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**News
Release**

TENDER OFFERS: THE ARGUMENTS AND THE EVIDENCE

Remarks to
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American Society of Corporate Secretaries
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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Good morning!

It's a pleasure to be here with you in Boca Raton today. I hope you're all enjoying your days away from the office.

As most of you can attest, life at the top of the corporate ladder is not without stress. Madison Avenue has learned to capitalize on the plight of the corporate decision-maker. By way of example, let's examine Alka-Seltzer advertising. A few years ago, Alka-Seltzer was known as the remedy for the pain and discomfort of the man who sat up in bed and said "I can't believe I ate the whole thing." Today's Alka-Seltzer commercial takes place, not in the bedroom, but in the boardroom where a dozen executives anxiously await the remarks of the chairman of the board. After the chairman proclaims that they've had "another record year," he announces the new goals: "sales -- up twenty percent; distribution -- expand another ten percent; and finance -- squeeze out four percent!" It's here that the volume on the sound track of "plop plop fizz-fizz" is increased. It's a sad sign of the times to note that the slogan for the 80's has become "Alka-Seltzer -- for the symptoms of stress that come with success."

Let's focus our attention on the corporate secretary who was seated next to the chairman of the board at that meeting. We'll call him Richard. Suppose Richard scheduled the meeting not with the expectation that the chairman would announce the year's upcoming objective to increase productivity, but to help prepare for the advent of a corporate takeover.

Poor Richard has worked hard to reach his status in life. He graduated from Harvard Business School nearly thirty years ago. He started with the company as a trainee and has diligently crawled up the ladder of success. It may have taken him thirty years to get from the first to the seventh floor, but the point is that he has "made" it. Richard is now the corporate secretary of a major corporation. He has always tried to exercise his best business judgment. He is even a member of the American Society of Corporate Secretaries. After years of struggle, Richard thought he was professionally secure.

As the potential for a takeover gained momentum, poor Richard was forced to schedule an emergency meeting to discuss the fact that a known outside raider was about to bid for control of the company. Richard has dedicated most of his adult life to ensuring that the company is sound and solid and suddenly an outside raider -- we'll call him Darth Raider -- doesn't believe that his efforts have been good enough. The outsider doesn't believe that the company's shareholders are realizing maximum value. How would you feel in his position?

Bear in mind that we are not just talking about any well meaning outsider. Darth Raider is someone you wouldn't want in your country club, let alone your boardroom. How would you react?

If my guess is right, you would react as any rational person on the board of a target company -- that is, defensively! Your first action would probably be to call in a specialist who would help develop creative strategies to position your defensive response.

You may choose to make a responsive counteroffer for the stock of the raider pursuing your company, otherwise known as the "pac man defense," or perhaps you'll cause the prospective bidder to swallow a "poison pill," by making your beloved company so unattractive as to discourage the bidder from taking on a company with newfound corporate debt. Whatever defensive method you employ, your decision is certain to affect the shareholders. Your business judgment will either cause the shareholders to realize a benefit or to experience a loss.

It's common knowledge that injected into most decisions concerning the takeover process, be it hostile or friendly, is an inherent conflict of interest between the concerns of management and the shareholders. This is particularly true when defensive tactics are being employed in a hostile takeover. A benefit to shareholders by virtue of receiving a higher price for their shares, for example, could translate into the loss of jobs and/or control for management.

The question of whether federal intervention, with respect to the business judgment rule, is appropriate in the takeover context has been subject to much debate and is beyond the scope of today's discussion. The Commission, however, has taken the position that the voting rights of corporate securities is fundamental to state corporate law and, as a general matter, it does not support federal preemption in this area.

I.

