PARTICULAR S.E.C. MERGER CONSIDERATIONS

by

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An analysis of the impingement of the Federal statutes administered by the Securities and Exchange Commission upon plans to acquire or dispose of a business by merger or otherwise begins with a determination of who is involved and how the proposed action, including perhaps some of its collateral aspects, is to be accomplished. Who you are and how you propose to handle the transaction can affect significantly your obligations under the Federal Securities Laws and the interest of the Commission in your affairs.

The two statutes with which we are primarily concerned are the Securities Act of 1933 and the Securities Exchange Act of 1934. I doubt whether it is necessary to consider the Public Utility Holding Company Act or the Investment Company Act for purposes of this meeting.

Reduced to its simplest terms, I believe the proposition can be stated that if in the process of effecting an acquisition or disposition of a business, securities are publicly offered and sold, the registration and prospectus provisions of the Securities Act must be complied with, absent some exemption; and if in the process a company having a voting security listed on a stock exchange solicits the holders of those securities for their proxies, consents or some person or group solicits their opposition with respect to the transaction, the persons soliciting must comply with the proxy regulations of the Commission under Section 14(a) of the Exchange Act.

Having stated the proposition so briefly and clearly, I hasten to caution you not to be deceived by its seeming simplicity. The interpretation and application of the statutes and the

Commission's rules to corporate reorganizations, of which I regard acquisitions of various types to be an aspect, continue after many years to present puzzling questions at times both for industry and the Commission. Some of these questions I propose to discuss with you today.

Viewed in relation to the law and the Commission's rules, the most striking feature of the vast volume of security transactions arising out of statutory mergers, consolidations, acquisitions and recapitalizations which we know have occurred is that they have been achieved without the necessity of complying with the registration provisions of the Securities Act at all. In the main, the only cases involving transactions of this character which are affected by the registration provisions and disclosure requirements of this Act are those for voluntary exchange offers made by one person or corporation to the public security holders of another company and those where securities are sold to the public for cash and the proceeds are to be employed to acquire another business or significant assets. These cases have not represented any substantial volume of financing in terms of the total offerings registered under the Securities Act in any year. They certainly have been insignificant in relation to the tremendous number of corporate acquisitions and mergers reported in various publications dealing with the subject.

The annual report of the Federal Trade Commission for 1956, in referring to merger investigations, states: "An Information sheet containing such information as is readily available from press reports and recognized reference manuals is prepared for each merger. In fiscal1956 more than 1,000 of these information sheets on reported mergers were prepared."[1]

[1] Annual Report of Federal Trade Commission, 1956, page 21

Our own annual report for 1956 shows that of total securities registered under the 1933 Act during the year aggregating $13,000,000,000, less than $500,000,000 was for exchange for other securities.[2]

The Federal Trade Commission in its report on corporate mergers and acquisitions states: "During the period 1948-54, 1,610 formerly independent manufacturing and mining concerns were reported in the financial manuals to have disappeared as a result of mergers and acquisitions. To this may be added 74 whole subsidiaries and 89 whole divisions, bringing the number of disappearances up to 1,773."[3]

I have no figures for the period which would provide any accurate measure of the registered security offerings which might have been primarily for the purpose of aiding in a major acquisition of another company directly or indirectly. My impression is that they have been relatively few. We know that in virtually all instances where the transactions take the form of a statutory merger or acquisition of assets pursuant to a vote of security holders, no registration occurs.

The avoidance of the Securities Act in these merger transactions the aggregate volume of which in the last ten years has been commented upon as one of the significant economic developments of the post-war years has come about not by virtue of any express statutory exemption but as a consequence of a rule[4] of the Commission adopted in the first instance in

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[2] Annual Report of SEC, 1956, Appendix Table 2, page 231

[3] FTC Report on Corporate Mergers and Acquisitions, May 1955, page 20

[4] Rule 133, General Rules and Regulations under Securities Act – SEC

1935, and of reliance by many people on constructions of the provisions of Section 4(1) of the Act.[5]

I will comment further upon these provisions in a moment.

At this point I merely wish to observe as a generalization that the principal problem of businessmen and their counsel Security Act-wise in connection with corporate mergers and acquisitions has been to understand the procedures for availing themselves of an exemption from the registration provisions rather than to encounter and deal with the disclosure problems which might arise were the security issues involved to be registered.

