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Remarks of

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Before the
American Corporate Counsel Association

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Recent Events Relating to Markets for Purchase and Sale of Corporate Shares

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The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners or the staff.

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DAVID S. RUDER
CHAIRMAN
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BEFORE THE
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RECENT EVENTS RELATING TO MARKETS FOR PURCHASE AND SALE OF CORPORATE SHARES

Good afternoon, and thank you very much for giving me this opportunity to speak before the American Corporate Counsel Association. Today, I want to address two interrelated and timely topics concerning the United States markets for the purchase and sale of corporate shares.

First, Congress has been considering several bills to amend the Williams Act in order to provide increased federal regulation of corporate takeovers. The Williams Act amendments to the Securities Exchange Act comprise the principal regulatory scheme governing tender offers. That Act is designed to protect the shareholders of target companies in tender offers by providing a careful balance between bidders and the management of the target company. 1/ This goal of neutrality as a means of protecting target shareholders remains as sensible today as it was when the Williams Act first became law, since it recognizes

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1/ See Piper v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977).

that the shareholders own the company. The concept that corporate managers owe their primary obligations to the shareholders of their corporations is well established in our law and serves as the cornerstone of corporate governance theory. The Williams Act neutrality goal also has important market implications, because it carries the implicit assumption that a competitive, honest market is the best arbiter of the many complex and intricate issues inevitably raised by takeover activity.

The Williams Act contains provisions designed to permit target shareholders ample time and opportunities to make informed decisions, to achieve equal treatment for them when takeovers occur, and to prevent fraud. The Commission has implemented these shareholder protection goals in many ways, including: setting forth detailed disclosure obligations, 2/ regulating the timing of tender offer announcements, 3/ extending pro rata and withdrawal rights, 4/ requiring tender offers to remain

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2/ Rule 14d-6, Schedule 14D-1, 17 CFR 240.14d-6, 14d-100. Regulation 14D, 17 CFR 240.14d-1 et seq., prescribes the means by which material information concerning a tender offer is filed and disseminated to shareholders.

3/ Rule 14d-2(b), 17 CFR 240.14d-2(b), provides that an announcement of the essential terms of a tender offer constitutes commencement of the offer, requiring the filing of a Schedule 14D-1 and dissemination of offering materials within five business days.

4/ Rules 14d-7, 14d-8, 17 CFR 240.14d-7, 240.14d-8. The Commission extended proration and withdrawal rights out of concern that more time was needed by shareholders to evaluate tender offers. Proration and withdrawal rights are now coextensive with the term of the offer.

open for 20 days, 5/ adopting all-holders and best price rules, 6/ regulating issuer tender offers, 7/ and mandating management responses to tender offers. 8/

Recently, the Commission proposed for comment rules that would govern the practice known as "market sweeps." These rules would govern certain acquisitions of securities undertaken during or shortly after a conventional tender offer for securities of the same class and related activities. 9/ The asserted theory is that once a tender offer is begun, shareholders should be protected against control acquisitions in the open market under circumstances in which their participation would not be assured.

5/ Rule 14e-1(a), 17 CFR 240.14e-1(a), establishes a minimum offering period of 20 business days. That minimum period is supplemented by Rule 14e-1(b), 17 CFR 240.14e-1(b), which requires that a tender offer remain open for at least 10 business days from the date that notice is provided of a change in (1) the percentage of the class of securities being sought, (2) the consideration offered, or (3) the dealer's soliciting fee.

6/ Rules 13e-4(f)(8), 14d-10, 17 CFR 240.13e, 140.14d-19. These rules require that the offer be made to all holders of the class of securities subject to the offer and that each shareholder receive the highest price paid to any shareholders tendering into the offer.

7/ Rule 13e-4, 17 CFR 240.13e-4. The Commission has also adopted detailed disclosure requirements for "going private" transactions by issuers and their affiliates to allow shareholders to evaluate the fairness of the transaction. Rule 13e-3, 17 CFR 240.13e-3.

