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Tender Offers and Insider Trading: A Search for the Missing Link

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TENDER OFFERS AND INSIDER TRADING: A SEARCH FOR THE MISSING LINK

Good afternoon. It is an honor to address the Olin Conference on Market Volatility, and to be in such distinguished company as we examine some of the most important issues in the structure and activity of our capital markets.

The panelists and commentators today have focused on questions of market activity in the context of program trading and index arbitrage. In my remarks I will discuss a different although related topic: corporate takeovers. Many observers have suggested that the increased volatility in today's stock markets -- be it real or imagined -- is only a symptom of some underlying fundamental change. These same observers often suggest that this fundamental change is the increase in corporate takeovers, fueled by speculation and manipulation. It is clear that increased activity in tender offers and insider trading activity are coincident. It is not at all clear that they are related. I have titled my remarks today "Tender Offers and Insider Trading: A Search for the Missing Link." Perhaps with such a search I can pioneer a new field -- corporate anthropology. At the SEC, we have created a vast new pool of former arbitrageurs, now looking for new careers, who might be willing to consider an endowed position in this new discipline.

Failing such a mentor, I will undertake the search for the missing link on my own this afternoon. First, I will review current developments in tender offer reform. There are many -- some are new proposals, and some are a reprise of old proposals. Next, I will review current developments in insider trading, including the highlights of the SEC's enforcement program, and its implications. Finally, I will look at the links, if any, between these two, and whether there are any other plausible explanations for the concern over the volatility -- be it increasing or only recently discovered -- of our stock markets.

I. Developments in Tender Offer Reform

Let's look at current proposals for changing the rules of the tender offer game. In the past few months, we have seen an unprecedented flurry of congressional activity in this area. Several bills have been introduced; the Commission has been and will be called upon to testify many times. In fact, this congressional process could itself be compared to a hostile takeover. I find the analogy interesting. The issue of "tender offer reform" was definitely "put in play" a couple of months ago. It has been a favorite target over the past several years, but there has been no successful raider. Now, however, we've got two new powerful expert bidders. On the House side, Chairmen Dingell and Markey have introduced a comprehensive bill. 1/ On the Senate side, Chairmen Proxmire and Riegle have done likewise. 2/ In true "hostile takeover" fashion, each has bombarded us -- the shareholders in my analogy -- with arguments why their plan is better than the rest. I might add that they have done all this under considerable time pressure, making it difficult for us to examine important policy questions. The atmosphere at the SEC these days is akin to a corporation and its shareholders during the "Saturday Night Special" days of old. We could certainly benefit from a "standstill" period in the heat of the current legislative battle, but this is not to be. This only further confirms the well-known axiom in Washington -- Congress exempts itself from the rules it makes for everyone else.

The bills introduced by these gentlemen have several items in common. I'll turn to these first. I'll refer to one as "the Dingell bill" and the other as "the Proxmire bill." I recognize that each bill reflects work by the staff of both Committees and that each has many co-sponsors, but my remarks must be finished sometime today, so shorthand is required.

Both bills address the problem of initial disclosure of acquisition of a significant amount of stock -- popularly known as the "13(d) window." Under current law, the time period between first acquisition of a five-percent block and disclosure of that fact and the purchaser's intention -- the "window" -- is ten days. The Proxmire bill would require disclosure of a three-percent stake by the business day after acquisition. Similarly, the Dingell bill would shorten the "window" to 24 hours, but would leave the ownership requirement unchanged. Because the sponsors of the Dingell bill have indicated a willingness to discuss alternatives, it is important to note the drastic impact these proposals could have on the amount of paper that flows into the SEC. An SEC report in 1980 estimated that decreasing the threshold from five to two percent would roughly triple the number of filings

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1/ H.R. 2172, the Tender Offer Reform Act of 1987.

2/ S. 1323, the Tender Offer Disclosure and Fairness Act of 1987.

required. 3/ This is not an insignificant amount: over seven thousand such filings and amendments were received by the SEC last year.

