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Competition, Mergers, Acquisitions,
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London, England
October 21, 1983

Competition and Takeovers in America

John S.R. Shad
Chairman
U.S. Securities and Exchange Commission

Note: U.S. dollar figures are set forth in U.K. pounds at the rounded exchange rate of $1.50 to the pound.

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Ladies and Gentlemen:

I bring you good tidings from the colonies. It is nice to return to this sceptered isle, this precious stone, set in the silver sea - which has such a large investment in American industry.

Since helping finance the 19th century industrialization of America, your investments have compounded nicely. You are, of course, the largest external investors in America. At last count, over £25 billion. And we know, there is more where that came from. And so I am here today, as a dutiful fiduciary, to give a full and accurate account - at least on aspects of competition and takeovers in America.

1984 will mark the 50th anniversary of the United States Securities and Exchange Commission. No time in the past half century has witnessed as broad and rapid changes in American financial markets and institutions as we are witnessing today. Mergers and acquisitions and new financial products and services are accelerating the rate of change. (The transactions I will be referring to are in dollars, but I will state them in pounds.)

The industrial conglomeration that started in the late 1940s has expanded into the financial service industries and has also escalated into multi-billion pound transactions. These trends may be expected to persist. Contested takeovers may be inhibited by innovative defensive tactics and state statutes, but the long time federal view has been not to tilt the balance in favor or against bidder or target corporations. Market forces have been permitted to prevail, within the limitations of the securities and antitrust laws and the restraint of trade prohibitions.

Today, I would like to begin by highlighting some post-war trends in the United States and then discuss changes in progress and prospect.

Post-War Trends

The results of economic competition among nations are in large measure a function of their relative rates of capital formation. Since the end of World War II, many of America's regulatory, fiscal and monetary policies have actually been antithetical to capital formation.

- o Mounting regulatory burdens;
- o Rising inflation, corporate and individual taxes;
- o Inadequate depreciation allowances for tax purposes;
- o Discriminatory taxation of interest and dividends;
- o As well as double taxation of dividends;
- o And one of the highest effective rates of capital gains taxation in the industrialized free world;

have been distinct disincentives to saving and investing.

These policies have contributed to the decline in our relative rate of capital formation, among industrialized nations. The inevitable consequence has been a similar decline in our relative growth of productivity.

Our less than 2% average annual increase in productivity per man-hour during the last 10 years, compares with nearly 6% for Japan, over 4% for western Europe and nearly 3% for the U.K. In other words, Japan's productivity has been increasing at over 3 times, western Europe's at over twice, and the U.K.'s at 1.4 times the rate in the United States! Such trends cannot be projected very far into the future, if the United States is to maintain its relative position in this keenly competitive world.

Britain and America have excellent labor forces, but the only way we can materially improve most workers' standard of living is by increasing their productivity - and that takes capital - savings, investments and corporate profits, plowed back into new technology and production facilities, which create new jobs and multiply workers' productivity - thereby permitting substantial wage increases.

On a favorable note, since 1980:

- o U.S. tax deductible depreciation allowances have been increased by over 14%;

- o the rate of inflation has been reduced by over 60%;
- o the prime rate by 50%;
- o the maximum federal tax rates on interest, dividends and capital gains, have been reduced by over 25%;
- o and the annual growth rate of our productivity has tripled.

Our productivity is now growing at a 5.7% annual rate and our Gross National Product, at an extraordinary 7% annual rate. This year's corporate profits are expected to exceed last year's by over 25% - and the prospects for next year are excellent.

These increases in our investment incentives - and decreases in the disincentives - have been reflected since August of last year in the broadest and strongest U.S. stock, bond and new issue markets in history, and will be reflected, during the balance of this year, 1984 and beyond, in rising demand for consumer durables, capital goods and jobs. Our unemployment rate has already declined from over 10% last year to 9.1%, and a year from now it is expected to be at or below 8%.

Thus, there has been a real change of direction in America. Major problems remain in the international arena, but the stage is set for an era of strong domestic growth and development.

Financial Conglomeration

The past 2 3/4 years, have also witnessed the rapid development of new forms of financial conglomerates. Several of America's largest investment banking and brokerage firms have merged into larger corporations, that are already major purveyors of multiple financial services. In addition, major banks, savings and loan associations and insurance companies are entering the securities industry. And securities firms are acquiring insurance companies, and a variety of other financial service concerns. The list is long and growing daily.

Just within the past 12 months ended September 30th, in addition to the extraordinary stock and bond markets, the U.S. has also witnessed:

- o Mergers and acquisitions, aggregating over £15 billion, which is a shade below the record £16 billion in 1981 and 1982, but over twice the 1980 level.