Two companies might be mentioned as an illustration of the growth of public shareholder investment over a period of time without Securities Act disclosures.

The Federal Trade Commission report on mergers, in referring to corporate acquisitions in the 1948-1954 period, states: "The most active acquiring firm during this period was Foremost Dairies, which made 48 acquisitions, as reported in the financial manuals."[6]

This company, as a Delaware corporation, filed its first registration statement under the Securities Act in 1935. At that time it had a capitalization of 52,000 shares of 6% preferred stock and 20,000 shares of 20¢ par value common stock. In 1949, the Delaware company merged into Maxson Food Systems, a New York corporation, the latter changing its name to Foremost Dairies. Since that time the company has filed four registration statements under the '33 Act, one of which was for the sale of common stock for the account of a selling stockholder.

The company became subject to the '34 Act in 1955. It has not filed any proxy statements with the Commission relating to mergers or acquisitions. Information on file

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[5] Section 4(1) of the Securities Act of 1933

[6] FTC Report on Corporate Mergers and Acquisitions, May 1955, page 3

indicates that apparently 2,000,000 shares of common stock and 270,000 shares of preferred stock were issued in connection with the acquisition of 43 companies between 1952 and 1956 in transactions for which exemptions from registration under the Securities Act were claimed. The company now has in excess of 37,000 shareholders.

Penn-Texas Corporation (formerly Pennsylvania Coal & Coke Corporation) has never filed a registration statement under the Securities Act. It registered under the Exchange Act In 1935, at which time it had slightly less than 1,000 stockholders owning 165,000 shares of common stock. The company has filed proxy statements on nine occasions with reference to mergers, acquisitions or authorizations of additional stock. The company now has about 30,000 stockholders, and, as you know, it has become a large, diversified manufacturing enterprise.

The Securities Act, of course, may apply to any company making a public offering of a security regardless of its size, age, financial history or condition.

The problem under the Exchange Act is quite different. Only those companies having voting securities listed on an exchange who may solicit proxies of the holders of these securities are required to comply with the Commission's disclosure requirements as set forth in the proxy rules in connection with mergers and acquisitions.

During the 1956 fiscal year, about 2,000 solicitations were made under the Commission's proxy rules by the managements of 1,700 companies. Of these, approximately seven per cent related to mergers, consolidations, acquisitions of businesses, purchases and sales of properties and dissolutions of companies.[7] The corresponding figures for fiscal 1957 and fiscal 1952 were six per cent and two per cent, respectively.

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[7] Annual Report of SEC, 1956, page 102

Should the Fulbright bill become law in its present form, an additional 650 companies might become subject to the Commission's proxy rules. At the present time there are 2,015 issuers having voting securities listed on exchanges, of which about 75 per cent solicit proxies for annual meetings.

Under the Exchange Act, your SEC problems, if any, depend on whether you are listed and whether the acquisition is one which must be put to a vote of security holders or may be accomplished in the discretion of management without seeking stockholder approval or ratification.

These requirements of the Exchange Act give rise to some peculiar situations. If two or more companies propose a merger or other acquisition requiring the vote of security holders, one may be required to comply with the proxy rules--because the securities are listed--and the other parties to the proposal not having listed securities are free to solicit without Federal supervision of the solicitation. If the acquiring company has sufficient authorized stock to permit an acquisition without securing specific authority of its security holders and the acquired company is not a listed company, it is possible that the acquisition could occur without being subject to any of the Commission's disclosure requirements other than a report after the event.

I am not here, however, to advertise exemptions from or means of avoidance of our product and services. Those who may encounter the problem of meeting some business deadline in company with the Commission's requirements are interested in the practical operation of the rules. That is one of our prime interests too.

