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Public Policy Issues Concerning the Subjects of Tender Offers and the Developing International Equities Market

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

I am very pleased to be here with you in Chicago at this meeting of the American Society of Corporate Secretaries and I am grateful to you for your invitation. I assure you that I have no lasting grudges over the Bears beating the Redskins.

We share the common goal of maintaining the integrity of our capital markets. You, because capital is the lifeblood of a competitive enterprise operating in a free market. I, because I have been fortunate enough to have been appointed to a position in a government agency whose mandate is to assure public confidence in the capital raising mechanism of that free market.

Perhaps we are both condemned to live and work in interesting times. Interesting because the changes taking place all around us increasingly occur at an exponential rate. Interesting too because how each of us, you in the private sector, I in the public sector, react to those changes, have an important collateral effect on each other. I am one who believes strongly that the public interest will be best advanced by recognizing this as a fact of economic life and that we should strive to work cooperatively by consensus and not as adversaries to accommodate ourselves to changing conditions.

The corporate form of organization is indispensable to the operation of a free market economy and is a basic ingredient to a democratic way of life. Capital is allocated,

management and labor organized, consumer wants satisfied by goods produced, communities prosper and stabilize, and the Nation gathers strength. Free entry and exit provide all of us with the ability to participate according to our respective talents. Economies that operate this process with a minimum of governmental intervention adapt to change more easily than do economies where there is heavy governmental involvement.

Changing times pose a challenge to the corporate community and to the S.E.C. Surely an important task for all of us, public and private policy makers alike, is to seek to identify those policies that have served to stabilize free market forces in the past and to consider whether new policies need to be adopted to current conditions to maintain open and competitive markets with a mimimum of governmental intervention.

Let us consider corporate takeovers for a moment because I believe that subject raises the kind of complex policy issues which arise in a changing climate.

TENDER OFFERS

Congress enacted the Williams Act in 1968 to maintain an essential balance between the bidders and the targets of corporate takeovers. Not only were hostile tenders not outlawed but hostile tenders, partial tenders and friendly tenders were subject to the same standard under the law.

The Act required full and fair disclosure to shareholders by requiring the bidder to present its proposal to shareholders while at the same time providing management an equal opportunity to present its position on the offer to investors. In this way shareholders could make up their own minds on the basis of the information after an adequate period of deliberate reflection on whether they should sell, look for a better offer, or hold their shares. Antidiscrimination provisions were included in the Williams Act designed to require equality of treatment to all shareholders by providing for minimum offering periods, withdrawal rights, proration rights, and best price protections.

Congress enacted the Williams Act at a time when there was a reasonable balance of power between the offeror and the target. For a time the Williams Act contributed to the maintenance of this balance. Two major factors in addition to the Williams Act supported the balance. One was the stability of share ownership in the hands of individuals and others that did not view short term appreciation as their primary goal. The other was that management operating under the business judgment rule was able to weigh the various constituent needs of the corporate enterprise: namely, management's responsibility to the juridical entity to maintain its long term viability; its responsibility to produce a competitive product; its responsibility to provide jobs in an

expanding economy; its responsibility to maintain stable employer and community relations; and its responsiblity to prove a fair return to shareholders. Other factors certainly were the legal uncertainty of some combinations under the antitrust case law prevailing at the time; and financing techniques that had not evolved quite as imaginatively as they have since.

Under this set of stable conditions, and in no small part to the operation of the business judgment rule historically, corporations built up an enormous value reserve base not necessarily reflected on their balance sheets or in stock prices based upon earnings multiples. This reserve base has been available to management for use under the business judgement rule to respond in a creative manner to marketplace challenges to achieve corporate purposes.

The balance of power no longer holds. For a variety of reasons the balance has shifted radically against the target and its management to the bidder. Creative financing techniques, creeping stock acquisitons, the 10-day window for reporting stock acquisitions, coercive two-tier partial offers, the advent of institutional holdings emphasizing short term gains, and an anti-incumbent management mood arising in the wake of disastrous Bendix golden parachute, have all combined to place the reserve equity base of corporations built up over many years at the mercy of bidders.