8/ Rule 14e-2, 17 CFR 240.14e-2. Target companies must file a Schedule 14D-9, 17 CFR 240.14d-101, within 10 business days following the commencement of the offer.

9/ *See* Release No. 34-24976, 52 Fed. Reg. 37472 (1987).

Promulgation of this rule for comment illustrates the Commission's continuing concern for target shareholders.

The Commission has now twice expressed its view that the bills presently being considered by Congress should not be adopted because they may alter the even balance of Williams Act regulation. With regard to takeover legislation introduced in both the Senate 10/ and the House, 11/ the Commission has supported measures which would require more prompt disclosure that the 5 percent beneficial ownership level has been crossed, with a standstill on further purchases until filing of a Schedule 13D. By and large, however, the Commission has not supported other aspects of the bills.

For example, while the provisions of the bills differ in various respects, all of them include provisions that would restrict the activities of buyers after certain threshold levels of beneficial ownership are reached. The Commission does not support such legislation because it believes that restrictions on substantial share acquisitions outside of tender offers are not beneficial to target shareholders. Tender offers place

10/ The Senate Banking Committee has approved its version of takeover reform legislation. Largely consistent with the Commission's recommendation, the Senate bill would close the 13(d) window to five days with a standstill on further purchases until filing of a Schedule 13D.

11/ In the House, hearings have been completed on H.R. 2172, the "Tender Offer Reform Act of 1987," introduced by Chairmen Dingell and Markey, and H.R. 2668, the "Securities Trading Reform Act of 1987," introduced by Congressman Lent.

pressures on shareholders to determine quickly whether to sell their shares. Generally, purchases of substantial amounts of stock in normal open market and privately negotiated transactions are not likely to create such pressures.

As you know, legislative proposals introduced to date have not been limited to the regulation of bidders' conduct. The proposals have included provisions which would curtail or eliminate certain practices developed by management as defenses to takeover attempts. The House bills would control the practice known as "greenmail," limit the use of "golden parachutes," and limit issuers' ability to adopt "poison pill" plans. While I share Congressional concerns regarding the potential for abuse in these areas, I believe such activities are internal corporate affairs which should be regulated under state law. If a board of directors fails to fulfill its fiduciary obligations to shareholders, appropriate remedies are available under state doctrines of corporate waste and breach of fiduciary duty. 12/ The Commission testified to this effect before the Senate Banking Committee, and I am pleased to note that the Senate Committee voted not to include provisions in the Senate bill

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12/ See Buckhorn, Inc. v. Ropak Corporation, 565 F. Supp. 209 (S.D. Ohio), aff'd, 815 F.2d 76 (6th Cir. 1987) (enjoining issuance of new stock options to employees and accelerated vesting of existing options in response to tender offer); Feinberg Testamentary Trust v. Carter, 652 F. Supp. 1066 (S.D.N.Y. 1987) (denying motion to dismiss suit claiming breach of fiduciary duty and waste with respect to greenmail payment); Polk v. Good, 507 A.2d 531 (Del. 1986) (same).

that would have inhibited the use of poison pills and golden parachutes. However, the Senate bill does include provisions that would address greenmail.

Concern for preservation of a system of governance of internal corporate affairs does not, however, automatically mean that states should be allowed to interfere with a free national market for sale of shares or that corporations should advocate restrictive state statutes in order to prevent hostile takeovers. In the aftermath of the Supreme Court's decision in CTS Corp. v. Dynamics Corp. of America, 13/ more than a dozen states 14/ have adopted statutes whose clear design is to provide for state control over the takeover process. Changes in control that occur through the vehicle of the nation's securities markets are matters of both state and federal interest. Each state has certain interests in the corporations it charters, especially those located within its boundaries. When a state's legislation primarily affects the transfer of shares in companies which are locally based and locally owned, the state clearly has a legitimate interest in regulating changes of control. On the other hand, Congress has determined that "transactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . in order to protect interstate

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13/ 107 S.Ct. 1637 (1987).