Both bills would also impose a "standstill," prohibiting further purchases: the Dingell bill for two days after disclosure, the Proxmire bill until a public announcement of the acquisition has been made. Both bills also specify the disclosure required by the purchaser in these disclosure statements, and specify the treatment of "groups" making purchases in concert. The Proxmire bill, in particular, would make the purchaser state its intentions, which can be one of two -- investment or control. And if the answer is investment, then the shares purchased must be held for six months. The Dingell bill would authorize the SEC to seek a daily fine of one percent of the value of the securities for each day the required reports are not filed.

All commentators, including the SEC, have recognized that the current ten-day "window" is too long. The SEC has proposed shortening the time period to two days, although one day is certainly a reasonable alternative if it is practical to make the required filing in that time. The other provisions restate and expand upon current SEC disclosure requirements to varying degrees. The provisions for a six-month investment test and an SEC fine are intended to put some teeth into the disclosure requirements. Each of these proposals requires careful consideration. But overall, I believe that compared to current regulation, they represent a change of magnitude and not direction.

Both bills also deal with certain tender offer problems. Each would extend the current 20-day minimum for tender offers: the Dingell bill to 60 calendar days, the Proxmire bill to 35 business days. The SEC previously examined this area, in considering the report of the Advisory Committee on Tender Offers in 1984. Also, the Commission considered a period as long as 30 business days before settling on the 20 business days in the current rule, subsequently modified to put competing offers and prorations rights on similar and uniform time schedules. We have no evidence that 20 days is insufficient time for shareholders to evaluate the merits of a tender offer and to act accordingly. Recent evidence suggests that a modest increase of the 20-day period would conform to current

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3/ The Commission's report, pursuant to Section 13(h) of the Securities Exchange Act, was submitted on June 27, 1980.

practice, however. The SEC's Office of the Chief Economist surveyed almost 300 successful tender offers in 1985 and 1986, and found the average length of the predominant type -- the any-or-all offer -- was 28 business days. Overall, only 28 percent of the tender offers remained open only for the minimum 20-business-day period. However, I suspect that the Congressional concern in this area is that the extra time is needed for the benefit of the target company's management, not its shareholders.

Each bill also attempts to deal with the problems of the "creeping tender offer" and the practice of "sweeping the street." The Dingell bill would preclude purchases by owners of more than ten percent of a company's stock except by tender offer. It would also prohibit someone who has made a tender offer from purchasing shares during or thirty days after the tender offer, except by another tender offer. The Proxmire bill is more succinct: it prohibits purchase by anyone of more than fifteen percent of a company's stock except by tender offer.

These proposals were drafted in response to specific open-market purchases which many people believed should be regulated as tender offers. Therefore, they were called "unconventional tender offers," a deft exercise in circular reasoning. My own biased definition of an "unconventional" tender offer is a transaction that slipped through the current maze of SEC regulation. Try as we might, the SEC has been unable to get a court to agree that these can be retrieved, as the decisions in Carter Hawley Hale 4/ and Hanson Trust 5/ show. The Second Circuit in Hanson even suggested that the sellers in that case -- professional dealers with large holdings -- did not need the protections of the Williams Act. 6/ Such an idea was immediately dismissed as heresy; indeed, a summary of the Dingell bill discusses Hanson and notes this legislation "should clarify any judicial misconstructions of the Williams Act."

In a June 1986 concept release, the SEC sought public comment on whether all significant share purchases should

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4/ SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985).

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

6/ Id. at 57-58.

be required to be in the form of a tender offer. 7/ The public reaction was mixed: out of 23 commentators, thirteen clearly favored some application of the Williams Act to these types of transactions, and five clearly did not. 8/

The fact that reasonable people -- including several commentators and a panel of the Second Circuit -- could conclude that the Williams Act could be limited in scope suggests to me that we can cast too wide a net with the term "tender offer." When the SEC decided to seek public comment on this question, it determined that a uniform "tender offer only" rule for large purchases, as the Proxmire bill proposes, or purchases by large shareholders, as the Dingell bill proposes, could impair legitimate transactions. I have stated before that I believe such requirements would impose significant costs on purchasers or sellers whether or not a change of control is involved. 9/ Innovative purchases would be squelched, and holders of large blocks would have no alternative but open market sales. Many companies have large shareholders who are not officers and directors. 10/ The alternative approach used in the Dingell bill, which directly regulates large purchases during or after a tender offer, better addresses these problems. I take some comfort in the fact that both bills provide the SEC with exemptive authority in this area, consistent with the public interest and the protection of investors.