In accordance with the mandate of the Williams Act, which added several new disclosure sections to the Securities Exchange Act of 1934, the Commission has taken a neutral role in the takeover arena since 1968. Prior to the enactment of the Williams Act, the bidder or aggressor corporation was not required to disclose the source of the funds to be used for the acquisition, the plans upon acquiring control of the target, or, in fact, its identity and background. The disclosure requirements embodied in the Exchange Act are intended, among other things, to provide the shareholder with adequate time and information to evaluate the merits of a tender offer and to make a reasoned decision with respect to either accepting or rejecting the tender offer. While it may be argued that federal regulation is not consistently neutral, the current regulatory scheme regarding tender offers is designed not to favor the bidder or the target corporation.

The takeover process, in step with the economic, technological, legal and financial environment, has undergone significant change since the adoption of the Williams Act. The accepted rules of the game have become more complex and sophisticated while the stakes have risen dramatically. The emergence of the two-tier bidding strategy -- where the per share consideration for one portion of the shares is higher than the remaining portion to be acquired -- is as typical, by today's standards, as is the takeover bid in the billion dollar range.

In response to the many changes in takeover practices in general, and in bidding and defensive strategies in particular, the Commission established the Advisory Committee on Tender Offers in February, 1983. As you may know, the Advisory Committee was established to review tender offer practices and regulations and to make recommendations for regulatory and legislative improvements for the benefit of all shareholders.

In its report, the Advisory Committee presented fifty recommendations that, while preserving the basic tenor of the current regulatory scheme, included changes in the federal regulation of both bidders and targets. After reviewing the staff's analysis of the Committee's recommendations, the Commission chose to implement many of the Advisory Committee's recommendations through existing rulemaking authority, and continues to study others. In addition, the Commission submitted a legislative proposal to Congress on May 21, 1984, in furtherance of still other recommendations of the Committee. The measure did not pass the House.

The Tender Offer Reform Act of 1984, as it was called, would have amended Sections 13(d) and 14 of the Securities Exchange Act of 1934 to:

- (1) shorten the ten-day filing period under Section 13(d);
- (2) prohibit golden parachutes or any increase in compensation of an officer or director during certain tender offers, unless the increase was made pursuant to a previous contractual agreement;
- (3) prohibit greenmail unless approved by a majority of the shareholders or unless an offer of equal value is made to all holders of the class;
- (4) prohibit issuer acquisition of its own securities, except through ongoing programs undertaken in the ordinary course of business during certain tender offers; and
- (5) prohibit issuance of securities constituting more than five percent of a class of securities or more than five percent of the issuer's voting power, during certain tender offers.

On May 20, 1985, the Commission voted to support its 1984 legislative proposal on tender offers with respect to the closing of the ten-day window period for filing a Schedule 13D. The Commission simultaneously voted against supporting its previous position with respect to golden parachutes, defensive reacquisitions, defensive share issuances and greenmail. The Commission expressed a number of views when it decided not to support the bulk of the 1984 legislative proposal. In particular, the Commission observed that many changes have occurred in the marketplace and that treating specific issues in such a dynamic environment may prove to be ineffective or unnecessary. In light of the fact that new tactics are constantly being developed, it was also felt that attacking specific defensive tactics would simply not solve the problem. Furthermore, the Commission heard testimony from diverse interest groups -- both institutional investors and large corporations -- and the overriding sentiment was consistent with the Commission's decision. 1/

II.

This year, public policy discussions have turned away from examining regulatory responses to specific abuses in the tender offer area, to a more general debate over whether hostile takeovers ultimately benefit shareholders and the economy. In this regard, I notice that Mr. John Hetherington, testifying before the House Subcommittee having oversight of the Securities and Exchange Commission, on behalf of the American Society of Corporate Secretaries, has questioned the economic benefits of tender offers. Furthermore, I remember he raised similar questions at the American Society of Corporate Secretaries meeting with the Commission in January of this year.