14/ These states include: Arizona, Florida, Hawaii, Louisiana, Massachusetts, Minnesota, Missouri, Nevada, North Carolina, Oklahoma, Oregon, Washington, and Wisconsin.

commerce, . . . and to ensure the maintenance of fair and honest markets in securities." 15/ This statement sets forth a federal securities law policy that I believe to be beneficial to the preservation of viable markets for the sale of securities. The existence of liquid secondary securities markets is extremely important for capital formation in our country, and Congress clearly supports this proposition.

Limitations on the free transferability of securities of corporations that are owned by shareholders nationwide diminish the efficiency, depth, and liquidity of the nation's securities markets. Accordingly, I believe that federal law should control in this area by preempting state statutes that unduly interfere with the free transferability of securities. I believe that corporations whose activities and ownership are national in scope should not be given protection against takeovers by the states where their primary production facilities are located. Just as I believe it to be imprudent for Congress to regulate internal corporate affairs through tender offer regulation, I believe it is imprudent for states to use their authority over matters of internal governance as a means of regulating the interstate market for corporate control. 16/

15/ Section 2 of the Securities Exchange Act, 15 U.S.C. 78b.

16/ In a speech this past September, Chairman Dingell of the House Energy and Commerce Committee expressed concerns that, "state statutes enacted recently may exceed traditional state corporate governance * * *." He cautioned against "balkanizing the economy." *See* Remarks of the Honorable John D. Dingell before the Garn Institute Conference on Restructuring of Corporate America (Sept. 21, 1987).

As I have indicated, my views regarding tender offers are based upon the premise that protecting the ability of shareholders of the target company to purchase and sell their shares is beneficial to a strong capital market. The secondary markets for securities are matters of great importance to the corporate community, since they promote capital formation by providing purchasers of corporate stock with liquid and efficient mechanisms for selling shares they have purchased. Concern for the health of these capital markets leads me to my second topic, the effect of the dramatic events of recent weeks on the market for corporate securities.

During the week of October 5, the Dow Jones Industrial Average declined 158 points. The following week, the Dow fell another 235 points, including then record daily price declines of 95 and 108 points on Wednesday, October 14th and Friday, October 16th, respectively. On "Black Monday," October 19, the Dow dropped 508 points, but on Tuesday, October 20 it rose 120 points and on Wednesday, October 21 it rose another 189 points. By the end of the week of the 19th, the Dow had recovered somewhat, but still closed down 296 points for the week. That day, the Dow stood at 1951. Yesterday, Thursday of this week, the Dow rose 61 points to close at 1960, approximately equal to its close at the end of the week of October 19th. The volatile decreases and increases in stock prices during the past weeks have been accompanied by unprecedented volume. Prior to Friday, October 16, the NYSE had experienced only one day with volume over 300 million shares, and its average daily volume was approximately 200 million shares. Beginning on Friday, October 16, volume increased enormously, reaching:

338 million shares on the 16th
604 million shares on the 19th
608 million shares on the 20th
449 million shares on the 21st
392 million shares on the 22nd and
246 million shares on the 23rd,

even with a 2 p.m. closing.

The Commission is deeply concerned about the impact of market volatility on public investors, on corporations, on market professionals, and on the structure of the market itself. The Commission has been active in its oversight of the operational and financial integrity of the markets during the past weeks, and it is now engaged in examining fundamental questions which have been raised regarding the operation of our market system.

During the extraordinary market events of October, the Commission expanded its usual monitoring and supervisory functions and engaged in significant decision making activities to respond to the market's record volatility and volume. The Commission's expanded monitoring commenced on October 6, when the Dow dropped 91 points. Beginning on October 14, the Commission staff further expanded its monitoring and began to canvas the various exchanges concerning market conditions and the financial conditions of their members.