- o Unprecedented movements of capital - over £250 billion, principally out of conventional bank accounts into new high interest rate, money market and other bank accounts, and over £35 billion out of the money market funds, into such bank accounts, equity mutual funds and the stock market;

- o Nearly a 100% increase in corporate equity offerings to a record £27 billion;

- o Nearly a 20% increase in domestic corporate debt financings to a record £37 billion, and a concomitant 50% decline in Eurodollar financings to £4 billion;

- o Net foreign purchases of U.S. equity securities of over £4 billion and net bond liquidations of only £650 million;

- o Rapidly rising trading volume, in a host of new financial instruments, including futures and options on government securities, foreign currencies and stock indices - which are facilitating government financings, international trade and hedging market risks;

- o Securities firms acquiring so called "non-bank banks", in order to offer trust services to pension funds, and federally insured money market accounts to the public;

- o Hundreds of bank and thrift institutions entering the discount brokerage industry, and others entering the investment company management field;

- o And banks commencing interstate banking through the mails, toll-free phone systems and automatic teller machine networks.

All of this has occurred within the past 12 months.

Outdated Regulations

One of the conclusions is that the U.S. financial service industries are thundering over, under and around the laws that are intended to separate investment and commercial banking, and to prohibit interstate banking. However, these laws are the product of the 1929 crash and the Great Depression - half a century ago. They addressed a different era and different problems than those the nation confronts today.

Our present regulatory structures are based on historical industry classifications, but major mergers and acquisitions and new financial products and services - such as the money market funds and dozens of others - have bridged the traditional gaps between the securities, banking and insurance industries.

Regulatory overlaps and conflicts have also multiplied. Today, 10 federal and over 100 state agencies regulate various aspects of the U.S. securities markets alone. In addition, some financial products and services compete on the basis of their regulatory classifications, rather than their economic merits.

Task Force

Shortly after arriving at the SEC, 2 1/2 years ago, I began advocating in Congressional testimony and speeches, the formation of a task force to help simplify and rationalize the regulatory structures of the financial service industries, for the benefit of investors, depositors and the nation. Specifically,

- o consolidation of overlapping and duplicative regulatory activities;
- o regulation by functional activities, rather than by outmoded industry classifications;
- o and elimination of excessive regulations within and between agencies.

Last December, such a task force was formed by Vice President Bush. In addition to the Vice President, the Secretary of the Treasury and the Attorney General, it includes the Chairmen of the Federal Reserve Board and the other federal agencies that regulate the banks, the savings and loans, and the securities and commodities markets.

The Bush Task Force is expected to propose major legislative initiatives later this year. Proposals under discussion would materially simplify and improve the regulatory structures of the U.S. financial service industries. Ideas being analyzed include the following, but I hasten to emphasize, all of them have not - and may not - be proposed or enacted.

One approach would be to place greater reliance on the disciplines of the market place and less on federal regulators. For example, individual deposits in U.S. banks and savings and loan associations are presently insured up to $100,000 by agencies of the federal government. When federal regulators facilitate upstream mergers of troubled depositories, depositors of over $100,000 also receive the full amount of their deposits. Less than full recovery for large depositors would cause them to shift their deposits out of weak into strong depositories, without action by the regulators.

In addition, the same percentage premiums are presently charged all depositories for such federal insurance. Risk-related insurance premiums would increase the cost to those depositories with high-risk loan portfolios.

The public financial and other disclosures by depositories are presently administered by five different federal agencies. Consolidation within the SEC would result in more uniform regulation and enforcement of such disclosures, at lower costs. It would also facilitate decisions by depositors concerning the relative soundness of depositories and by investors concerning the attractiveness of their securities.

Additional concepts include:

- Consolidating certain of the bank regulatory and compliance responsibilities, administered by the Federal Reserve Board and other agencies;

- Consolidating federal insurance functions, now being performed by three agencies;

- And consolidating the antitrust responsibilities of the depository regulators within the Justice Department.

Treasury Proposal

In a related area, the Treasury's Financial Institutions Deregulation Act is presently pending before Congress. It would permit depositories to engage in a number of new activities including the underwriting of municipal revenue bonds and the sponsoring of mutual funds - through separate corporate affiliates, subject to the same rules, regulations and tax treatment, as securities firms that engage in such activities. Depositories that offer the new securities products and services would be required to include their other securities activities within such affiliates.

The bill would also permit securities firms - that engage in no greater securities activities than those permitted depositories - to set-up separate banking affiliates, subject to the same regulations as all other banks.

Thus, this bill is a major step toward the replacement of regulation by industry classifications, with regulation by functional activities.

The 1984 Elections

Next year, Congress will be preoccupied with the national elections, coming in November. However, there is substantial bi-partisan support for regulatory simplification and improvement.

Tender Offer Trends

With reference to corporate takeovers, the targets are often corporations that are trading in the market at significant discounts from their underlying asset values, at low multiples of their cash flows, and which have significant untapped borrowing capacity. The acquisition of such companies can often be financed largely against their own assets and borrowing capacity.

Since the 1974 contest between Inco Canada and United Aircraft for ESB, there has been a significant increase in the size and number of contested tender offers. Some have been in excess of a billion pounds.

