues that come before the Commission because it requires, on the one hand, a balancing of the states' right to regulate matters of particular interest to their citizens as they see fit with, on the other hand, the federal interest in having uniform national policies, especially where those policies affect interstate commerce.

Three current initiatives illustrate how the Commission must make adjustments for competing state and federal interests in resolving issues before it. First, the Commission is reviewing the New York Stock Exchange's proposal to modify its requirement that the shareholders of companies listed on the exchange have equal voting rights. Second, the Commission recently adopted a rule prohibiting so-called "discriminatory" tender offers and in a related action published for comment a proposal that would

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1/ This address was prepared by Commissioner Peters with the assistance of Mr. David Mahaffey, Counsel to the Commissioner.

allow corporations to exempt themselves from that rule, as well as from certain other aspects of federal tender offer regulation.

Finally, the Commission is seeking comment on a proposal to require that after a tender offer for a company is initiated any substantial purchase of the target company's shares must be through a tender offer subject to the SEC's rules.

II. One Share/One Vote

As you may know, the Board of Governors of the New York Stock Exchange recently voted to amend the exchange's rules to permit the listing of common stock with unequal voting rights. 2/ As applied to companies with shares currently listed on the NYSE, the rule would permit a change in voting rights subject to shareholder approval. This rule proposal is a departure from the New York Stock Exchange's 60-year tradition against listing common stock with unequal voting rights. 3/

The motivating factor behind the New York Stock Exchange's decision appears to be competition for listings. The New York Stock Exchange's two primary domestic competitors are the American

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2/ See Securities Exchange Act Release No. 23724 (Oct. 17, 1986).

3/ The NYSE's rule against dual-class common stock has never been totally rigid. For example, in 1956 the exchange listed Ford Motor Company, despite the fact that the Ford family's Class B Common Stock, representing only 5.1% of the equity, was entitled to 40% of the shareholders' voting power. J. Seligman, The One Share, One Vote Controversy 7 (Jan. 1986).

Stock Exchange and the National Association of Securities Dealers Automated Quotation System, called "NASDAQ"; both permit the listing of securities with unequal voting rights. 4/ Moreover, to my knowledge, the major exchanges abroad do not prohibit the listing of shares with unequal voting rights. With the rise of hostile tender offers and the increased willingness of non-management shareholders to initiate proxy contests, management has found itself increasingly vulnerable in contests for control. Accordingly, some see dual-class capitalization as providing a certain measure of anti-takeover protection. It is this aspect of the NYSE rule proposal that has caused the most controversy.

The focus on a dual-class capital structure as a potential takeover defense tends to obscure the fact that the question of what voting rights must be given to shareholders is ordinarily a matter of state corporation law. To my knowledge, virtually all 50 states now permit corporations to have classes of common stock with unequal voting rights. 5/ Furthermore, it has been argued that certain benefits may inure directly to the shareholders from a dual capitalization structure. For example, some managers assert that the stability afforded by dual-class capitalization permits them to pursue longer term strategies that are in the

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4/ *Id.* at 8-10.

5/ Sommer, *Drop the "One Share, One Vote" Rule*, N.Y. Times, Apr. 7, 1985, at F2.

best interest of their companies. Others can point to the good management historically provided their companies by their controlling stockholders, citing examples such as Wang Laboratories, the New York Times 6/ and Dow Jones as public companies that have prospered under dual-class capitalizations. Finally, General Motors' recent acquisition of Electronic Data Systems is cited as an illustration of the value of dual-class capitalization as a means of financing major acquisitions.

The issues presented by the New York Stock Exchange's proposal are weighty and their resolution is complicated by the heated debate involving vehement arguments that the future of corporate America depends on stability and certainty in the managerial process countered by no less emotional calls for the preservation of corporate democracy and shareholder sufferage. Resolution of the issue will require careful consideration of the alternatives and a balancing of interests.

The SEC's role in this controversy comes about because, under Section 19(b) of the Securities Exchange Act of 1934, 7/ the Commission must approve or disapprove any proposed rule

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6/ The New York Times Company has two classes of common stock. The Sulzberger family owns all of the company's Class B shares, which are the only shares with full voting rights and have the right to elect 70% of the company's directors. The Sulzbergers recently agreed among themselves to sell Class B shares only to other family members or to the company. At the same time, the board made the Class B shares freely exchangeable into Class A shares. These two steps make the family's shares marketable while guaranteeing the family's continued control of the company. N.Y. Times, June 20, 1986, at A1.