The statutory basis for the Commission's proxy rules is stated in general terms in Section 14(a) of the Exchange Act. Penalties for willful violations are prescribed by Section 32(a) of the Act. Maximum penalties upon a conviction may be a ten-thousand-dollar fine or two years'

imprisonment or both for "any person who willfully violates any provision of this title, or any rule or regulation thereunder . . . or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder . . . which statement was false or misleading with respect to any material fact . . ."[8]

Civil liability provisions are found in Section 18(a) which provide that "any person who shall make or cause to be made any statement in any application, report or document filed pursuant to this title or any rule or regulation thereunder . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing such statement wag false or misleading) who in reliance upon such statement shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.[9]

As I understand the law, it is doubtful whether a person could recover damages under this section from a person soliciting proxies for a misleading statement in proxy material, in reliance upon which the security holder executed a proxy, absent circumstances which would give rise to the conclusion that the giving of the proxy itself involved a purchase or sale of a security, or absent some other transaction involving a purchase or sale of a security. In any event, I know of no court decisions under Section 18(a) arising out of a proxy transaction. It is possible, however,

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[8] Securities Exchange Act – Section 32(a)

[9] Securities Exchange Act – Section 18(a)

that a person who executes a proxy in reliance upon proxy material which violates the rules and is damaged thereby might recover as a matter of general law.

If a company is subject to the rules, they apply whether in the acquisition transaction the issuer is the acquiring company or the company being acquired. Items 14, 15 and 16 of Schedule 14A of Regulation X-14 outline the information to be included in a proxy statement with respect to Mergers, Consolidations, Acquisitions and Similar Matters. Item 14 applies in five situations:

(a) the merger or consolidation of the issuer into or with any other person or of any other person into or with the issuer;

(b) the acquisition by the issuer or any of its security holders of securities of another issuer;

(c) the acquisition by the issuer of any other going business or of the assets thereof;

(d) the sale or other transfer of all or any substantial part of the assets of the issuer;

(e) the liquidation or dissolution of the issuer.

The material features of the plan, the reasons therefor and the general effect thereof upon the rights of existing security holders of the issuer must be stated. In addition, certain basic data must be included concerning the other party or parties to the transaction. These latter requirements are stated in general terms designed to indicate the nature and scope of the information desired rather than to specify in detail particular items of information.

The market history of the shares of each company for at least two years is required.

Certified financial statements of the Issuer and its subsidiaries (usually consolidated financial statements are required) must be included in the proxy statement. These, as indicated by item 15, include a balance sheet as of the close of the last fiscal year and profit and loss and

surplus data for the three full fiscal years then ending. Schedules other than those pertaining to supplementary profit and loss information may be omitted.

Since the soliciting issuer is one having securities listed on an exchange, it already will have financial statements certified by an independent public or certified accountant and presumably any major accounting problem with respect to its financial statements for prior periods will have been resolved in the course of filing the customary periodic reports required to be filed with the Exchange and the Commission pursuant to Section 13 of the Exchange Act.

In addition, however, equivalent financial statements for the other party or parties to the proposed transaction likewise must be included in the proxy statement, with the proviso, however, that such financial statements need not be certified.

Item 16 inquires into consideration and factors bearing on fairness of consideration.

These provisions for disclosures by an issuer in its proxy statement of information concerning another issuer or issuers give rise to difficulties in certain cases, depending upon the relations between the parties and the reasons underlying the action of the parties. Furthermore, a question frequently is raised on the part of an issuer and its officials concerning the responsibility of the issuer to its security holders for information concerning another company over which the issuer has no control, and with respect to which it may or may not have access to the latter's books and records. In general, our position has been that an issuer under these circumstances may state the sources of the information concerning another issuer contained in its proxy statement--assuming an arm's length relationship--but efforts to include disclaimers of responsibility for such Information are objected to. Assuming good faith, there could be no criminal liability. Section 18(a) provides that in a civil suit a person sued may escape liability if he can prove good faith and that he had no knowledge of the falsity or misleading character of

the information, the truth of which is challenged. Whether an official of the other company giving the issuer false information which the issuer innocently includes in its proxy statement might be held liable under Section 18(a) is a question which to my knowledge has not arisen and I don't know the answer.

A proxy statement filed with the Commission for an acquisition or disposition of a business becomes for us another problem of security analysis and disclosure, within the framework of the rules and the general standards of materiality applicable to all financial reporting under the Exchange Act. It will do no harm to repeat here the fundamental theses of the Securities Act and the Exchange Act and the Commission's administration of them--that we do not pass on the merits of an acquisition or other corporate action nor approve or disapprove terms and conditions of the transaction or, indeed, the disclosures made concerning them. It seems that no matter how frequently or emphatically we make this assertion, many people have the notion that we have some power to prevent a transaction because some feature, objective or anticipated result of a proposed acquisition or disposition is offensive to some person or interest. Petitions that we prevent, delay or attempt to change the terms of a proposed transaction come with particular frequency and insistence in those situations in which opposition groups organize to solicit proxies to oppose the consummation of transactions for the approval of which proxies are solicited by the issuer and its management.

