University of Miami Law School
Institutional Repository

University of Miami Law Review

9-1-1979

The Federal Securities Code: Some Comments on Process and Outcome

Richard R. West

Follow this and additional works at: http://repository.law.miami.edu/umlr

Recommended Citation

Richard R. West, *The Federal Securities Code: Some Comments on Process and Outcome*, 33 U. Miami L. Rev. 1485 (1979)
Available at: http://repository.law.miami.edu/umlr/vol33/iss5/6

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.

The Federal Securities Code: Some Comments on Process and Outcome

RICHARD R. WEST*

The author questions the merits of certain aspects of the Code and the process which produced them. He examines the tender offer provisions in the Code and offers empirical evidence which demonstrates that regulation of tender offers under the Williams Act has increased the costs of tenders and has hurt investors. Noting that the goal of the Code is to "protect" investors, he concludes that the tender offer provisions fail to attain that goal.

I. INTRODUCTION

In a moment or two it will become quite obvious that I am rather skeptical about the merits of certain aspects of the proposed Federal Securities Code, as well as about the processes that produced it. I do not apologize for this. Indeed, I suspect I was asked to participate in this event primarily because its organizers assumed that my views might include some critical dimensions. All the same, it is important to state at the outset that I am basically very supportive of the importance of a codification effort and of much of what the proposed Code includes. It goes without saying that Professor Loss and his colleagues deserve to be congratulated for their efforts.

There is no doubt that some will conclude that my comments and criticisms are unfair. As an economist, I will concentrate on the substantive economic aspects of the Code rather than on what is generally referred to as the "lawyers' law." Furthermore, and in spite of Mr. Wechsler's caveat that "[t]hose who appraise the product must compare it with the law as it now stands, not with the statutes and their gloss as they would like to have them be,"[1] I will engage in normative analysis. In defense of this, I would argue that such analysis is quite relevant to improving our understanding of the strengths and weaknesses of the Code. Moreover, I think a case

* Dean and Professor of Finance, Amos Tuck School of Business Administration.

1. ALI FEDERAL SECURITIES CODE viii (March 1978 Proposed Official Draft) [hereinafter cited as FED. SEC. CODE].

can be made that a normative approach should be seen by all parties as "cricket" at this juncture.

If the project of The American Law Institute had strictly focused upon codification of the existing statutes—upon merely rearranging them in a systematic manner to achieve simplicity and to eliminate duplication—one might accept the notion that comments regarding the substance of the Code were out of place. After all, who would assert that a tailor ought to be criticized for the color or texture of the cloth he is asked to fashion into a garment? In this case, however, the "tailors" clearly went beyond cutting and sewing. They not only chose some of the cloth but engaged in spinning and weaving here and there. Indeed, in his introduction to the proposed official draft of the Code, the "chief tailor," Professor Loss, said that one of the principal aims of the project was the "reexamination of the entire scheme of investor protection with a view to increasing its efficiency and doing so, in President Roosevelt's words, 'with the least possible interference to honest business.' "[2] Given that Professor Loss (or at least his typesetter) spelled the word principal with an "le," one must assume at least from time to time, that this particular aim played a paramount role in the codification effort.

In any event, it seems reasonable, at a gathering such as this, to analyze all aspects of the Code from a normative perspective, asking whether they can be expected to increase investor protection—however that phrase may be defined—in an efficient manner. To avoid being accused of foul play, however, I will focus my remarks primarily on areas where the codifiers themselves made substantive changes in existing law. Presumably, such changes must have reflected a judgment that amendments would have a particularly salutory effect on the fabric of investor protection.

II. REEXAMINING THE SCHEME OF INVESTOR PROTECTION: THE PROCESS

Before offering any observations about specific changes in the Code, it seems appropriate to examine the process which produced them. As a victim of what Michael Cohen and James March have referred to as "a powerful overlearning with respect to rationality,"[3] I would argue that any thorough reexamination of the securities laws ought to begin with a discussion of goals and objectives. What

2. *Id.* at xv (quoting S. REP. No. 47, at 607 and H.R. REP. No. 85, at 1-2, 73d Cong., 1st Sess. (1933)).