The Commission remains neutral on this issue and has concluded that tender offers are not per se beneficial or harmful to the economy, the securities markets, or, indeed, to issuers or shareholders. I would, however, like to share my personal perspective

1/ The Commission heard testimony from the following experts: Harrison J. Goldin, Comptroller, City of New York, representing the Council of Institutional Investors; Douglas Ginsburg, Administrator for Information and Regulatory Affairs, Office of Management and Budget; A.A. Sommer, Jr., Esq., Morgan, Lewis & Bockius, representing the New York Stock Exchange Advisory Committee on Listing Requirements; Philip R. O'Connell, Senior Vice President and Secretary, Champion International Corporation, representing the Business Roundtable; and Lawrence Spiedell, Senior Vice President, and Alan Strassman, Executive Vice President of Batterymarch Financial Management.

with you today. The views that I am about to express have been developed based on my research as an economist as well as from my experience as a member of the Securities and Exchange Commission.

At the center of the debate over whether hostile takeovers benefit the economy are two competing hypotheses. The first hypothesis, the pro tender offer theory, is that the overall effect of hostile tender offers is to bring a resulting benefit to shareholders with a concomitant increase in economic efficiency. This theory has long been espoused by financial economists who contend that the shareholders of both the target and the bidding company receive a benefit. In addition, these economists argue that the end result of a successful tender offer is to reallocate resources to higher valued uses and in so doing to benefit the economy.

The opposing hypothesis, which I shall refer to as the short-term argument, is generally espoused by critics of hostile tender offers. These critics are likely to be corporate managers and are no doubt sitting among you. In Mr. Hetherington's words, "the larger question certainly is whether in fact investors do actually benefit from tender offers." He says, "an affirmative conclusion is far from proven." 2/ The proponents of this theory contend that the mere threat of a hostile takeover so preoccupies corporate management with short-term objectives as to sacrifice its use of foresight in the process. Specifically, the critics assert that by concentrating on the immediate need for increased short-term earnings, the corporate executives associated with the target company ignore or sharply curtail any investment in such long-term projects as research and development ("R&D"). As Mr. Hetherington testified, "if companies are deemed to have only present value there will be no new opportunities or motivation for individuals nor stimulus for research and innovation. We cannot hope ever to compete effectively in world markets if the diet of our capitalism consists only of dessert."

This short-term theory is premised on the perception that institutional investors, such as pension funds and mutual funds, now dominate ownership of corporate equity. It is further perceived that these institutional investors are applying pressure on the respective corporations to concentrate on short-term performance and to abandon long-term investments that are not likely to show a short-run profit in the process. Unlike the individual shareholder, who no longer controls the market, the institutional investors are said to have a proclivity to regularly "churn" their portfolios. The tendency for institutional investors to churn their accounts presumably stems from the fiduciary

2/ Statement by John W. Hetherington, Esq., before the U.S. House of Representatives, Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, May 22, 1985.

responsibility of fund managers and from the intense competition in the market among money managers. This competition has prompted quarter-to-quarter monitoring of their performance.

It has been said that the short-sightedness attributable to large institutional shareholders tends to facilitate hostile tender offers in that the institutional investor will not hesitate to tender shares to the next bidder who offers a premium, however slight, over the market price. In accordance with the short-term argument, once the corporate managers are faced with investors' short-sighted behavior, they respond by increasing short-term earnings, thereby propping up stock prices, and quickly sacrificing otherwise profitable long-term investment plans. In brief, if a future project requires that the corporation incur current expenditures in anticipation of future earnings, the project is in jeopardy of being abandoned. The hypothesis finally concludes that this widespread myopia among corporate executives is impeding our ability to compete in the international economy generally, and with Japan specifically. 3/

Those of you who attended the meeting of corporate secretaries, which was held by the Commission in January of this year, can probably predict my next statement: What is the evidence for each of these hypotheses?