It is not our job to pass judgments concerning these business transactions in terms of their social or economic desirability, their possible effect upon labor or some community in which plants may be located, concentration of economic power or conflicts with the antitrust laws.

Our purpose is to attempt to secure a fair and truthful disclosure of certain basic material business and financial facts in accordance with the established standards in order to assist

security holders and the market place to come to a reasonably informed judgment of the proposal.

Since our basic interest is analysis and disclosure, such problems as are encountered--other than procedural and mechanical matters--tend to approximate those which arise in the review of registration statements and prospectuses filed under the Securities Act. I say "approximate" because the disclosures required in proxy statements and in registration statements are not governed by precisely the same rules.

The proxy rules are grounded on the Exchange Act, and the disclosures specified in Sections 12 and 13 of that Act for purposes of financial and other reports are somewhat less comprehensive than the corresponding provisions of Schedule A of the Securities Act. Furthermore, the proxy rules as they relate to mergers and acquisitions are less specific than the registration forms and related rules and instructions under the Securities Act.

It is fair to say, I think, that there may be a little more administrative improvisation in our handling of proxy statements than in the case of the Securities Act cases, in part because of the less specific character of the governing regulations. On the other hand, it is much more difficult to be specific in writing rules and disclosure requirements directed particularly to the variety of transactions which are encountered in the field of corporate reorganizations.

In the ordinary Securities Act filing we are concerned with disclosures relating to a single business and one or more issues of equity or debt securities of a single issuer. In the field of mergers and acquisitions under the proxy rules, the issuer and the Commission must deal with disclosures as they relate to at least two issuers on an historical basis and the various classes of securities which may be present and a third set of data which represents a pro-forma presentation showing the effect of the proposal in terms of financial position, operating records and the rights

of security holders. Various measures of corporate values and earnings will be employed which may not appear in the conventional Securities Act prospectus. Textual matter is more likely to include material which falls in the category of argument and persuasion rather than the mere factual recitations found in prospectuses.

It goes without saying that the financial statements of the parties to the transaction are the data most important and essential to any presentation in a proxy statement with respect to mergers and similar transactions. The financial statements required for both companies are those which would be filed in an application for registration of securities under the Exchange Act. Accordingly, balance sheets, profit and loss and surplus schedules must be submitted in the content and scope required by Form 10 and must be prepared in accordance with Regulation S-X.

If both companies are listed companies, the preparation and presentation of appropriate financial Information should be a relatively simple task. In addition to the required financial statements of both companies, you will probably be requested to supply a tabular summary of earnings for a period of five years or more for each company and, depending on the circumstances, a pro-forma summary giving effect to a combination of the operations of the two companies on the basis of certain stated assumptions with such adjustments and explanations or qualifications as may be necessary and a pro-forma balance sheet.

Extraordinary transactions which may have affected the operating or balance sheet figures during the period will require explanation or in some circumstances, elimination from or special treatment in the summary or pro-forma figures.

Problems arise as to the proposed basis upon which fixed assets and other accounts will be stated for balance sheet purposes upon consummation of the merger transaction.

Frequently these matters become the subject of prefiling conferences with our staff--a practice we welcome. In clear-cut cases these discussions may cover questions of presentation of financial data rather than of principle. Usually the parties involved know when they have a marginal case and arrange a discussion before printing rather than risk a conflict in views which might require reprinting to reflect, for example, "acquisition accounting" rather than a "pooling of interests" solution. Such a result may arise in a situation when factors favoring a "pooling of interests" solution have been deemed by the registrant to justify this procedure, whereas the staff, on the basis of the evidence initially at least, may have been more impressed with factors which would seem to lead to a contrary result.

The concept of "pooling of interests" accounting (which avoids the booking of goodwill as would be required in many "purchase" transactions and permits the combining of earned surplus of the constituent companies rather than "acquisition accounting") has been recognized by the Commission for about fifteen years. At first this accounting was deemed appropriate when the corporations to be combined were of about equal size and were engaged in similar or complementary businesses. This latter test is now outmoded with the emphasis on diversification in corporate mergers.