3. M. COHEN & J. MARCH, LEADERSHIP AND AMBIGUITY 226 (1974).

is it that the laws should seek to accomplish? At what cost to honest business should we protect investors? Indeed, what does it mean to "protect" investors? Once having wrestled with questions such as these, hopefully to the point where reasonable individuals might reach some general agreement, the next logical step would be to examine alternative approaches to the regulatory process. Only after considering the pros and cons of the alternatives in some detail, would decisions regarding appropriate courses of action be made. I realize, of course, that this is not the process by which political decisions are usually made, nor is it the manner in which the law generally evolves. Nonetheless, given that we are focusing on a codification effort having a first principle of the type discussed above, it seems to be a reasonable benchmark against which to compare what was actually done.

The second step in this idealized process—that having to do with the examination of the pros and cons of alternative courses of action—is particularly important and often overlooked. There tends to be a propensity among policymakers to assume that once agreement about broad objectives is achieved, the appropriate course of action is obvious. All too often, however, this propensity results in adopting policies that cannot possibly lead to the achievement of the desired objectives.

Rational policy analysis, admittedly a normative concept, and perhaps a naive one, calls for a dispassionate examination of whether any given course of action—in this case any given change in the securities laws—can be expected to achieve some desired objective. It demands that alternatives be examined within some theoretical context and that relevant empirical findings be given their due.

Although I have not read each and every word of the various drafts of the proposed Code, let alone been privy to any of the discussions among the Reporter, consultants and advisors, my reading of the final product suggests that the process of the project left something to be desired relative to the benchmark. Regardless of how much (or how little) time and effort was devoted to an examination of the objectives of the Code, there seems to have been less than adequate analysis of the degree to which existing regulations or proposed changes would, in fact, lead to some desired results. Throughout the proposed official draft there are notes that this or that change was made "on the theory" that something was true or desirable. But, there is no discussion of the merits of the theories proposed or of their underlying logic or empirical foundations; nor are the reasons for the rejection of alternative theories offered. Perhaps, all this was nothing more than an oversight, but I doubt it.

My reason for skepticism, incidentally, is very simple. The project was dominated by lawyers. The Reporter was a lawyer, of course. But, so too were virtually all of the consultants and advisors. While I have a high regard for members of the legal profession, I would venture the opinion that a thorough reexamination of the entire scheme of investor protection ought to involve members of the accounting profession, financial economists and representatives of corporate America. Such individuals would not only provide different perspectives on the substantive issues, but also come to the task with a rich knowledge of relevant empirical data. It is a pity that they were not made part of the process, particularly given the acknowledgment by the Code that there are problems in the existing statutes that do not "adequately reflect" economic and technological changes.

III. The Quality of Outcome: An Illustration

Given the process followed by the codifiers, one might predict that their substantive changes would not necessarily contribute to the enhancement of investor protection. A reading of their final product—at least *my* reading of it—suggests this prediction is valid.

I could illustrate this by focusing on a variety of issues contained in Parts IV through VI of the Code. In view of time constraints, however, and in order to do more than merely gloss over a variety of subjects in a superficial manner, I will concentrate on one particular issue—*i.e.*, section 606 which deals with tender offers.