Numerous studies have been prepared by financial economists showing the effects that successful and unsuccessful tender offers have had on shareholders. These studies report gains to shareholders in both the target corporation and the bidding companies where successful corporate takeovers are concerned. While the benefit to shareholders in bidding firms hovers near a four percent capital gain, the benefit to shareholders in target corporations is substantially greater and has climbed from thirty percent in the mid to late seventies to nearly fifty percent today. These studies also reflect a gain of twenty percent to shareholders of the target company from mergers. Economists have concluded that such gains to shareholders from tender offers ultimately benefit society as they reallocate resources from lower valued to higher valued uses. These results are consistent with the operation of an efficient capital market and have been quantified.

Critics who are hostile to hostile tender offers cite studies by Kidder Peabody or Forbes that purport to show that target

3/ It is interesting to note that in Japan the percentage of equity that is owned by institutional investors has grown rapidly in recent years. By way of example, the percentage of institutional investors was 38.6 percent in 1950. By 1982, the equity ownership by institutional investors nearly doubled at 71.9 percent. Certainly, no one here would argue that the Japanese corporate hierarchy has sacrificed long-term objectives for short-term goals.

shareholders are generally wealthier when hostile tender offers are defeated than they would have been if the offer had succeeded. However, both studies' results are seriously biased. 4/ The proper test is to invest the proceeds of the tender offer, as if it had been accepted, into a general market portfolio and, at a future date, compare the value of the hypothetical portfolio with the target's actual stock price. When this is done the results are reversed = target shareholders are generally worse off when the offer is defeated. For twenty-seven of thirty-one targets in the Kidder Peabody sample and twenty-nine of thirty-three targets in the Forbes sample, shareholders would have fared better by accepting the offer.

So far, the critics of hostile tender offers have not presented any evidence to support their short-term hypothesis. In an effort to increase the Commission's knowledge about the tender offer process, the Office of the Chief Economist has been testing implications of the short-term hypothesis. 5/ Contrary to the critics' claims, the evidence shows the following:

First, the growth of institutional ownership of corporate stock has been accompanied by an increase in R&D expenditures. This fact contradicts the notion that the expansion of institutional ownership is forcing corporate managers to become more myopic.

Second, target firms exhibited lower, not higher, R&D-to-sales ratios than the industries in which they operate. This indicates that investment in long-term projects does not increase a firm's vulnerability to a takeover.

Third, institutional ownership in target firms was substantially lower than average institutional ownership in the firms' industries. Hence, the data contradict the assertion that high institutional ownership gives rise to hostile takeovers.

4/ Kidder Peabody measures the target's stock performance relative to inflation rather than the market and Forbes measures the target's stock performance relative to a price thirty to sixty days after announcement of the tender offer rather than the price immediately after the offer.

5/ The following indirect evidence is inconsistent with the short-term argument: (1) the market effectively values time-discounted cash flows, not merely current reported earnings; (2) the market does not devalue companies that change their inventory valuation from FIFO to LIFO during periods of positive inflation rates; (3) price-earnings ratios vary widely across firms; and (4) the principal sources of financing for venture capital firms are institutional investors.

Fourth, reactions of stock prices show that the capital market positively values an announcement that a company is embarking on an R&D project. This evidence contradicts the argument that the market penalizes companies that invest in long-term projects and thereby makes them candidates for hostile takeovers.

I would like to make a point for the benefit of the critics in the audience. While I recognize that any study is subject to some criticism, the opponents lose credibility in the absence of an independent study in support of their short-term hypothesis. The Commission welcomes constructive comments for improving the study, and because we view the study as a first step in attempting to measure the phenomenon, we continue to encourage the critics of hostile tender offers to produce a well reasoned empirical study to the contrary. While I understand and appreciate the concerns of corporate management associated with the short-term argument, I am dissuaded by the fact that the evidence belies the argument.

To summarize, the available evidence consistently supports the theory that shareholders and the economy benefit from tender offers. At the same time, the available evidence contradicts the theory that the threat of a hostile takeover inflicts economic harm by leading corporate managers to concentrate on the short run at the expense of better corporate opportunities. This is not to say that the threat of a hostile takeover does not disrupt business as usual at a corporation -- it does. Nor is it to say that every tender offer is good for shareholders and the economy. Rather, the evidence shows that tender offers are generally good for shareholders and for economic efficiency.