In 1945 the Commission considered a merger proposal in which all factors other than size clearly supported a pooling of interests solution. The result was that goodwill was not recorded and the earned surplus of both companies was carried forward. In this case the assets and common stock equity of the smaller company were less than one-fifth and one-third respectively of the larger. From this point on, relative size was considered to be less important than other factors in considering whether a business combination was a pooling of interests or not.

The significant next step in the case-by-case consideration of the problem by the Commission was raised in a proposed merger involving the possibility that a minority interest would remain after an exchange offer and the smaller company would continue as a subsidiary. It was concluded that in these circumstances it would be inappropriate to treat the transaction as a "pooling of interests" and therefore the earned surplus of the acquired company could not be combined with that of the registrant. On a purchase basis goodwill would have been negligible.

Adhering to this interpretation that pooling of interests accounting was inapplicable when parties to a merger continued in a subsidiary relationship led to a reconsideration of Section C of Chapter 7 of Bulletin No. 43 of the American Institute of Accountants, which succeeded Bulletin 40 with only minor changes. Bulletin No. 48,[10] published in January of this year, omits the requirement of similar or complementary business and permits a pooling of interests when substantially all of the ownership interests in the constituent corporations continue and permits a subsidiary relationship to survive "if no significant minority interest remains outstanding, and if there are important tax, legal, or economic reasons for maintaining the subsidiary relationship, such as the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases, or licenses." The revision retains the tests of continuity of ownership and of management or power to control the management and introduces a specific test of relative size. Although relative size may not necessarily be determinative, the bulletin says that "where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90 per cent to 95 per cent or more of

[10] Issued by the Committee on Accounting Procedure of the American Institute of Accountants.

the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests."

As you would suspect, the first questions raised under Bulletin 48 were with regard to the size test and minority interests. The first cases involved combinations in which the smaller company fell in the range of five per cent to ten per cent of the combined equity. No objection was raised to pooling of interests accounting in these cases when it appeared that a strong case had been made under the other tests. As a general proposition we have objected to pooling of interests when the equity of the smaller company would be less than five per cent. However, in some situations pooling of interests accounting has been accepted when the acquiring company's interest has exceeded 95 per cent, when, for example, the other factors involved were persuasive and the size and position of the companies were such that any other view would, for all practical purposes, have the effect of excluding certain industry leaders from the pooling of interests doctrine entirely.

If any extended period of time has elapsed since the date of the certified financial statements for the latest fiscal period, you may be asked to include interim earnings data in the summary for one or both companies together with later balance sheets. These frequently are supplied voluntarily but if not, you need not be surprised if a request is made. In any event, you probably will be asked to supply--either for our own information or for inclusion in the proxy statement—information concerning the trend of sales, orders and costs since the date of the financial statements. The Commission and its staff have been extremely sensitive with respect to this problem after several cases in which failure to secure responses to specific questions on this subject led to later difficulties.

The financial statements and earnings summary provide the basis for comparisons and explanations which should be included in every proxy statement in order that the reader may grasp the essential features, purpose, and effect of the plan. It should be remembered that the purpose of the proxy statement is to explain and reveal to the stockholder. Our experience too frequently has been that they seem designed to obscure and distort various aspects of a proposal.

I asked our examining staff to give me some illustrations of problems encountered in recent experience with merger proxy statements. Their responses are illuminating:

(a) necessity for calling for data which will illustrate graphically by the use of well-known statistical and financial analytical presentations the values passing and being received as a result of the merger;

(b) the use of appraisals or projections of earnings to explain or support exchange ratios;

(c) securing adequate disclosures of the relative rights and values of various classes of securities of the constituent companies as they will be affected by the transaction;

(d) adequate disclosure of the effect of income tax carry-forwards.

