

RESPONSE TO QUESTIONS OF SENATOR CRANSTON

Hearing of April 17, 1985

Question 1. What studies have been undertaken, and what statistics are available regarding the costs to business involved in defending against takeovers?

Answer. We know of no studies that have attempted to measure the direct legal and other costs involved in devising and defending against hostile tender offers. However, on average, such costs must necessarily be small in relation to the total social cost of failed tender offers (or, for that matter, to the total social benefit of successful tender offers).

By far the largest directly measurable social cost of defending against takeovers is the capital loss to target and bidder shareholders that occurs when the defense causes the defeat of the takeover attempt. The statistical evidence is very strong here. The SEC's Chief Economist, Gregg Jarrell, has authored two published studies on this question. 1/ The data show on average large and "permanent" stock price declines are caused when target firms reject tender offers to remain independent. Also, in response to an article drawing the opposite conclusion appearing in Forbes, the

1/ See the two enclosed articles: "The Wealth Effects of Litigation by Targets: "Do Interests Diverge In a Merge?" Journal of Law and Economics 28 (April 1985), and (with Frank Easterbrook) "Do targets Gain from Defeating Tender Offers?" New York University Law Review, 59 No. 2 (May 1984).

Office of the Chief Economist recomputed the stock price evidence and showed that in 88 percent of the cases surveyed in that article, target shareholders suffered large capital losses. 2/ These losses take the form of forgone capital gains that these shareholders could have enjoyed had the offer not been defeated. This same point is demonstrated in yet another study by the SEC's Office of the Chief Economist which examines the various impacts of tender offers. 3/

Another major cost to shareholders of defense from takeover is the payment of "greenmail" -- a premium (above market) payment to buy out a large individual shareholder. The SEC's Office of the Chief Economist has released an economic study of these targeted share repurchases which shows that for the 89 greenmail cases occurring during the period from January 1979 to September 1983, a total of over one billion dollars in above-market premiums was paid out to large block shareholders. 4/

2/ See enclosed April 1, 1985 memo by Gregg Jarrell, et al.

3/ "The Economics of Any-or-All, Partial, and Two-Tier Tender Offers," Office of the Chief Economist, SEC (Washington D.C.: April 1985).

4/ "The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices," Office of the Chief Economist, SEC (Washington, D.C.: September 1984).

Another cost of defending against takeovers is that associated with antitakeover charter amendments. The Office of the Chief Economist has released a study focusing on this subject. ^{5/} In addition, the SEC's economists are continuing to examine this issue using a large updated data base containing over 600 cases of post-1979 antitakeover amendments. We expect a follow-up study to be released within a few weeks. The research so far indicates that supermajority type provisions and "poison pills" impose substantial capital losses upon shareholders. These capital losses represent a major cost of deterring takeovers. Fair price amendments, which have dominated the market since 1983, are not associated with such large stock price declines.

Finally, in case there is any question as to the appropriateness of share price evidence as a measure of the social costs and benefits associated with takeover events, it should be pointed out that the gains to the target and bidder shareholders are not merely the gains of private individuals, or, worse yet, at the expense of society as a whole. The prices which are paid for capital assets reflect the future earnings which those capital assets are expected to generate. If assets are more highly-valued in combination with other assets than standing

^{5/} "Shark Repellents: The Role and Impact of Antitakeover Charter Amendments," Office of the Chief Economist, SEC (Washington, D.C.: September 1984).

alone, it must be that they are more efficiently employed when joined with those other assets. Therefore, combinations of corporate assets which are wealth producing for shareholders are also beneficial to society because they to improve productive efficiency. That is, more highly-valued capital assets means greater output per person employed. The alternative notion that such wealth generating combinations are somehow bad for society requires significant divergence between private benefit and social benefit and between private cost and social cost. The existence of such divergences, also known as externalities, is a largely inappropriate idea in this context. (See the comments of Prof. Harold Demsetz at the Economic Forum on Tender Offers.)