7/ 15 U.S.C. 78s(b).

change made by a national securities exchange. The alternatives available to the Commission to resolve this issue present interesting questions. For example, the Commission has a statutory obligation to consider the effect of its decisions on competition. In this instance, disapproval of the NYSE rule proposal would put the NYSE at a competitive disadvantage, making it difficult not only for the exchange to attract new listings but also to retain its current ones. Of course, another alternative would be to require all organized markets to prohibit their listed companies from having dual-class capital structures. The result of such a move would be either to deny issuers like Ford, Wang and Dow Jones a national public market in which to raise capital or to deny public investors an opportunity to choose between potential higher return on the one hand and voting control on the other.

In my opinion, any decision with respect to the one share/one vote issue should take into account the fact that the states are the primary overseers of corporate governance matters. The adoption of a federally imposed one share/one vote corporate governance requirement would be a pre-emption of state law. To note this fact is not to suggest that federal intervention should not occur, but rather it is to point out that a resolution of this issue will require a careful evaluation and balancing of competing federal and state interests.

Currently, the Commission is soliciting public comments on the proposed rule change. Thereafter, we expect to hold public hearings on the matter before deciding whether to approve the change.

III. The Self-Governance Concept

A recent instance in which a majority of the Commission concluded that the national interest required federal regulation in an area of corporate governance was the adoption of Rule 13e-4(f) and its sister Rule 14d-10, known as the "All-Holders Rules." 8/ These rules were developed in response to a perception that tender offer bidders, whether target companies or third parties, could abuse the tender offer process to the detriment of shareholders by making "exclusionary" or discriminatory tender offers. These concerns arose out of a court decision that permitted a target to make a self-tender excluding the bidder in a competing tender offer. 9/

In July 1985, the Commission proposed the All-Holders Rules, which were adopted, with some modifications, on July 11th of this year. 10/ Rule 14d-10 prohibits any third party bidder from making a tender offer that is not open equally to all shareholders. Its counterpart, Rule 13e-4(f), prohi-

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8/ 17 C.F.R. 240.13e-4(f) and 240.14d-10.

9/ Unocal Corp. v. Pickens, 608 F. Supp. 1081 (C.D. Cal. 1985).

10/ Securities Act Release No. 6653 (July 11, 1986).

bits an issuer from making a self-tender that is not open to all shareholders. Of course, both of these rules have certain exceptions.

A few weeks after adopting the All-Holders Rules, the Commission issued a concept release 11/ seeking comment on a proposed exemption from the All-Holders Rules. The so-called "self-governance exemption," also known as the "opt-out rule," would permit an issuer, through a vote of its shareholders, to exempt itself from the application of one or more provisions of the Williams Act. Although the concept of an opt-out provision originated specifically in the context of the All-Holders Rules, the Commission has also requested comment on whether a self-governance exemption would be appropriate for other tender offer rules.

I opposed the All-Holders Rules and voted against their adoption. Therefore, one might think that I would be in favor of the opt-out concept. That is not the case.

I am troubled by the concept of a self-governance exemption in this context for several reasons. First, the rationale on which it is founded would represent a significant departure from the basis for existing exemptions from the federal securities laws. The Commission's concept release cites various provisions of the securities laws that permit registrants to

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11/ Securities Exchange Act Release No. 23486 (July 31, 1986).

engage in certain kinds of corporate actions with the consent of shareholders, offering them as precedents for the opt-out concept. In my view, these examples differ significantly from the opt-out proposal. I would observe generally that the examples cited in the release are all exemptions that (1) permit registrants to engage in certain specified corporate transactions and (2) give shareholders a meaningful opportunity to approve those transactions. By contrast, the opt-out exemption would permit a corporation to ask shareholders to forego a protection afforded them by the federal securities laws without shareholders necessarily having the opportunity to evaluate the proposal in the context of a specific transaction.

Second, it is significant that the examples cited in the release <u>all</u> involve obligations which the statute itself contemplates may be waived by shareholder vote, by SEC rule or by exemptive order. In contrast, the proposed self-governance exemption is not derived either from an explicit statutory exception or from an express delegation of authority to the Commission to create an exemption. The Commission has no authority to create an exemption from any statutory provision of the Williams Act. Thus, I question whether it may legitimately create one from its own rule when the rule has been adopted pursuant to the Commission's authority to make rules "necessary or appropriate" to carry out the purposes of the statute.