Other comments not directly related to financial and statistical data include the following:

(a) adequacy of the description of the businesses of the constituent companies;

(b) reasons for the transaction are not given adequately in many cases. In this connection, one of our analysts stated: "Often there are reasons for a merger not presented in the proxy statement nor evident from the facts

which may be readily obtainable. Conversations with counsel or other persons sometimes reveal important motivating factors;

(c) disclosures of interests of officers and directors in the business of the constituent companies and the survivor;

(d) in multi-line businesses, information as to the relative importance of major business lines;

(e) dependence upon large customers or limited sources of supply;

(f) effect of the plan upon compensation and option arrangements;

(g) failure to respond to Items 6 and 7 of the proxy rules when the merger agreement in effect involves an election of directors--these items requiring information as to the identity and interest of directors and nominees and remuneration and other transactions with management and associates;

(h) failure to explain reasons for increase in authorized stock substantially in excess of requirements for the capitalization of the surviving company;

(i) description or explanation of changes in the articles and bylaws which may affect materially the rights of security holders such as quorum requirements, cumulative voting or a classified board of directors, preemptive rights, indemnification of officers and directors and limitations upon dividends;

(j) disclosure of any antitrust problems;

(k) disclosure of status of surviving corporation as listed company--if one of constituent companies is a listed company and the survivor will not have its stock listed, a statement to this effect and its significance will be required;

(l) adequate disclosure of dissenters' rights and the procedure to be followed to perfect such rights.

I do not wish to suggest that the foregoing recital indicates proxy statements generally are defective in these many respects. They are not; in fact, many of them when filed reflect careful consideration of the many factors as to which discussion in the proxy statement is essential or appropriate. When problems do arise, however, they are quite likely to fall within one of the categories I have mentioned.

Obviously a proxy statement must be a short summary of the vast amount of thinking and paper work which precede the formal presentation of a merger proposal. There can be many reasons for a firm conviction that a particular way of describing or handling a transaction is the most desirable from the point of view of the proponent. On the other hand, we know, too, that frequently a proxy statement for a merger transaction like a Securities Act prospectus takes the form it does because it is modeled on a published proxy statement or prospectus employed by some other company and ignores or fails to emphasize facts or circumstances which give meaning to the particular transaction being considered.

Two or three of the subjects mentioned above deserve a word of explanation. Some of our most difficult problems as administrators of disclosure statutes have arisen in connection with attempts to employ appraisals and projections of earnings in prospectuses and proxy statements.

It is probably impossible to give you any brief, generalized statement of Commission policy or practice with respect to the use of appraisals. It is obvious, of course, that the proposed basis of exchange of the securities of two or more merging companies in an arm's length transaction is the result of a valuation process by the parties. Frequently this value judgment relates to an extremely complex and wide array of business and financial factors which are not necessarily given equal weight by the various parties concerned.

The management should, in response to the rules, set forth in the rules, set forth in the proxy material a reasonable explanation of the pertinent factors which they considered in arriving at their price judgment. When an appraisal report is mentioned as one of these factors, we, of necessity, must be concerned with the nature of the appraisal or valuation report and the circumstances of its use.

Certainly there can be no objection to management securing expert advice to aid it in coming to a conclusion which it is willing to submit for shareholder action. Usually we inquire as to the nature and scope of the report and its conclusions, and request that a copy be submitted for inspection. We find that they represent all types of expressions ranging from property valuations to letter opinions which contain no indication of how or why the opinion was reached. Further, they range from comprehensive engineering reports by well-known appraisal concerns to various types of economic opinions by business consultants.

If the opinion or conclusion of a consulting or engineering firm is included in the proxy material, the nature of the opinion should be clearly explained, the expert identified and such explanation or qualification given as may be necessary to indicate the scope of his review and the factors considered by him. Further, the general nature of the reliance by management upon the outside opinion should be indicated.

It is our general practice to object to the use of reproduction cost appraisals of physical assets for the obvious reason that they are almost invariably employed to indicate an upward reach of values which have little or no significance in the usual merger problem. It is also our general practice to object to the inclusion in proxy material of projections of estimates of specific future net income to support an enterprise valuation. We frequently are asked to explain our reasons for this position, particularly in view of the fact--our critics remind us-- that in Chapter X cases the Commission itself indulges in the practice.

In the first place the problem is not the same and, further, the Chapter X case in all its aspects is before a court where all the contentions of contesting interests are subjected to scrutiny and argument for the purpose of permitting the court to reach a decision in equity.

A merger is a bargain arrived at without supervision and it may or may not be a good bargain in terms of apparent equities, although it may represent a good business solution to certain problems.

