

MINUTES  
CABINET COUNCIL ON ECONOMIC AFFAIRS

July 24, 1984

8:45 a.m.

Roosevelt Room

Attendees: Messrs. Regan, Block, Baldrige, Donovan, Porter, Wright, Smith, Niskanen, Poole, McCormack, Rule, Knapp, Gibson, DeMuth, Healey, Cicconi, Ginsburg, Halpert, Neal, Newman, Breeden, Ms. Chao and Ms. McCaffrey.

1. Tender Offer Legislation

The Council resumed its discussion of tender offer reform legislation, focusing on the potentially abusive practice of "greenmail," where a firm buys back, at a substantial premium, shares purchased by an outside bidder in order to prevent a takeover.

Mr. DeMuth reviewed the economic effects of greenmail in seven major recent takeover battles where target firms used greenmail as a defensive tactic against hostile bidders. He stated that, contrary to popular belief that greenmail ultimately lowers stock values, net-of-change stock price data show an average gain of nearly 7 percent in share values in the seven cases. Greenmail also had a negligible effect on the debt to equity ratios of the firms.

Mr. DeMuth also reviewed the extensive litigation relating to these seven cases now pending in State courts. More than 53 shareholder lawsuits are pending. But none have yet been resolved. Mr. DeMuth also summarized the case law involving takeover defenses and observed that several legal experts who follow State law developments have noted that the courts in New York, California, and Delaware have been very active in this area and that they are moving toward a broader definition of the business judgment rule. He concluded that there is no compelling need for a uniform Federal rule.

The Council's discussion focused on short-and medium-term changes in stock values where greenmail is used; the merit of waiting for the outcomes of State litigation; the standard State courts are likely to use in considering greenmail cases; and the prospects for passage of tender reform legislation during 1984.

The Council approved establishing a working group, chaired by OMB, to determine the extent of the problem of management abuses in tender offers and whether State case law and regulations adequately cover potential abuses. Secretary Regan noted that the working group should consult with Securities and Exchange Commission Chairman Shad in its review of tender offer practices.

2. Insider Trading Sanctions Act of 1984

Mr. DeMuth reviewed a paper on the Insider Trading Sanctions Act of 1984 (S. 910), expanding the scope of insider trading violations and sanctions. Mr. DeMuth stated that because insider trading is vaguely described in the bill as "material non-public information," using information gathered in legitimate ways potentially could be subject to the Act.

The Council's discussion focused on prominent cases involving insider trading and the Administration's support for legislation deterring such abuses. The Council requested the Office of Management and Budget to work with the SEC and House and Senate conferees to define more precisely "material non-public information".

3. Adjustable Rate Mortgages

Assistant Secretary Healey presented a paper discussing the increasing popularity of adjustable rate mortgages (ARMs) and the potential that an increase in interest rates would cause a higher ratio of defaults and foreclosures than would otherwise occur with fixed-rate mortgages.

Mr. Healey reported that ARMs represent about 60 percent of all new mortgages and that there is now approximately \$175 billion in outstanding mortgages. The instruments offer an advantage over fixed-rate mortgages by helping lower homebuyers' average interest costs (ARMs are about 125 basis points cheaper than fixed rate mortgages) and correcting the portfolio mismatches of saving and loan associations. He reviewed three potential ARM problems: "payment shock"; "teaser" mortgages; and builder buydowns.

Congressional hearings have focused on concerns that defaults and foreclosures will increase as ARM owners face the "payment shock" of meeting higher payments after the initial mortgage rate is adjusted. Some Congressmen have referred to ARMs as an "insidious evil" and called for a national usury ceiling. Mr. Healey reported that some payment shock problems may be caused by inadequate disclosure by lenders to consumers about how payment rates will be adjusted. Mr. Healey noted that tighter market standards by private mortgage insurers, including increased disclosure about terms, should mitigate problems in the future.

The Council's discussion focused on the tradition of ARMs in other countries; and in the U.S. before the 1930's, the portion of family income devoted to financing mortgages; and increased disclosure requirements issued recently by the Federal Home Loan Bank Board and the Federal Reserve Board.