7/ See Securities Exchange Act Release No. 23,486, 51 Fed. Reg. 28,096, 28,098 (1986).

8/ Division of Corporation Finance, Securities and Exchange Commission, Summary of Comments Relating to Takeovers and Contests for Corporate Control 5-6 (Mar. 19, 1987) (on file in the SEC Public Reference Room, File No. S7-18-86) (hereinafter "Comment Summary").

9/ See "Anti-Merger Mania -- Current Proposals for Tender Offer Regulation" at 6 (remarks to the Sixteenth Annual Business Conference of the Association for Corporate Growth, April 6, 1987).

10/ Recent statistics compiled by the SEC's Office of the Chief Economist show that about 20% of publicly-traded companies had at least one non-officer shareholder who owned a block of over 10% of the firm's shares. Such blocks were owned by officers in about 15% of the firms. Id.

Finally, both bills deal with three popular responses to tender offers, each with its own popular name: "greenmail," "golden parachutes" and "poison pills." Greenmail is defined in the bills as the purchase by an issuer of its own shares, at a price above the recent market price, from a seller who owns more than three percent of those shares, and who has held them for a short time. 11/ Both bills would prohibit greenmail unless a majority of the shareholders approve or an offer of equal value is made to all shareholders.

The most interesting thing about prohibiting greenmail is that it's difficult to decide whose side this helps. Greenmail has been decried as the lure of the raider to the hapless target; it has also been criticized as another tool for management entrenchment at shareholder expense. I suspect the latter is more accurate, for the following reason: a company that wants to remove greenmail as a prize for the raider can do so by simply announcing that it will refuse to pay it. A survey by the Investor Responsibility Research Center in 1987 showed that 70 companies adopted anti-greenmail charter amendments in 1984 to 1986. In any case, the decision to pay or refuse greenmail is in the judgment of the company. To date, state courts and legislatures have been left to decide if the greenmail decision should be reviewable or should remain in the company's discretion. A federal rule would preempt both of these decisions.

Both bills also deal with golden parachutes and poison pills. Golden parachute agreements are prohibited during a tender offer. This may solve a perception problem but I think that most companies would put golden parachutes into place before a tender offer. Furthermore, there remains the question of whether golden parachutes are defensive tactics or substitutes for costly defensive tactics. The Proxmire bill prohibits poison pills -- defined as bargain purchase provisions for securities of the target or the offeror -- but only when adopted during a tender offer. This seems to be a fairly limited prohibition. The Dingell bill deals more broadly with what it calls "abusive defensive tactics," and directs the SEC by rule to require shareholder approval of poison pills, so-called "tin parachutes," and other tactics the SEC may define as abusive.

11/ The Dingell bill defines this "short time" as less than two years; the Proxmire bill as less than six months.

The SEC also requested comment on the issue of poison pills in its July 1986 concept release. Of the 70 commentators who addressed the issue, 44 favored some federal action, and 21 did not; but only two of those in favor of action thought it should be legislation -- most recommended SEC rulemaking. 12/ Recent developments suggest that poison pills may not be an abuse requiring a federal response. One major reason is that poison pills don't seem to work; hostile tender offers have proceeded even in the face of such provisions. In addition, this is an area -- like greenmail -- which has traditionally been left to the states. Although the trend in state law took off on the wrong foot when the Delaware Supreme Court deferred to the poison pill in Household International, 13/ cases since that time have held that such plans are beyond the authority of the company's directors, or are a violation of their fiduciary duties to the shareholders. 14/

These are the main areas covered by both bills. Each has some other interesting provisions. The Proxmire bill, for example, requires that "tender offer arbitrageurs" register with the SEC and be regulated as securities dealers. The Proxmire bill also attempts, for the first time that I am aware, to legislatively divide the world of corporate governance between the states and the federal government. The bill gives the states authority over the internal affairs and governance of corporations, to the extent that the filing, disclosure, procedural or antifraud provisions of the federal securities laws do not require otherwise. In a memo written just before their legislation was introduced, Chairman Dingell and Markey also indicated

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12/ Comment Summary, supra note 8, at 68-71.