By way of introduction, let me ask you to remember that federal legislation concerning tenders is only slightly more than ten years old.[4] It was initially proposed in 1965 by Senator Harrison Williams. In the words of Aranow and Einhorn, the original Williams Bill was introduced "for the ostensible purpose of protecting incumbent managements from 'industrial sabotage' resulting from what were deemed to be reckless corporate raids on 'proud old companies.' "[5] As such, it was "unique in that it represented perhaps the first attempt to enact securities regulation designed primarily for the issuer rather than the investor."[6] The initial version of the

4. The Securities & Exchange Act of 1934, 15 U.S.C. §§ 79m(d)-(e), n(d)-(f) (Supp. IV. 1969).

5. E. Aranow & H. Einhorn, Tender Offers for Corporate Control 64 (1973).

6. *Id.* When the original Williams Act was passed, it was thought that it was designed to regulate cash tender offers. In fact, it did far more. It required extensive disclosures in stock acquisitions, whether made through tender offers or at private placement; it gave the SEC

bill, of course, failed to garner the support needed for passage. A decendent was more fortunate, and, like the original bill, it too embodied the notion that those who make tender offers are typically pirates bent upon ousting competent managements.

Given the thrust of the Williams Bill, with its emphasis on issuer protection, one might have thought that codifiers who wanted to reexamine matters with an eye toward improving investor protection without interfering with honest business would have been reluctant to add to the burdens of those making tenders. Indeed, one might even have hoped that they would have given serious consideration to rolling back the existing requirements.

What, in fact, did they do? In a note to section 607, the Reporter indicates that they "made only minimal changes in existing law."[7] What may seem minimal to one person, however, can be regarded as quite substantial by others. I personally regard their changes as significant and suspect that many others involved in the process of mergers and acquisitions will agree.

The Code proposes that tenderers must comply with a new ten day advance filing and publication requirement[8] that is, in the Reporter's words, "designed to reduce the element of surprise."[9] In addition, it provides for "a considerable extension"[10] in the minimum offer period.[11] Clearly, then, despite the Reporter's comment that section 606 should not sacrifice "the natural approach that is essential in a free economy,"[12] it goes some distance toward making

broad rulemaking power over purchases by a company of its own stock; and, as amended in 1970, it applied to exchange offers as well as cash tenders. One commentator expected its broad proscription of fraud to be as fruitful a source of litigation in the tender offer area as rule 10b-5 was in the area of purchase and sale of securities. *See* Brown, *The Scope of the Williams Act and its 1970 Amendments*, 26 BUS. LAW. 1637, 1637 (1971).

7. FED. SEC. CODE § 607, Note (4). The provisions in the Code, which change existing law, are largely the result of political compromise between the authors of the Code and the states which have passed tender offer statutes. The Reporter admits that the state statutes have substituted an anti-takeover philosophy for the neutrality emphasized by Congress. *Id.* Note (2). Yet, the Code incorporates those aspects of the state regulatory scheme which its authors thought would improve the regulatory scheme "without sacrificing the neutral approach that is essential in a free economy" and would facilitate the redemption contemplated by § 1904(c). *Id.* Note (3). As the discussion below indicates, the adoption of these provisions could have a substantial impact and certainly shifts the regulation from Congress' intended position of neutrality.

8. *Id.* § 606(d)(1).

9. *Id.* § 607, Note (4)(f). The ten day advance filing requirement was taken from state statutes.

10. *Id.* Note (4)(j).

11. *Id.* § 606(e).

12. *Id.* § 607, Note (3). The Williams Act was designed to protect investors through full disclosure of the names, business associates and background of the offeror. Congress thought

it even more difficult for tenders to be successful.[13]

Whether or not these changes were intended to be minimal, the codifiers must have recognized that they would, if adopted, increase the difficulty of consummating a tender. This being the case, they must have believed that fewer successful tenders would be in the public interest. They offered no evidence, however, to support this position; nor did they attempt to reconcile it with their statement espousing the importance of "neutrality." Here, then, is a classic example of an instance in which the codifiers neither carried out a thorough theoretical analysis nor examined the relevant empirical evidence. It seems clear that the types of changes proposed would in fact add to the difficulties associated with consummating tenders.