Question 2. Chairman Shad, you have a division of Economic and Statistical Research of some 43 people. Why don't you conduct a study of the effect and cost of hostile takeovers to business?

Answer. The office at the Commission which produced the previously mentioned studies is the Office of the Chief Economist. There are six professional economists on their staff, assisted by a research support staff of five additional individuals.

With respect to a study of the effect and cost of hostile takeovers to business, our Office of the Chief Economist has, as a matter of fact, produced several studies which deal in good measure with this issue, some of which are listed in our response to your first question.

In particular, we have addressed the correctness of the very arguments which you made a basis for your questions -- that business decisions are influenced by whether they will increase or decrease a company's vulnerability to takeover and that threat of takeover forces management to focus on short term rather than long term results.

This is a popular theory which is based on the notion that the equities market is increasingly dominated by institutional investors who focus on short term results. This theory further alleges that because of these short run minded professional money managers, firms are forced to forego expenditures on R&D

in order to boost current earnings at the expense of future earnings in an effort to drive up the price of the stock and ward off takeover. Our office of the Chief Economist has produced a study which shows that there is no statistical support for this theory. 6/ The data show, for example, that increasing institutionalization is, on average, accompanied by increasing expenditures on R&D. In fact, the data show that institutional investors generally seem to favor firms with higher R&D ratios. After accounting for industry differences, changes in institutional holdings appear to be unrelated to changes in R&D expenditures. Further, announcements of new R&D expenditures are generally greeted with favorable stock market reactions. This evidence also reveals that firms which became targets of takeover attempts between 1980-1984 generally had lower, not higher, R&D to sales ratios than other firms in their industry. Also, these target firms tended to have roughly the same R&D to sales ratios in the year prior to the tender offer as they had in the prior three years. Finally, these takeover targets are characterized by low institutional holdings, which contradicts the theory that money manager shareholders were responsible for the eventual takeovers.

6/ Institutional Ownerships, Tender Offers, and Long Term Investments," Office of the Chief Economist, SEC (Washington, D.C.: April 1985).

Any single one of these points taken separately might not be conclusive, but taken collectively they provide a very strong refutation of the popular theory that threat of takeover induces corporate short-sightedness. These arguments have been summarized in a recent Wall Street Journal editorial (also enclosed) written by OCE's Chief and Deputy Chief Economists. 7/

7/ "Takeover Threats Don't Crimp Long-Term Planning," Wall Street Journal, May 1, 1985, p. 32.

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QUESTION. "It has been suggested by some people that now might be a good time to repeal Glass-Steagall altogether. What is your opinion on that?"

ANSWER. The Commission has not formally considered whether the Glass-Steagall Act should be repealed. The Act is a banking statute which the Commission does not administer. However, the Commission has supported carefully crafted modifications to the prohibitions of the Act, if they are accompanied by limitations designed to minimize potential abuse.

In this connection, the Commission has taken the position that if new entities wish to participate in the securities business, they should do so subject to the full panoply of the securities laws -- that is, under a system of functional regulation. Functional regulation would neither promote nor deter the crossing of traditional lines between the banking and securities industries. It would, however, fill a gap in the current regulatory framework by providing public investors the protection of the securities laws regardless of the type of financial entity investors use for their securities transactions.

Consistent with this principle, the Commission has supported legislation that would make limited modifications to the Act. For example, the Commission supported S. 2181, introduced by Senator Garn, which would have permitted banks to engage in a limited number of new activities through holding company affiliates. These activities included underwriting municipal revenue bonds and sponsoring, advising and underwriting mutual funds.

Moreover, the Commission also recommended that, consistent with the principle of functional regulation, all bank brokerage activities marketed to the general public should be transferred to securities affiliates. */ In addition, the Commission has made specific recommendations to address potential conflict of interests between banks and their holding company affiliates, if banks are authorized to engage in additional securities activities.

*/ On July 1, 1985, the Commission adopted Rule 3b-9 which requires banks that engage in certain brokerage activities to conduct those activities through a registered broker-dealer.