Due to the significant declines that occurred during the week of October 12, particularly the then record 108 point decline in the Dow on Friday, October 16, preparation was begun over the weekend for possible disruptions in the markets. Throughout the day on Black Monday, the Commission was in constant communication with the New York Stock Exchange to determine volume, the extent of order imbalances, the capital positions of specialists, and any operational problems occurring at the Exchange and other market participants. This constant monitoring continued for the next two weeks, with the Commission keeping in contact with the stock exchanges, options markets, clearing agencies, major broker-dealers, mutual funds and order routing firms. The Commission also monitored mutual fund operations and, specifically, the level of shareholder inquiries and redemptions.

In addition to these monitoring functions, the Commission participated with the New York Stock Exchange, other major securities exchanges, the NASD, the CFTC, and other major governmental agencies in making certain key decisions throughout these weeks. These decisions related, among other matters, to:

1. curtailing program trading on the New York Stock Exchange;

2. dealing with that Exchange's order imbalance problems on October 20;

3. closing the exchanges early;

4. assuring the financial viability of certain specialists;

5. dealing with the liquidity problems of options market making clearing firms;

6. increasing margin requirements of stock index options contracts;

7. clarifying interpretive questions relating to the acquisition by corporations of their stock; and

8. dealing with problems raised regarding mutual funds.

As I have noted, the Commission's staff is studying the market events of recent weeks. In particular, I have asked the staff to investigate causes and effects of extreme volatility. This study will entail a very careful reconstruction of stock, options and futures trading. Among the issues to be addressed by our study will be the role of index-related trading in the markets during this period. Our preliminary information is that so-called index arbitrage and portfolio insurance activity were significant during the market downturns, particularly on the 16th, 19th and 20th.

The study will also cover other questions raised by these events, including the adequacy of dealer capital during increased volume and volatility, and the adequacy of the financial integrity regulations governing broker-dealers. In this connection, I would emphasize that, at this point, the data available to the Commission indicate that all major securities firms remain in a strong capital position.

Additionally, the study will examine the market's operational capacity for order execution, order routing and clearance functions. While, as a general matter, those systems operated remarkably well during the past few weeks, we will study the strains that did appear during the October market break to determine where improvements may be necessary. Finally, we will attempt to study the relationships between the various foreign and domestic markets during this time.

In the wake of the market downturn, a number of public commentators have suggested that takeover stocks and the takeover phenomenon contributed to the market break. As part of the Commission's study, we plan to examine a series of takeover-related questions including: Did takeover stocks lead the market decline? 17/ To what extent, if at all, did the bridge loan positions of major broker-dealers create liquidity problems for them during this period? Another fact specific inquiry which we plan to pursue is whether company buy-back plans, announced in response to the market break, had any effect on the market. According to yesterday's Wall Street Journal, since "Black Monday", approximately 600 companies have announced buy-backs involving more than one billion shares with a combined market value of about $34 billion. 18/

17/ Some commentators have suggested that approval by the House Ways and Means Committee of its proposal for a "Corporate Raider Tax Act" may have affected the market on October 19. See H.R. 3545, Budget Reconciliation Act of 1987. The proposed law would impose a 50 percent non-deductible excise tax on "greenmail" and would disallow interest deductions for indebtedness incurred to acquire stock or assets of a corporation if 20 percent or more of the stock was acquired in a hostile purchase.

18/ See The Wall Street Journal, "Firms' Stock Buy-Back Plans Abound, but Seriousness of Intentions Is Unclear," p.4 (Nov. 12, 1987).

During October, we experienced a market-wide sell off accompanied by unprecedented volume. These events tested the efficiencies of the markets' trading systems, personnel and settlement operations. I believe the systems and the industry handled this crisis quite well under the circumstances. Nevertheless, we have witnessed the most dramatic and volatile market decline since the SEC was formed. Unraveling and analyzing the events of the past weeks is a high Commission priority. We remain committed to determining what course of action should be taken to ensure the continued protection of investors and the financial and operational soundness of the securities industry.