---

that while takeovers should not be discouraged, they must be regulated. It believed that disclosure of this information was necessary to inform investors of a possible takeover by a well-run firm or by a firm of dubious character. In addition, Congress believed that disclosure would provide both the offeror and the management with an equal opportunity fairly to present their cases. Congress also noted, however, the necessity of taking "extreme care to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid." S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967).

13. The SEC recently released a series of proposed rules which, if adopted, would make the completion of successful tenders more difficult. They would augment the present statutory requirements by providing specific filing requirements, delivery and disclosure requirements, nonexclusive dissemination provisions, additional substantive regulatory protections with respect to certain tender offers, and antifraud provisions which would apply to any tender offer. SEC Release Nos. 33-6022, 34-15548, 10575, [Current Volume] FED. SEC. L. REP. (CCH) ¶ 81,935 (Feb. 5, 1979).

For example, proposed rules 14d-1 to -5 define the duties of the target company and bidder in disclosing and disseminating information between themselves and the shareholders of the target company. These rules require substantially more disclosure than is required under present law. In addition to imposing a greater burden on the acquiring company, it should increase the costs of making a tender and present more opportunities to fall technically outside the antifraud provisions.

These rules reflect the Commission's attitude toward tenders. Comments received on similar rules proposed in 1976, SEC Release Nos. 33-5731, 34-12676 [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,659 (Aug. 2, 1976), and, in particular on a proposed rule requiring dissemination of information to all shareholders whose names appeared on the shareholder list, questioned the Commission's authority to adopt such rules. The Commission now claims that its proposed rule 14d-5, pertaining to shareholder lists, implements the remedial purposes of the Act and is consistent with its legislative history. The Code dispells any doubts about the Commission's power to enact rules such as these under § 606(c) and the Reporter's notes comment on the reach of this general rulemaking provision: "[T]he 'disclosure and dissemination' phrase makes explicit that the authority extends to requiring that particular disclosures be made, not merely to regulating the content of those disclosures that are in fact made." FED. SEC. CODE § 607 Note (3)(e). The provision specifically applies to shareholder lists. With this rulemaking authority, therefore, in addition to the specific provisions that make tenders more difficult, it is likely that the Commission will adopt rules similar to those proposed, shifting the balance away from neutrality in favor of incumbent management.

Robert Smiley has reported that the requirements of the Williams Act have had a substantial impact on the costs of tenders, increasing them by thirteen to twenty-seven percent. Reflecting on the public policy implications of this finding, Smiley concluded as follows:

> Whether or not this was the desired effect of this piece of legislation is unclear (it probably was for some interest groups involved in lobbying in favor of the Amendment). But this impact should be considered the next time a legislative body begins consideration of a market mechanism which could (if left alone or encouraged) be instrumental in providing market imposed discipline on managers of U.S. firms.[14]

Quite obviously, the codifiers either did not read Smiley's paper or did not agree with his notion that increasing the costs of tenders might not be in the public interest.

At the time the original Williams Act legislation was being debated, many economists opposed passage,[15] generally on the grounds that tenders provide a "market imposed discipline" of the type described by Smiley. Quite recently—in fact since the publication of the proposed official draft of the Code—a paper by Donald Kummer and Ronald Hoffmeister provided powerful empirical sup-

14. Smiley, *The Effects of the Williams Amendment and Other Factors on Transactions Costs in Tender Offers,* 3 INDUS. ORG. REV. 138, 145 (1975). Professor Smiley set up a model of the tender offer process using a "state preference model" to develop a novel empirical technique. By observing rates of return and risk measures, he was able to estimate, with *ex ante* certainty, equivalent transaction costs in tender offers. These costs were then estimated for each of 80 tender offers in the period of 1956-1970.