Securities, in fact all sorts of property, have been sold since commerce began on the basis of promises of future values and future income. We cannot project the Commission's administration of the disclosure provisions of the statutes into every conversation or communication in which this device may be employed. The Commission has always stood firm, however, on the proposition that literature filed with it in response to statutory provisions designed to lay basic material business facts before the public may not properly include predictions of future net income. For the Commission to lend its procedures to this device would involve it in an impossible and indefensible task. We are not prepared to accept someone's opinion as to future profits of an enterprise as a material fact for purposes of the statutory standards.

In all cases involving business acquisitions, it is necessary that we keep in mind that the transaction may be of interest to the Antitrust Division of the Department of Justice and the Federal Trade Commission, both of which have the responsibility for enforcing Section 7 of the Clayton Act.

We have worked out over the years a fairly simple procedure of being sure the Antitrust Division and the FTC know about the transaction. Any prospectus or proxy statement involving a proposed merger, consolidation, or other form of acquisition of a business where the transaction is in excess of $3,000,000 and not subject to specific a authorization by another Federal agency, such as the Interstate Commerce Commission, Federal Power Commission, etc., is brought to the attention of these two agencies.

The actions taken by the Department of Justice through its Antitrust Division fall into four main categories insofar as our problems of disclosure in prospectuses and. proxy statements are concerned:

(1) The Department takes no action at all.

(2) The "no action" letter. If requested by the parties to the transaction, the Department of Justice will issue an official letter, signed by at least an Assistant Attorney General, to the effect that the Department "does not presently intend to take action with respect to the proposed acquisition."

(3) The "we will see you in court" letter.

(4) Without any notice to the parties, the Department of Justice will move directly into court in an attempt to block the proposed transaction by a restraining order and an injunction. Failing that move, the Department will file a civil antitrust complaint in the court when the transaction is consummated.

By far the largest number of cases fall under the first category of "silence." The next largest number fall under Category (2), the "no action" letter.

Because of the time limits under which we operate in Securities Act and proxy matters, it is essential that we complete our examination and other processing procedures in a relatively short period of time after the date of the filing. Since it may take weeks, or even months in the case of Category (3) and (4) cases for the Antitrust Division to complete its work to the point of "clearing" with the Attorney General's Office, it is obvious that we cannot very well coordinate our examining procedure at the Commission with that of the Department of Justice in every case.

Accordingly, in the vast majority of these acquisition cases, we go ahead and complete our examination, prepare our letter of comments, and if by that time we have not heard from the Antitrust Division, we send out our letter.

There is of course no real problem of disclosure if the Department of Justice has taken "official' action under Categories (2), (3), or (4). The same is true if either the Department or the Federal Trade Commission has sent out to the parties a questionnaire or letter of inquiry. We consider that a brief factual statement of the situation is all that is necessary to be made in the prospectus or proxy statement. Of course, the statement may be followed by a further statement that counsel are of the opinion that the proposed transaction, if consummated, will not violate the antitrust laws.

Our real disclosure problems arise when we have completed our examination and are about to send out our letter of comments on a preliminary proxy statement, or we are about ready to "clear" a registration statement and we are advised that the staff of the Antitrust Division is about to recommend, or has already recommended, to the Attorney General's Office the sending of their Category (3) "see you in court letter," or, where the staff of the Antitrust Division are prepared to recommend to the Attorney General's Office that court action be commenced to block the transaction.

About all we can do, and have done, in these situations if we know the parties have received a questionnaire from the Department of Justice or a letter of inquiry from the Federal Trade Commission, or if it is otherwise no secret that the transaction is being investigated by these agencies, is to request the parties, in addition to including in the prospectus or proxy statement information about the receipt of the questionnaire or letter of inquiry, to let us know by

letter what they intend to do if the Department's Category (3) "we will see you in court letter" is received before the exchange offer or proxy solicitation commences.

Earlier, I mentioned the fact that in most merger transactions the securities being issued have not been registered under the Securities Act. The question of the applicability of the registration provisions of the Securities Act to a statutory merger or consolidation was one of the first major policy decisions to be faced by the new SEC shortly after it succeeded the FTC in the administration of the Securities Act in 1934.