This leads me to my second concern about a proposed self-governance exemption, which relates particularly to its application to the All-Holders Rules. In proposing those rules in July 1985, the Commission stated that the Williams Act contains

> an *implicit* requirement for equal treatment of security holders. This interpretation *requires* a tender offer subject to Section 14(d) to be made to all security holders on the same basis. 12/

The Commission also stated that "[t]he All-Holders Rule is necessary for the protection of investors and to achieve the purpose of the Williams Act." 13/

One year later, in adopting the All-Holders Rules, the Commission, by a majority vote, determined that the rules were "necessary or appropriate" to effectuate adequate tender offer regulation. Moreover, the Commission "inferred that Congress intended that, when a tender offer is made, it will be made to all holders of the outstanding securities of such class." 14/ In the face of such conclusions, to suggest simultaneously with the adoption of the rules that issuers should be permitted to opt out of them is to lend substantial credence to the position of those who argued there was insufficient justification for the

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12/ Securities Act Release No. 6596 (July 1, 1985) (emphasis added).

13/ *Id.*

14/ Securities Act Release No. 6653 (July 16, 1986).

rules in the first place. Furthermore, I am conerned that the opt-out concept would establish the precedent that market participants may decide when and whether to adhere to the rules the Commission promulgates to insure fairness and integrity in our capital markets.

There may very well be an inherent contradiction in the Commission concluding that the All-Holders Rules are implicit in the Williams Act and are "necessary or appropriate" to protect shareholders in tender offer contexts, and then suggesting shareholders don't need the rules' protection if they don't want it. If the federal government is going to intrude into this area, it should do so only when it is very confident that the benefits of its regulation outweigh the costs. In my opinion, adoption of an opt-out rule would cast doubt on the Commission's apparent conclusion that the All-Holders Rules do indeed provide benefits that justify their costs.

The contradiction continues to be apparent if one considers that the Commission's stated purpose in adopting the All-Holders Rules is to protect individual shareholders from the effects of discriminatory offers. Yet it has proposed a procedure whereby shareholders having control of majority voting power would decide for all whether the protection is needed. Under the proposed exemption, for example, a group of shareholders holding 10% of a company's equity, but having 50% or more of its voting power, could act to exclude non-controlling shareholders from a self-tender or to authorize exclusions from third-party tenders. 15/ Thus, the concept calls for a system that could, and very well may, legitimize "unfair" discrimination. In this regard, it is important to note that there are many corporations where majority voting control is in the hands of a minority. Moreover, if the NYSE's proposed rule amendment I discussed earlier is approved, there will be more.

My third concern about the self-governance concept is a logical extension of the second. The opt-out rule may permit unscrupulous managers to deprive their shareholders of state law protection in cases of unfair discrimination. Currently, if a corporation makes a discriminatory self-tender, a state court could scrutinize the transaction to determine whether the corporation's board of directors exercised reasonable business judgment in authorizing it or violated its fiduciary duty in doing so. However, under a federal opt-out rule, a corporation, with the approval of its shareholders, could exempt itself from the application of the All-Holders Rules and thereafter make an unfairly discriminatory self-tender. There may be an excellent argument that the transaction was not subject to state court

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15/ The Amex's current rules permit one class of common stock to have up to ten times the voting rights of any other class. J. Seligman, *supra* note 3, at 9. The NYSE's proposed rule would impose no limitation on the ratio of voting rights between any two classes of common stock, so long as each class has at least some voting rights. Securities Exchange Act Release No. 23724 (Oct. 17, 1986).

review or redress because the company complied with the SEC's self-governance exemption. Thus, what superficially appears to be deference by the Commission to state laws on corporate governance might prove in fact to preempt state law to the detriment of shareholders.

IV. Regulation of Changes in Corporate Control

A third area where SEC regulation and state corporation laws overlap is in the regulation of changes in corporate control. Traditionally, changes in corporate control have been regulated by the states. For example, state law applies to the question of whether a controlling shareholder violates a fiduciary duty toward other shareholders by selling his control block at a premium. Federal law applies only where a change in corporate control is attempted by means of a tender offer. Recent developments highlight what, in my opinion, is a dilemma facing the Commission, namely whether it can effectively regulate the tender offer process without regulating all changes in corporate control.