There is a major policy issue at stake here. Hostile tenders do have a salutory effect on incumbent management. But many bidders do not wish to acquire targets to operate them, build a better product or compete more effectively. Their interest is a financial one in the reserve base of the target built up by incumbent management under the business judgment rule. In the process some takeover transactions are leveraged to the hilt with the breakup of the enterprise a likely result to pay off debt. Some shareholders benefit. These are mainly professionals and institutions. More cautious shareholders, primarily interested in long term appreciation, receive the lesser benefits. Nevertheless, in a frontierlike manner industry is being restructured and capital reallocated. But is the free market in capital, plant and equipment continuing to be best served by a regulatory system heavily weighed against target companies?

I find convincing the arguments of responsible corporate groups that the current atmosphere respecting hostile takeovers raises important public policy questions that should be addressed in a fundamental way. There is virtual unanimity of business opinion that takeover threats are distracting corporate managements, forcing them to think short term rather than long term, and reducing their focus on competing in international markets, and thereby threatening the national economy. I believe that the policy ramifications raised by

those responsible business groups deserve most serious consideration by the public, the Congress and the S.E.C.

As in physics, so in life, every action has an equal and opposite reaction. Corporate managements are now attempting to reinstitute the balance of power between bidders and targets by altering the by-laws of corporations and their financial structures and creating various classes of voting stock. Exchanges which have historically required corporations to adhere to the one share one vote principle are now reconsidering their listing requirements to accommodate the new reality. The new reality is that unless their listing requirements are altered other exchanges, over the counter markets, and even as yet underdeveloped overseas markets, will efficiently handle market trading in delisted stocks.

The discussion of listing criteria is a side issue. I am not in favor of the S.E.C. mandating listing requirements concerning voting rights not only because I do not believe we have the statutory authority to do so, but that with the international market as sophisticated as it is becoming, I do not believe the S.E.C. can effectively prevent markets in stocks with different voting rights from going abroad. More importantly, I believe one should regard the stock voting issue for what it is, and that is an aberration caused by a fundamental problem with takeovers.

Having raised the policy issue, the next question may be what is to be done about it. It might be argued that nothing need be done, that things are working just fine. Bidders had their way for a while, now target managements are developing their defensive strategies, and if and when shareholders who are disenfranchized discover that their share prices fall there will be yet another reaction. This argument has appeal for me since I am reluctant to look to the enactment of federal statutes as solutions to what are essentially state matters of corporate law.

Despite these reservations I believe the time has arrived for Congress to conduct a fundamental review at the federal level of takeovers including bidder and defensive tactics. I do not believe that Congress has conducted such a review to date.

In my view such a review is necessitated by the clear fact that our historically balanced and stable industrial and financial policies and the national market for securities is in danger of substantial disruption by the offensive and defensive tactics being increasingly deployed in corporate takeovers. It has become a big money game to many but the stakes for our national well being are too great to be ignored by the rest of us.

Does that overstate the case? I think not. Policies that dissuade corporate managements from their historical role under the business judgment rule of concern for the long term viability of the enterprise, building a competitive product for domestic and international markets, devising strategies for stable employee and community relations, and concern for enhancing shareholder values and force those managements into emphasizing new policies designed for maximizing short term interests and which alter corporate capital and voting structures are counterproductive to our best economic interests. Corporate managers need to operate under regulatory and tax incentives that maximize corporate competitiveness, not defensive strategies to ward off takeovers. The national market for securities is not enhanced by substantial numbers of securities issued for trading whose chief purpose is to gerrymander corporate control and in the process shift corporate wealth to the current generation of corporate managers. The current atmosphere results in too much emphasis on short term fiancial results at the expense of long term productive economic considerations.

I would establish 8 goals that deserve serious consideration in any comprehensive review of corporate takeovers. Those 8 goals are as follows:

1. Hostile offers should not be banned but serious consideration should be given to requiring hostile tender offerors to tender for all outstanding shares at the same

price and for identical consideration. This goal would eliminate coersive two-tier offers, resulting in equal treatment to the shareholders. Managements could not become complacent since hostile tenders would be permitted but the offeror presumably would have the purpose in taking over the corporation of running the enterprise.