Initially, it was determined administratively that no objection would be raised by the Commission if a statutory merger under the laws of New York and New Jersey were consummated without registration. Later--in 1935--a rule was adopted, as a note to the reorganization registration form, which provided in effect that no sale to security holders was involved when a plan of consolidation or merger was submitted to a vote of security holders pursuant to the provisions of State law where the affirmative vote of the required majority bound the minority holders.

In 1951, an amendment to the general rules and regulations under the Securities Act was adopted--Rule 133, which provided that <u>for purposes of Section 5 of the Act only</u>, no sale or offer for sale shall be deemed to be involved so far as the stockholders of a corporation are concerned when, pursuant to statutory provisions in the State of incorporation or provisions contained in certificates of incorporation, there is submitted to a vote of stockholders a plan or agreement for a statutory merger or consolidation or reclassification of securities or a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities under such circumstances that the vote of a required favorable majority will operate to

authorize the proposed transaction so far as concerns the corporation whose stockholders are voting and will bind all stockholders except as to dissenters' rights.

The significant change in the rule at that time was the specification that the rule applied for purposes of Section 5; i.e., registration, only, the clear implication being that the Commission considered that the rule should not operate to remove a security transaction, in an acquisition of the character specified, from the operation of Section 12--which creates vivil liabilities in connection with the sale of securities--and Section 17(a), which makes certain activities unlawful in the sale of securities.

The theory of the rule briefly is that the transaction occurs as a corporate act rather than as a consequence of the volition of individual shareholders in a contractual sense.

I don't want to discuss the rightness or wrongness of the rule or its underlying premises. The rule is on the books and as long as that is so, it may continue to be relied upon.

I think it is important to point out, however, that the Commission in recent years has tended in the direction of narrowing the application of the rule to the merger transaction itself and to the view that the issuance of securities in a Rule 133 transaction did not create "free stock" for all purposes. In other words, Rule 133 does not provide a "security exemption-- at most it may be relied upon as a "transaction exemption"--and the Commission has ruled in various situations that public distributions of securities subsequent to the merger transaction must find their own and some other exemption if registration is to be avoided.

The safest course to follow in planning procedures in a projected merger or other acquisition by stockholder vote is to consult with the Commission's staff if it appears likely that the merger transaction is but a step in a process which involves a public distribution, to others than the voting stockholders, following the merger transaction.

About a year ago, the Commission announced in a published release a proposal to repeal Rule 133. After receiving many objections from industry and the bar and after a public hearing on the proposal, the Commission on March 15 of this year announced deferral of any action and that further study would be given the problems involved before making any further proposals.

The other type of transaction which I mentioned earlier, in which registration under the Securities Act is considered unnecessary, is the so-called "private sale." In these cases the Issuers rely upon Section 4(1), which provides that the registration provisions do not apply to transactions by an issuer not involving any public offering. The usual pattern of these cases is the acquisition of stock or assets of another company from a limited group of stockholders or owners (a group small enough not to be considered as "the public"), payment being made in stock of the acquiring company. The recipients of the stock usually represent that the shares so taken are being taken for investment and not for distribution.

It has come to bur attention in many cases that these so-called investment representations are regarded as a necessary part of a ritual which once completed leaves the owner free thereafter to sell the shares upon the occurrence of any event which can be asserted as a "change of circumstances." In Many of these cases, a public distribution has occurred under conditions which lead us to the conclusion that the sellers should be regarded as statutory underwriters, that the securities should in fact have been registered and that the Issuer had been placed in the position of having violated the law.

There is no insulating magic for an issuer in an investment letter of the character which we have seen in circulation if the transaction in fact is a first step in a public distribution of the issuer's shares. An issuer if it chooses to employ its shares as currency for purposes of an acquisition of a business in reliance on Section 4(1) should, to protect itself against the risk of a

one-year put under Section 12(1) and against possible injunctive action, seek specific and clear-cut assurances as to the intention of the persons to whom shares are to be issued and provide by agreement for appropriate notice of an intent to sell and otherwise guard against the possibility that it may find itself involved in an illegal distribution

One final bit of advice should be offered in concluding this review of SEC merger considerations. After you have worked your way through a complicated acquisition, prepared your proxy statement, held your meeting and won the overwhelming approval of your stockholders--before you put your files away and celebrate--please file your Form 8-K to report to an awaiting public the results of your endeavors.

Thank you.