13/ Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985).

14/ See, e.g., Minstar Acquiring Corp. v. AMF Inc., 621 F.Supp 1252, 1257-59 (S.D.N.Y. 1985) (plan held beyond authority of directors under New Jersey Law); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F.Supp 407, 410 (S.D.N.Y. 1985) (plan held beyond authority of directors under Delaware law); Plaza Securities Co. v. Fruehauf Corp., 643 F.Supp 1535, 1539 (E.D. Mich. 1986) (plan, among other devices and actions, held to be a breach of fiduciary duty under Michigan law).

their willingness to address this question. 15/ They cite the recent CTS case, 16/ which suggested that if Congress meant to preempt state regulation in the federal securities laws, it would have done so explicitly. I believe this is an important policy question, because of another unique legislative proposal.

The Dingell bill prohibits brokers or dealers from transacting on an exchange or through NASDAQ the securities of any issuer whose voting securities have fewer or greater than one vote per share. Just yesterday, the SEC took up this question, deciding to institute rulemaking proceedings which would require that exchanges and the NASD adopt listing standards with regard to votes per share, and would be permitted to allow any recapitalization except when it disenfranchises current shareholders. 17/ With some reluctance, I dissented from this decision. While I recognize that recapitalization may wrest the ability to vote from current shareholders, I cannot conclude that this is a matter for the federal securities laws to address. What is at issue is not oversight of trading on exchanges and other trading arenas, or even of competition among them, but rather the capital structure of corporations. I do believe that the SEC has legal authority to proceed, but I question the policy of using the fiction of our oversight of exchanges and their listing standards to make rules in what is essentially a corporate governance area. I believe the Dingell bill is equally disingenuous in using the SEC's regulation of nationwide trading of securities by brokers and dealers to achieve the same result. If Congress wishes to preempt this area traditionally reserved to the states, then that should be done directly and the bounds of that preemption should be clearly set forth. But I believe that the implication of provisions such as the one I quoted from the Proxmire bill is that a look in the other direction -- away from preemption -- may be warranted.

I hope this overview gives you a taste of the corporate takeover issues facing the SEC this summer. There are other important provisions in each of these

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15/ Memorandum to Members, House Energy and Commerce Committee, from Chairman John D. Dingell and Subcommittee on Telecommunications and Finance Chairman Edward J. Markey (Apr. 23, 1987).

16/ CTS Corp. v. Dynamics Corp. of America, 107 S.Ct. 1637 (1987).

17/ See Securities Exchange Act Release No. 24,623, 52 Fed. Reg. 23,665 (1987).

bills, and there are perhaps a dozen other bills pending in this session of Congress dealing with the same area. In a couple of weeks I will kick off the SEC's rounds of testimony before the relevant House and Senate committees discussing this legislation. The foregoing remarks do not, of course, imply that the opinions of my colleagues on the Commission are similar. We'll see the results in a few weeks. I trust the colloquy will be interesting, and I think it's important to raise all these issues.

II. Developments in Insider Trading Prosecution

I'll turn now to the subject of insider trading. This is unquestionably an area of pressing national importance. The dramatic increase in the number and size of insider trading cases brought both by the SEC and the Justice Department has drawn great attention in the press, in the Congress, and no doubt throughout the financial community. Although investigation of insider trading is not the predominant area of SEC enforcement effort, it has brought dramatic results, with the number of cases brought in the last few years far exceeding those brought since the SEC's inception. The cases have grown larger in dollar amount and significance. The overseas trading of Dennis Levine 18/ led to the information-swapping dealing of Ivan Boesky, 19/ which in turn led to Martin Siegel 20/ and similar activities by Kidder, Peabody and Company. 21/ Chairman Shad promised in testimony before Congress earlier this year that "shoes will continue to drop" over the summer, 22/ but I cannot comment on the scope of the SEC's ongoing investigation. Whether shoes are still dropping or not, the stocking feet now showing are impressive. Recent

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18/ *See* *SEC v. Levine*, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986), Litigation Releases Nos. 11,095, 11,117 and 11,144.