III.

I would like to turn to a brief discussion of three recent developments in the takeover arena.

The first area concerns the development of the so-called "junk bond" phenomenon. I emphasize "so-called" because I regret the pejorative term that has been ascribed to these bonds. While it is difficult to pin down a specific definition, the term junk bond generally refers to a high yield non-investment grade corporate debt or debt securities that have not been rated at all by a nationally recognized investment rating service. Because these securities are rated below the investment grade, that is, below the top four investment grades by Moody's Investors Service or Standard & Poor's Corporation, the risk that attaches to the security is high. Junk bonds are also perceived as high risk because non-investment grade bonds are said to be more likely to default. Although, as I have indicated, junk bonds are typically rated at less than investment grade, a grade cut off point which would trigger junk bond status has yet to be determined.

While other agencies are planning a crackdown on investments in high-yield bonds, the Commission does not believe that the situation warrants any regulatory action on its part. It is however, closely monitoring the use of these instruments as a means of financing hostile or friendly tender offers as disclosed in filings on Schedule 14D-1.

The Office of the Chief Economist at the Commission has recently compiled data on the high yield bond issue. Not surprisingly, as a percentage of total new corporate straight debt issues, non-investment grade issues have increased from six (5.6) percent in 1980 to a striking twenty-four (24.2) percent in 1984. Furthermore, as a percentage of total corporate borrowings, non-investment grade debt issues increased from three (2.6) percent in 1980 to ten percent in 1984. As a percentage of total debt issues, the relative amount of junk bond financing has increased three to four fold in the past three years. Of the total amount of junk bond issues, however, a relatively small amount has been used for acquisitions and leveraged buy-outs, approximately twelve percent, 6/ and for hostile tender offers, two percent. 7/ As far as leveraging, data show corporate debt ratios are not much different than they have been historically.

Legislative initiatives in response to the proliferation of junk bond financing have received considerable attention. One initiative, proposed by Senator Domenici, would prohibit all investments in junk bonds for federally-insured institutions as well as place a temporary moratorium on hostile takeover attempts financed with junk bonds. The Commission, as you might guess, considers this response to be an overreaction and would not support a moratorium simply for the purpose of providing a period of time in which to consider the efficacies of the situation. A moratorium could prevent these high yield bonds from being put to perfectly legitimate uses.

Underlying Senator Domenici's bill is the issue of whether junk bond financing of hostile takeovers should be prohibited. Those in favor of the proposed legislation find an inherent evil in hostile takeovers; a concern that I do not share. Regardless of where you stand on this issue, it is important to keep the growth of junk bond financing in perspective. Because it has

6/ Drexel Burnham Lambert Incorporated; "Acquisitions and High Yield Bond Financing." Submitted to the U.S. House of Representatives, Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, March 20, 1985.

7/ Joseph, Frederick H., Testimony before U.S. House of Representatives, Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, February 27, 1985.

been shown that junk bond financing makes up only a small segment of the available financing for hostile takeovers, a prohibition will have little, if any, effect in preventing hostile takeovers. Even if a prohibition were to pass, the financial industry has proven to be ingenious enough that the creation of an alternative means of circumventing the legislation would be inevitable.

The position of the Securities and Exchange Commission has been to ensure that the industry fully complies with its disclosure rules. If disclosure remains full and accurate, the Commission believes that the ultimate decision of whether or not to invest in junk bonds should remain with the investor.

The second development, two-tier tender offers, has been subject to much criticism. Two-tier tender offers, as previously mentioned, are acquisitions initiated by a tender offer, wherein the per share consideration is different for the control portion of the shares to be acquired than for the remaining portion.