2. Partial offers should be permitted with the approval of the board of directors of the target. Hostile partial offers should be prohibited. In my view hostile partial offers are the prime cause creating the adverse public policy consequences I have established. Hostile partial offers permit bidders with no purpose other than a threatened bust-up takeover to blackmail managements into paying them off by using the reserve equity of the corporation built up over many years under the exercise of the business judgment rule. Public policy in the past has fostered the use of this reserve equity to maintain the competitiveness of the enterprise in domestic and international markets. In my judgment public policy should continue to foster this objective. Fostering highly leveraged operations while putting equity capital into the hands of greenmailers and takeover entrepreneurers is not a public policy which should be fostered.

3. Antitrust and tax policies which favor lightening strikes and leveraged takeovers hould be discouraged. Amalgamations, even large amalgamations, are perfectly permissible

under antitrust statutes. But loopholes in those laws designed to foster notice of an impending takeover have contributed in concert with loopholes in the Williams Act to the ability of bidders to establish increased positions at the expense of shareholders. Serious thought should be given to prohibiting the deductibility of interest expense for takeovers other than for all shares and for partial tenders not approved by the board of directors of the target.

4. The viability of the business judgment rule should be reaffirmed. Proposals to shift the burden of proof once a takeover has begun serve to frustrate the valuable historical public policies I have discussed concerning management flexibility to concern itself with the several corporate purposes including but not limited to short term shareholder appreciation.

5. Greenmail (a polite term for extortion) should be banned by prohibiting the purchasers of blocks of shares from selling those shares to the corporation for a period of years. This would put the prohibition where it belongs, squarely on the extortionist. Most takeover entrepreneurs do not have the seriousness of purpose that would be entailed to sustain an offer for all shares or to maintain a partial position for years and they simply will not make offers.

6. Serious consideration should be given to eliminating margin regulations for purchasing stock. Recent studies indicate little or no evidence to support such regulations. Share prices are undervalued. Can one imagine what would happen to housing prices or to the housing industry or to consumer goods industries if 50 percent cash were required for every purchase.

7. The Williams Act should be updated. The 10-day window should be closed. The best price rule of identical consideration should be extended to two-tier offers.

8. Within the context of the adoption of the goals I have outlined a policy goal should be established concerning shareholder voting rights. One share one vote cannot be mandated unless international markets establish such a regulatory base. But the goals I have set forth if adopted would re-establish the heretofore existing balance of power between bidders and targets so that defensive tactics would fall of their own weight because they would no longer be necessary.

THE INTERNATIONAL MARKET

Change is the order of the day. Since World War II we have gone from a domestic producer economy to an economy characterized by worldwide competition. Every one benefits by international competition.

Just as the domestic economy prospered from a large unfettered market from the Atlantic to the Pacific so will the world economy continue to prosper with free and open international markets.

There is no turning back. Beggar thy neighbor protectionist policies gave us the Great Depression of the 1930s and contributed substantially to the advent of World War II. Since then, especially in the wake of World War II, we have built an infrastructure of international trade and finance that has helped forestall a repetition of the castastrophies of the earlier years of this century and provide the base of essential economic integration between the U.S., Canada, Japan and Europe.

The infrastructure consists of Asiatic and Western multinational corporations producing goods and components essentially without regard to national boundaries and a world-wide commercial banking system for deposits and commercial loans backed up by the Intenational Monetary Fund to stabilize world currencies. Capital debt financing is well on its way to being internationalized and with the development of computer technology an international equity market centered in New York, Tokyo and London will surely follow closely the paths of the international production and banking markets.

Integrated and well developed international equity markets that parallel international lending and debt issue markets hold the potential for substantial corporate and investor benefits. A wider range of investor interest may deepen the market for corporate share issuances. Certainly increased international competition should give corporate managers a greater range of options. Increased liquidity should enhance investor values while enabling the investor to respond to changing requirements without regard to current trading hour restrictions.

It seems that almost every day we read something in the press about the integration or discussions to integrate various trading markets in one respect or another between a U.S. market and a corresponding market in another part of the world. The continued develoment in high speed computer communications technology makes it inevitable that these developments will accelerate.

As markets will be challenged, so will the S.E.C. as a regulatory body. The challenge for the S.E.C. and foreign regultory bodies will be to adopt regulation to the integrated international equity markets in a manner that fosters the competitive evolution of those markets but does not introduce elements of distortion.