19/ *See* *SEC v. Boesky*, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986), Litigation Release No. 11,288.

20/ *See* *SEC v. Siegel*, No. 87 Civ. 963 (S.D.N.Y. Feb. 13, 1987), Litigation Release No. 11,354.

21/ *See* *SEC v. Kidder, Peabody & Co.*, No. 87 Civ. 3869 (S.D.N.Y. June 4, 1987), Litigation Release No. 11,452.

22/ Testimony of John Shad, Chairman, Securities and Exchange Commission, before the Senate Banking Committee (May 13, 1987), quoted in Cong. Rec. at S7599 (Daily Ed. June 4, 1987).

insider trading cases have led the SEC to securities analysts and risk arbitrageurs, to individuals and to major firms such as First Boston 23/ and Kidder Peabody. 24/ You should recall that cases have led the SEC to others as well: to corporate insiders, 25/ to their attorneys working on corporate takeover deals, 26/ to the typist 27/ and printer 28/ on the deal, and the taxicab drivers they tip. 29/ Current insider trading investigations have also uncovered related improper financial practices at Kidder Peabody 30/ and at Jefferies and Company. 31/

Overall, the insider trading cases assembled by the SEC are not just a collection of talkative arbitrageurs. They are people from many walks of life who have traded while having inside information they knew to be improperly obtained. Cases have not been limited to tender offers either, but have included friendly mergers which did not involve tender offers, internal restructuring by a company, recommendations in the financial press, good corporate news and bad corporate news.

23/ See SEC v. The First Boston Corp., No. 86 Civ. 3524 (S.D.N.Y. May 5, 1986), Litigation Release No. 11,092.

24/ See note 21 supra.

25/ See, e.g., SEC v. Wahl, No. 86-0568 (D. Neb. Aug. 20, 1986), Litigation Release No. 11,203; SEC v. Borer, No. 86-1204 (C.D. Cal. Feb. 25, 1986), Litigation Release No. 11,009.

26/ See, e.g., SEC v. David, No. 86 Civ. 9462 (S.D.N.Y. Dec. 30, 1986), Litigation Release No. 11,334; SEC v. Elliott, No. 86C10184 (N.D. Ill. Dec. 30, 1986), Litigation Release No. 11,335.

27/ See SEC v. Karanzalis, No. 84 Civ. 2070 (S.D.N.Y. Jul. 12, 1984), Litigation Release No. 10,471.

28/ See SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 105 S.Ct. 2112 (1985).

29/ See SEC v. Karanzalis, No. 84 Civ. 2070 (S.D.N.Y. Sept. 18, 1984), Litigation Release No. 10,542.

30/ See note 21 supra.

31/ See SEC v. Jefferies, No. 87 Civ. 1804 (S.D.N.Y. Mar. 19, 1987), Litigation Release No. 11,370.

III. Linking the Fraud and the Financing

This brings me to the question of the missing link. As you can see, the perceived abuses in the tender offer area include manipulation, but have a lot more to do with disclosure, shareholder protection, and even what I would call misguided attempts at regulating corporate governance at the federal level. And the illegal conduct in the insider trading area involves not only trafficking in tender offer takeover information by arbitrageurs, but many other types of information by other people.

I think you can look at the two areas and say they have little to do with each other. I've discussed the major proposals for tender offer reform: they don't necessarily have anything to do with preventing insider trading. I've discussed insider trading cases: many have nothing to do with tender offers. I believe what creates the image of a causal relation between insider trading and tender offers is current focus on tender offer arbitrageurs who have abused their position for personal gain. We see this kind of activity, and we think -- "Aha! This means that tender offers are inherently rigged. And if there's abuse and insider trading going on here, then it must be everywhere!"