The basic premise for the model of the tender offer process used by Smiley was that a tender offer was a risky investment. "The outcome of the offer may involve a large wealth loss for the bidder, as well as the possibility of a large gain. Only when the probabilities of possible outcomes . . . [were] such that the certainty equivalent present value of the investment [would] not result in a wealth loss, [would] an offer be forthcoming by a wealth maximizing bidder." *Id.* at 139. All potential costs had to be taken into account and the bidder had to be able to recover the expected value of the costs, in addition to the price paid for the shares, before a bid would be made. Smiley measured these costs by assuming that the shares of the target must have fallen below the potential maximum price by the expected transactions costs.

15. *See,* Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen,* 1967 DUKE L.J. 231. Professor Manne was highly critical of the disclosure requirements in the proposed Act. He advocated an unrestricted market for corporate control which, by itself, would weed out incompetent and crooked management. In addition, he argued that protection for investors could best be achieved in a free market. "An unhampered and unregulated market for corporate control will be far more effective in gaining efficient management for shareholders than plans based on the idea of millions of unsophisticated shareholders making intelligent decisions about the relative qualities of opposing management groups." *Id.* at 245. *See generally* Liman, *Has the Tender Movement Gone Too Far?* 23 N.Y.L.S. L. REV. 687 (1978); Note, *Tender Offer Regulation—Injunction Standards Under the Williams Act,* 45 FORDHAM L. REV. 51 (1976).

port for this position.[16] The authors studied all cash tender offers made between January 1956 and June 1974 for firms on the New York Stock Exchange meeting certain criteria—eighty-eight firms in all. Using methodology that is now a standard part of the tool kit of financial economists, they tested the following hypotheses: (1) that investors in the common stock of target firms generally experienced abnormally low returns in the period prior to a takeover attempt; (2) that the stockholders of firms which resisted a tender generally experienced particularly abnormal low returns prior to a takeover attempt; and (3) that successful tenders lead to an improved wealth position for the shareholders of both firms involved.[17] Overall, their results supported all three hypotheses, thereby leading them to make the following statement about the process of tendering:

> Bidding firms seek out targets for take-over. The focus is on the purchase of the rights to manage the assets of the target firm. In order to obtain those rights a premium is paid to the target's existing shareholders. However, in spite of the premium paid the value of the expected cash stream increases. Evidently capital market participants believe that the purchases of the target's

16. Kummer & Hoffmeister, *Valuation Consequences of Cash Tender Offers*, 33 J. FIN. 505 (1978).

17. *Id.* at 506-07. The authors engaged in a quantitative economic analysis of cash tender offers to 88 firms, deriving their data from the *Austin-Fishman Data Base*, the *Wall Street Journal Index* for 1958-74 and the *SEC Statistical Bulletin*. As well as evaluating conditions of all target firms, the authors distinguished firms where the incumbent management was passively amenable to takeover, firms where management successfully resisted takeover and those in which management unsuccessfully resisted the takeover. The overall data, after statistical analysis, revealed that "firms subject to take-over experience abnormally low returns prior to the announcement of the attempted take-over," with a cumulative average abnormal return (C.A.R.) of -.094 within three months prior to the announcement of takeover. *Id.* at 509. Firms with passive management, where the takeover was successful, experienced a similar although not as great a C.A.R., as did firms that unsuccessfully resisted takeover. Target firms that successfully resisted takeover experienced higher preannouncement C.A.R.'s while, subsequent to the announcement, the C.A.R. failed to return to its previous level.

The authors concluded that their first hypothesis was confirmed for the firms which fell into the "resist" category. *Id.* at 511. They suggested that the low returns were "reflective of unrealized gains subject to the replacement of incumbent management." *Id.* at 514.

