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M E M O R A N D U M

TO: Advisory Committee on Tender Offers
FROM: Douglas Scarff, Director
Division of Market Regulation
SUBJECT: Regulation of Market Participants



This memorandum briefly sets forth certain background information that may assist you in focusing upon the principal issues to be addressed in the subject area.

I. Short and hedged tendering

- Should the Commission regulate short tendering and hedged tendering?

Before the adoption in 1968 of Rule 10b-4 under the Securities Exchange Act of 1934, market professionals who could guarantee their tenders would tender more securities than they owned, i.e., would short tender, in order to secure acceptance of a disproportionately larger number of securities owned by them than could be secured by other persons who tendered only securities that they owned. The Commission adopted Rule 10b-4, because it believed that short tendering by market professionals represented an abuse of the tender offer process.

Rule 10b-4 makes it a "manipulative or deceptive device or contrivance" within the meaning of Section 10(b) of the Securities Exchange Act of 1934 for any person to tender a security unless he owns it or an equivalent security. An owner of a security is defined as one who has title to the security, or has purchased the security, or has converted, exchanged, or exercised another security (e.g., an option) that entitles him to obtain the security. A person is deemed to own a security, however, only to the extent that he has a "net long position" in the security.

Although Rule 10b-4 prohibits short tendering, it does not prohibit hedged tendering. Hedged tendering involves the tender of securities followed by the sale of some of those securities into a market that reflects the tender offer premium. The shares sold may in turn be tendered by the purchasers, thus increasing the proration pool. An arbitrageur's ability to hedge may enable him to bid higher for target securities and thus benefit shareholders who wish to sell in the market to avoid proration risk. This benefit, however, comes at the expense of all other tendering shareholders, who have fewer shares accepted as a result.

In 1981, the Commission published for comment two alternative approaches that would result in the similar practices of short and hedged tendering being treated in the same manner. The first alternative was to amend Rule 10b-4 to prohibit hedged tendering; the second was to deregulate short tendering entirely. A copy of Securities Exchange Act Release No. 18050 (August 21, 1981) and of the Summary of Comments on the proposals is attached for your information.

II. Options/Overtendering

- The potential exists for more than 100% of a target's securities to be validly tendered ("overtendering"). In such event, there are procedures that would provide the cash benefit of the tender offer to those clearing members who could not fulfill their guarantees of tender. As a policy matter, is reliance upon these procedures preferable to the adoption of the Commission rules that would reduce or eliminate the likelihood of overtendering?

Under current rules, it is possible for the same shares to be tendered by two (or more) owners. In the aggregate, this double tendering could result in the tendering of more than 100% of the outstanding shares of a target security. The transactions that may result in overtendering are as follows:

1. Option exercises against uncovered writers - there is no limit upon the number of option contracts that can be exercised or written on an uncovered basis. The staff believes that overtendering is unlikely unless there are exchange traded options on the target security.

2. Short selling - both the lender of shares to a short seller and the person who purchases from the short seller are "owners" and each may tender.
3. Hedged tendering - the post-tender sale of shares during a tender offer results in their purchase by arbitrageurs who in turn tender them. See discussion of hedged tendering above.

The potential for overtendering could be curtailed or eliminated by any of a variety of regulatory approaches, including redefining "net long" in Rule 10b-4 to require netting of in-the-money short call option positions against long stock positions, restricting the writing of uncovered call options on target securities, requiring that exercisers of call options obtain possession of the underlying stock before tendering, prohibiting hedged tendering, restricting short selling during tender offers, or restricting the use of guarantees.

III. Depository participation

- Should bidders' depositories be required by SEC rule to establish during tender offers an account with qualified registered securities depositories to permit depository-participating financial institutions to use centralized, book-entry tender and securities delivery services if those participants choose to do so?

Banks and broker-dealers clear and settle nearly all their securities transactions today through centralized, automated clearing corporations and securities depositories registered with the SEC as self-regulatory organizations. The automated clearance and settlement systems provided by those organizations greatly reduce costs and risks to financial institutions involved in securities transaction settlement. Indeed, the ability to process and account for high-volume trading is critically dependent upon the immobilization of securities certificates in depositories and the efficient comparison and netting facilities provided by the clearing self-regulators.

During a tender offer, however, stock deliveries for purposes of tender must be made to the bidder's tender agent. If that agent does not participate in a registered depository for purposes of book-entry delivery of securities within the

depository, delivery by financial intermediaries must be accomplished physically outside the depository. Because processing time constraints are severe during the critical stages of a tender offer, and because depositories are designed to operate in an automated rather than a paper-intensive mode, depositories can encounter unmanageable inventory control problems during large tender offers. As a result, to facilitate participants' need to process stock physically ex-depository, the largest depositories step out of the processing stream during active tender offers by declaring the stock of the subject company ineligible for depository services and returning deposits to participants.

Unfortunately, when securities are declared ineligible for depository services, none of the efficiencies and cost savings associated with automated, book-entry net trade settlement are realized by brokers, banks and other depository-participating institutions. Moreover, in that instance, because settlement requires the physical exchange of cash for securities, confusion and delay (with attendant costs and risks) affect both the processing of tenders and regular-way trade settlement.

Accordingly, The Depository Trust Company, Inc., of New York has urged the Commission to adopt a rule that would require a bidder's agent (commonly a bank transfer agent) to establish, for purposes of receiving tendered stock, an account with registered securities depositories that provide tender offer book-entry services. With such a rule in place, DTC has argued, the significant processing cost savings and efficiencies associated with book-entry services can remain available during tender offers to the major financial institutions that participate in DTC.

I anticipate that the Commission will be considering these matters in mid-April, and may decide to issue a release discussing the securities processing problems associated with large tender offers, and the benefits of participation by bidders' agents in securities depositories.

Market Professionals/Arbitrageurs

- Do arbitrageurs have unfair trading advantages in the context of tender offers as a result of their access to market information?

- Do broker-dealers engaged in arbitrage have unfair advantages because of their ability to (i) monitor customer tendering decisions, (ii) borrow untendered customer securities, and (iii) receive soliciting dealers fees?

The Commission has often acknowledged both the beneficial role that arbitrage plays in maintaining market efficiency and the inherent time and place advantage that accrues to market professionals. Arbitrageurs enable shareholders who wish to avoid prorationing risk to sell their shares at prices that reflect the tender offer. On the other hand, the advantages of market professionals during tender offers should not be such as to undermine investor confidence in the fairness of the markets. Accordingly, the trading activities of arbitrageurs during tender offers should be examined by the Committee.

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Please let me know what, if any, additional information would be helpful to you in your deliberations.

cc: Linda C. Quinn, Associate Director
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