I don't mean by this to make light of the argument that insider trading and tender offers are linked. I can't really, because the argument comes from prestigious and close sources. In introducing his bill on the Senate floor, Senator Proxmire quoted U.S. Attorney Rudolph Giuliani, who said "there's no doubt that there is a connection;" he also quoted the SEC's Enforcement Director Gary Lynch, who said "I definitely think there is a causal relationship." 32/ When we turn to the empirical evidence, the results are encouraging, but not completely satisfying. In a study of 172 successful tender offers over a five-year period, the SEC's Office of the Chief Economist found that about 40 percent of the eventual takeover premium had already been reflected in the stock price by the day before the announcement of the tender offer. While the study finds that about a third of the pre-announcement price run-up can be attributed to media publicity, that leaves a lot that is not attributed to anything. Indeed, the study concludes that the results "cannot reject the theory that illegal inside trading is the dominant source of the

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32/ Cong. Rec. at S7595 (Daily Ed. June 4, 1987).

information that spurs [a stock price] runup." 33/ Other academic studies have concluded that insider trading is the main cause of price run-ups. 34/ Even the Securities and Exchange Commission has concluded there is a link. In the 1986 Annual Report, Chairman Shad states: "The large increase [in insider trading cases] is due principally to the increase in corporate takeovers and to improved surveillance and enforcement systems and techniques by the Enforcement Division." 35/

Therefore, I might concede more than the simple fact that an increase in tender offer activity has occurred at the same time as large insider trading cases involving takeover arbitrageurs. One might conclude that the prevalence of takeovers has led to easy money in the inside information market, and that unscrupulous individuals have seized this opportunity.

However, I am willing to assume that there may be such a link, because I don't believe it tells us much about how to deal with either problem. No one has suggested that tender offers be eliminated in order to eradicate a predominant source of insider trading. Nor are most of the tender offer reforms undertaken with insider trading in mind. For example, in his eloquent opening statement introducing his legislation, Senator Proxmire noted that "[t]akeovers are now the toys of white collar criminals." 36/ However, he stated three goals of his bill: (1) complete and timely tender offer disclosure; (2) stiffer criminal penalties for manipulation; and (3) observance of the guiding principle that "tender offers themselves should be neither encouraged nor discouraged by law." 37/ Now, it's hard to argue with increased sanctions for insider traders, but that really is incidental to

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33/ Office of the Chief Economist, Securities and Exchange Commission, Stock Trading Before the Announcement of Tender Offers: Inside Trading or Market Anticipation? 33 (Jan. 14, 1987).

34/ See Keown and Pinkerton, Merger Announcements and Insider Trading Activity: An Empirical Investigation, 36 J. Fin. 855 (1981).

35/ Securities and Exchange Commission, Fifty-Second Annual Report 1986, at 3 (1987).

36/ Cong. Rec. at S7595 (Daily Ed. June 4, 1987).

37/ Id. at S7596.

tender offers and the main provisions of Senator Proxmire's bill. Fairness in tender offers is the goal.

Would such a proposal -- elimination or severe restriction of tender offers -- even be successful in decreasing insider trading? It is reasonable to assume that insider traders bent on their behavior would find other ways to exploit material nonpublic information. My review of insider trading cases suggests that there are many other ways to do that. And the simple fact that insider trading activity may accumulate around tender offers doesn't necessarily mean that there is more insider trading activity overall. It's like saying the old-fashioned milk with the cream at the top has more cream; it doesn't -- it's just all in one place.

Conclusion

In conclusion, even if insider trading and tender offers are linked, I think it's clear that you don't deal with one by dealing with the other. As a regulatory matter, therefore, I don't see the significance of this link. Tender offers are properly regulated with full disclosure, fairness to shareholders and neutrality between bidders and targets as the guiding principles. Insider trading is regulated with surveillance, by neutralizing foreign secrecy havens, by vigorous enforcement and by stiffer sanctions including fines and imprisonment.

Now, as far as dealing with market volatility, which is after all where this started off, I would give the same answer. To the extent increased volatility -- if it exists -- can be linked to tender offers or manipulative activities, we still should deal with those directly, and not say that dampening volatility will solve the problem. But the causes of volatility are the thrust of this conference, and with that, I'll send you all back to work to discover them.