A recent study by the SEC's Office of the Chief Economist examined the economics of any-or-all, two-tier and partial tender offers. Using a sample of 228 tender offers initiated between January 1981 and December 1984, this study found the following results:

- (1) the predominant type of tender offer is the any-or-all offer;
- (2) the frequency of two-tier offers has declined during the past two years;
- (3) the average blended premium, i.e., the total value averaging the front and back end of the offer, paid in two-tier tender offers, fifty-five (54.5) percent, is not significantly different from the average premium paid in any-or-all offers, sixty (59.6) percent;
- (4) a higher proportion of outstanding shares are tendered on average into any-or-all offers (73 percent) than into two-tier offers (62 percent) or pure partial offers (34 percent); and
- (5) more than one-half of all tender offers begin as negotiated offers while more than three-quarters of all tender offers are ultimately negotiated. 8/

8/ Approximately seventy percent of these offers were any-or-all offers, seventeen percent were two-tier and thirteen percent were partial offers.

One inference that can be drawn from the data is that any regulatory attempt to restrict partial or two-tier tender offers would insulate management of large corporations from a takeover because two-tier and partial offers are most common for large firms. A second policy implication is that two-tier offers do not necessarily result in a disadvantage to the shareholder. In fact, shareholders collectively fair almost as well in two-tier offers as they do in any-or-all offers. Furthermore, even shareholders who do not tender into the first tier of a two-tier offer receive a substantial premium over the pre-offer price. A third implication is that regulation designed to deter hostile two-tier offers could end up deterring offers generally because it is not clear a priori whether the offer will end hostile or friendly. Another implication is that two-tier offers don't lead more shareholders to tender than in any-or-all offers.

The third area concerns the need for the bidder to extend its offer to all holders of the target security. Recently, the Commission observed the contest between the Unocal Corporation and the Mesa Group with particular interest. Unocal's amended issuer tender offer specifically excluded the Mesa Group and in so doing failed to make its offer to all shareholders of the class, which was the subject of the offer. Their conduct defied the spirit of Section 13(e) of the 1934 Act and Rule 13e-4 thereunder. The fact of the offer, coupled with recent court opinions on both the state and federal level, which permitted Unocal to exclude the Mesa Group from participating in Unocal's issuer tender offer, has given the Commission cause for concern. In this regard, members of the staff are currently considering a rule that generally would bar companies from excluding shareholders from a tender offer.

8/ (Footnote Continued)

In 1982, twenty-seven percent of all tender offers were two-tier offers. This percentage declined to fifteen percent in 1983 and to nine percent in 1984.

The average premium paid in the first tier of two-tier offers, sixty-three (62.8) percent, actually exceeds the average premium paid in any-or-all offers. Contrary to the popular perception that back-end premiums in two-tier offers are low, the study found that the average back-end premium paid in two-tier offers is forty-five (44.8) percent. The average blended premium paid in partial offers, twenty (20.1) percent, is considerably lower than that paid in any-or-all or two-tier offers.

Ninety-two percent of all two-tier offers, eighty-four percent of all any-or-all offers and thirty-nine percent of all partial offers are ultimately negotiated.

CONCLUSION

When the climate is so sophisticated that greenmail payments have been appropriately renamed camomail -- that is, where payments are so camouflaged that the presence of a greenmail-type arrangement is disguised -- then reexamination of the takeover process and a continuous reevaluation of the regulatory scheme is essential. In this regard, the Commission is actively exploring a number of issues surrounding corporate takeovers and other contests for corporate control.

To summarize my remarks today, there is an abundance of evidence for the pro tender offer hypothesis with a corresponding lack of evidence for the short-term hypothesis. Next, there is a troubling move toward prohibiting junk bonds and altering tax treatments as a means of attacking hostile tender offers. In addition, the arguments against two-tier tender offers don't stand up against systematic examination of those offers. Finally, I emphasized the basic principle that tender offers should be offered to all shareholders.

Thank you.

Now, I would be happy to respond to any questions that you might have.