In addition, the authors confirmed the hypothesis that firms involved in target takeovers where management resisted, displayed poorer performance (prior to the takeover) than do friendly takeovers. Clearly, if the low returns are due to inefficiency, incumbent management will resist takeover because it will mean the loss of their positions, and in offering this resistance it will deplete the already low and inefficiently used corporate resources. The hypothesis, therefore, that shareholder wealth in both the target and bidding firms will improve upon successful tender was clearly established.

shares and the right to control the firm's assets will generate an increase in cash flows that exceeds the cash outlay required.[18]

If we are to believe Kummer and Hoffmeister—and their results certainly convince me—it would seem that the typical successful tender offer is a classic example of a very rare event. Namely, it is an instance in which there are winners but no losers. Strictly speaking, this is not quite true. There are losers, but they do not happen to be among the investors in either firm. Instead, they are managers of the firm that is the target of a tender. More often than not, they lose their positions as a result of the tender.

In view of the probable consequences of a successful tender offer on the fortunes of the managers of target firms, it is surprising that they frequently resist being acquired. Kummer and Hoffmeister report, for example, that approximately one-fourth of the takeover candidates in their sample resisted a tender.[19] If resistance leads to an improved bid for the shares of the firm, it may be justified as being in the interest of the shareholders. When it results, however, in an unsuccessful tender, the outcome is less fortunate for them. In either event, of course, the managers use the resources of the firm to resist. In other words, whether motivated by a desire to assist the shareholders in obtaining a better price or simply by a desire to keep their jobs, they deplete the shareholders' equity.

By adding an advance filing provision and extending the length of tenders,[20] the changes in the proposed Code would give manage-

18. *Id.* at 514.

19. *Id.* at 509-10. Resistance may occur for various reasons; most commonly it is the desire of the target's management to maintain its power. A bidding firm must successfully overcome this resistance in order to effectuate the takeover.

> This resistance suggests two valuation consequences. First, only a larger bid premium to the target's shareholders will insure the success of a contested takeover. Second, a larger premium may only be offered in anticipation of large gains. These conclusions suggest that target firms involved in unfriendly take-overs may be relatively poor performers prior to a take-over attempt when compared to the prior performance of target firms involved in friendly take-overs, *ceteris paribus.*

Id. at 506.

20. The Code provision regulating the minimum offer period is similar to the Commission's proposed rules. The proposed rules are promulgated under the authority granted in § 14(e) of the Williams Act. The rules require that an offer remain open for a minimum of 30 business days and run concurrently with a 10 business day minimum on any offer of increased consideration. 2 FED. SEC. L. REP. (CCH) ¶ 24,295. This is expanded from an earlier proposal of 15 business days. SEC Release Nos. 33-5731, 34-12676 [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,659 (Aug. 2, 1976). Two policies espoused by the Commission for the rule are: (1) providing security holders with full disclosure to make an investment in an unpressured manner and (2) providing the target company management an opportunity to counter the proposed offer. Securities Act Release No. 6022, [Current Volume] FED. SEC. L. REP. (CCH) ¶ 81,935.

ments more time to resist tenders, thereby permitting them to use up more of the resources of the firm and reducing the probability of a successful tender. Is that really what a reexamination of the entire scheme of investor protection should do? Frankly, I doubt it.

IV. A CONCLUDING REMARK

In my introduction, I indicated that I had reservations about both the processes used by the codifiers and the outcome of their efforts. The reasons for these reservations should now be apparent as should my conclusions. Despite Professor Loss' statement regarding the aims of the Code, I seriously doubt whether it is the product of a thorough reexamination of the entire scheme of investor protection. Instead, I would argue that it is the result of a magnificent effort to improve the "lawyers' law" and a haphazard analysis of the sustantive economic fabric of the existing securities laws. In the interest of full and honest disclosure, the Reporter's statement of the principal aims of the codification effort ought to be modified, or a truly thorough examination of the entire scheme of investor protection should be initiated.

The Code, by its inclusion of § 606(e), has made the same assumption as the Commission—that the longer period does not tip the scales in favor of management. It provides for a 20-day effective period with a 15-day minimum if there is a change in consideration. Though 20 days is better than 30, the Code gives the Commission authority to extend the minimum periods by rule. Again, it is likely that the end result will be even more restrictive and more favorable to management in light of the proposed rules.