One concept that bears a huge potential to distort the developing integrated equities market is the so-called waiver-by-conduct concept issued for comment by the S.E.C. Under the concept a foreigner purchasing securities in the United States would be held to have waived by his conduct of purchase in the U.S. any rights he may have to secrecy privileges in the foreign country of origin.

Waiver by conduct emcompassed the Lone Ranger concept to international economic relations. Essentially, it says that the U.S. will unilaterally establish the standards for cross-border trading and that the rest of the world will have to pass muster. Implicit is the arrogance that the U.S. market is so enviable that the foreigners will be forced to comply with our requirements regardless of their historical sensibilities.

The concept and its rationale flies in the face of economic and practical reality.

My concern is that if such a concept were ever to be put into effect it would adversely effect capital flows into the U.S., distort the developing international equity market by driving business overseas, and create bilateral tensions that would obstruct efforts to liberalize worldwide financial markets and improve international economic cooperation.

With the development of integrated equity markets, regulators the world over will have to develop cooperative means to identify practices which adversely affect the integrity of their respective markets and then to effectively devise enforcement programs to prevent such practices from going undetected or unprosecuted because of procedural delays that have been up to now built into the international legal system. The international legal system surely needs updating. But the updating must take place in bilateral discussions between soveriegn nations which have historically benefited greatly by open and unfettered international markets and who no doubt will see it in their own and everyone elses best economic intent to provide reasonable regulatory protections to an integrated world equity market.

Not only does waiver-by-conduct approach the subject of integrated world markets with a too heavy burden but in practical terms the probability is that as a solution it will not work. It has no effect on foreign blocking statutes and as far as foreign secrecy statutes is concerned I think the Treasury Department hit the nail on the head when it said that "foreign governments and courts are not likely to view a legislated implied consent to disclosure (the key element of the waiver by conduct concept) as equivalent to the consent to disclosure which is required under many foreign secrecy laws in order to authorize the production of documents."

Waiver by conduct has shown us the wrong way to go both for economic policy and practical reasons. What is the right approach?

I believe that we should establish an international structure for the developing world equities market that parallels the structures which now exist for international commerce and international finance. Those structures are the General Agreements on Tariffs and Trade, the Coordinating Committee of Western Nations for Strategic Trade, the coordinating role played through the Bank for International Settlements on monetary policy and on the regulatory policy for commercial banks and the coordinating role being developed by the International Monetary Fund concerning financial information regarding borrowing countries.

The unifying principal of these international bodies which have played such a key role in the development of the world economy is that they operate by consensus not by fiat; and they are comprized in membership by officials in their respective countries with the authority to influence and to put into effect policies in home countries which advance the goals of free and open international markets.

In my view, such a body, established for the international equity market, should be limited in its first years of operation to representatives of the United States, Canada, England,

Switzerland and Japan. It appears to me that the developing integrated international equities market will be centered in those nations. In addition maximum coordination by consensus requiring unanimous action will be achieved by focusing on the central core of the world market.

The representatives to such an international body should be on behalf of the United States the Securities and Exchange Commission and the S.E.C. counterparts overseas. This limitation would ensure that the new structure would concentrate on the specific technical matters requiring attention and would also assure that whenever agreement is reached, implementing regulations would be adopted. I would envision the establishment of a working body having the authority to implement agreements reached by unanimous consensus.

Clearly, the S.E.C. is the agency which should represent the United States. Throughout its 50 year history the S.E.C. has proven that it knows how to implement its mandate of full disclosure while steering clear of the temptation to fine tune the market by regulation. The regulatory system regarding securities markets places heavy reliance on the concept of self-regulation, both for accounting rules and practices, and for the regulations of trading in securities. The S.E.C. has shown that it has the correct sensitivity for the unique structure and the role of the Federal government in this process.

As the world equities market develops, the self-regulatory organizations will exercise the substantial responsibility for the evolution of the market. The S.E.C. can play a crucial and helpful role in the development of the market by assuring that unnecessary regulatory impediments are removed and new procedures devised by consensus to meet new realities in international markets.

It has been my pleasure to be with you this evening and I look forward to hearing your comments on the points I have raised for discussion.