In two recent cases, U.S. Courts of Appeal have permitted parties in contests for control to purchase large blocks of securities in transactions that were purportedly private, but which the Commission contended were unconventional tender offers. For example, Carter Hawley Hale Stores, reacting to a hostile tender offer, publicly announced its intention, among other things, to repurchase 50% of its securities in open market transactions. In response to Carter Hawley's announcement, investors within a matter of days sold their shares in the open market. The SEC instituted an enforcement action against Carter Hawley, alleging that its repurchase program constituted an "unconventional" tender offer. However, the courts disagreed. 16/

In a second case, Hanson Trust PLC, a British conglomerate, announced a tender offer for SCM Corporation. When SCM and its "white knight," Merrill Lynch, announced a leveraged buyout of SCM at a price higher than Hanson's offer, Hanson publicly terminated its tender offer. Within hours, however, Hanson purchased 25% of SCM's shares from six investors. SCM obtained a preliminary injunction from a federal district court in New York prohibiting Hanson from acquiring additional shares. However, the Court of Appeals for the Second Circuit dissolved the injunction, finding that Hanson's purchases fell outside the scope of the Williams Act. 17/

Frankly, if I had any concern about these transactions being outside the reach of the federal securities laws it would be lessened if they were subject to regulation under state corporate law. This may not, however, be the case. Six states have attempted to regulate acquisitions of control blocks of stock as part of their state corporation laws. The federal courts have

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16/ SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945, affirming 587 F. Supp. 1248 (C.D. Cal. 1984).

17/ Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985).

struck down five of these statutes as being unconstitutional, finding that they interfere with interstate commerce. 18/ Three of these courts have also found these state statutes to be unconstitutional under the Supremacy Clause, holding that they are preempted by the Williams Act.

As a result, a policy that federal regulation applies only to tender offers -- as opposed to changes in control -- may have two unintended consequences. First, certain transactions that resemble tender offers in their operation and their impact on investors may fall outside the scope of federal regulation. Second, because of constitutional law conflicts, these transactions may occur free of state regulation as well.

One possible way of dealing with this situation would be to change the emphasis of the Williams Act from tender offers to "changes in control." In Great Britain, takeovers are subject to regulation whenever a person seeks to acquire 30% or more of a company's shares. Several Canadian provinces require all attempts, with some exceptions, to acquire 20% of a target's shares to be by tender offer under their regulatory schemes. Other Canadian jurisdictions apply their takeover rules to all attempts to acquire more than 10% of a target's shares. The SEC itself proposed legislation of this sort in 1980.

18/ See, e.g., Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986), prob. juris. noted, 55 U.S.L.W. 3198 (U.S. Oct. 6, 1986) (No.86-71); Fleet Aerospace Corp. v. Holderman, 796 F.2d 135 (6th Cir. 1986), appeal filed sub nom. Ohio v. Fleet Aerospace, 55 U.S.L.W. 3175 (U.S. Aug. 2, 1986) (No. 86-344).

Such a system might prove much simpler to administer. It could also be fairer to the extent it brings more certainty to the regulatory process. Nevertheless, this concept has significant disadvantages, the most obvious of which is its inflexibility and the most touchy of which is its perceived restriction of market forces.

The Commission is currently considering a modified version of this concept. In its July 31 concept release, the Commission requested comments on the advisability of applying the tender offer rules, under certain circumstances, to all acquisitions over a given percentage of the target's shares. 19/ The release proposed that a substantial acquisition of a target's securities by any person after commencement of a formal tender offer, and until the expiration of a specified period after termination of the offer, would be deemed to be a tender offer required to made in compliance with SEC rules. A "substantial acquisition" would be defined as some percentage, such as 10%, of the target's shares. Viewed from a certain perspective, the proposed concept is simply a way of defining what constitutes a tender offer.

There are two questions that still need to be answered. First, would this definition of tender offer solve the problem? Second, is there a sufficient national interest to warrant federal action? There are no easy answers to these questions. But they are ones with which we must deal if we are to administer sensibly the regulatory process as it relates to changes in control.

19/ Securities Exchange Act Release No. 23486 (July 31, 1986).

V. Conclusion

I could cite other examples of regulatory issues that require striking a balance between federal regulation and state law. The three I have described, however, illustrate the complexity and delicacy of the questions involved and emphasize the importance of the SEC's responsibility to make every attempt to strike the balance properly.

Thank you.