In the 1981 contest for Conoco, the participants which included DuPont, Mobil and Seagrams, lined up over £13 billion in credit. Conoco shareholders ultimately accepted DuPont's offer of £5 billion, over £2 billion in cash and the balance in DuPont common stock. The victors in other billion dollar bidding bees, include:

- o U.S. Steel's 1982 acquisition of Marathon Oil for over £4 billion;
- o Occidental Petroleum's 1982 acquisition of Cities-Service for over £2.5 billion;
- o And CSX's 1983 acquisition of Texas Gas for over £650 million.

Thus, size does not provide immunity from takeover bids. While the antitrust and restraint of trade aspects of major mergers are carefully reviewed by the Justice Department and the Federal Trade Commission, both have indicated that size alone is not an inhibition.

Take-Over Tactics

On the other hand, members of Congress and others have questioned some bidder and target tactics. The American press has evolved a new lexicon in describing these tactics. Those questioned include, "two-tier" or "front-end loaded" offers, in which high cash offers for a portion of the shares, are followed by forced statutory mergers, in which the remaining shareholders receive a lower price. Also, defensive tactics by potential targets, such as "shark repellent" charter and by-law amendments, which require:

- o super majority shareholder approvals to effect changes in control;

- o or the highest price paid for any of the shares, to be paid for all;
- o or that limit the total voting power that may be exercised by a single shareholder.

Also, the so called "Pac Man" defense in which the target tenders for shares of the bidder.

And other defenses, in which the target:

- o makes a higher bid for its own shares than the bidder's offer;
- o or declares a dividend to its common shareholders of a preferred stock, convertible into the bidder's common stock. This has been labelled a "poison pill preferred".

In order to forestall competitive bids, "white knights" and other friendly bidders have been granted options to purchase:

- o large blocks of targets' treasury shares;
- o or their most attractive assets - their so called "crown jewels".

Many of these tactics have been challenged in the courts.

So called "golden parachutes" are multi-million dollar termination compensation packages, payable to executives if they quit or are fired following a change in control. Based on a 1982 survey, over 10% of the 1000 largest U.S. corporations provide their top managements with some form of such arrangements. They may temper opposition to takeovers, since the managements have less to lose. Following Allied Chemical's acquisition of Bendix, Bill Agee, the Chairman of Bendix, received over £2.5 million when he quit.

State Laws

U.S. corporations are incorporated under the laws of the various states. The states' initial attempts at anti-takeover legislation were struck down by the courts. However, Maryland has recently amended its corporate statutes to require that any transaction with the holder of more than 10% of a company's voting power must be approved by 80% of the shares and two-thirds of the disinterested shareholders, unless certain value and other standards are met. A new Ohio law requires shareholder approval, prior to the consummation of specified "control acquisitions", unless a company's charter or by-laws, provide otherwise. These new statutes have not as yet been tested in the courts.

Tender Offer Advisory Committee

The SEC's job is to enforce the federal securities laws and regulations, which proscribe certain of the contestants' activities, but not to pass upon the social or economic merits of such transactions.

In February, the SEC formed a Tender Offer Advisory Committee of distinguished businessmen, attorneys, economists and others, who have been on both sides of such transactions and who are thoroughly familiar with the issues.

The Committee's mandate was to review the methods of changing control of publicly-owned corporations, from the point of view of the best interests of all shareholders - those of target, bidder and bystander corporations - and to address additional issues raised by the Senate Banking Commmittee.

The Committee delivered its final report in July. Its recommendations include:

- That acquisitions of over 20% of a company's shares be made through direct purchases from the issuer or through tender offers;
- That partial tender offers be subject to the disincentive of a two-week longer offering period than offers for all or any of the shares - thus affording targets additional time for defensive tactics;
- That certain state anti-takeover statutes and corporate charter provisions be prohibited by Congress;
- That pending such prohibition, the adoption of anti-takeover super majority charter amendments, be subject to approval by such a super majority of the shareholders;
- That super majority provisions, "golden parachutes", and limitations on the purchase or sale of shares, or on the one-share, one-vote rule, be subject to annual advisory votes by shareholders - a new concept, such votes would not bind the board, but they would put the directors on notice of shareholders' reactions;

- o That shareholder approval be required for a target company to repurchase a block of its shares at a premium price;
- o That during takeover contests, target companies not be permitted to provide management with "golden parachutes";
- o And that the regulatory process permit exchange offers - of one company's securities for those of another - to be made on the same short time schedules as cash tender offers.

The SEC and Congress are studying the Committee's recommendations, with a view to administrative and legislative action next year.

Conclusion

In conclusion, America's regulatory structures are lagging far behind the accelerating rate of change in the marketplace. Many are no longer responsive to the problems, or the opportunities, of the balance of this century. However, the issues are being identified and addressed by the SEC, the Bush Task Force, the Administration and Congress. Major steps have already been taken for the benefit of investors, depositors and the nation - and more are in prospect.

This concludes my formal remarks. I would welcome your comments and suggestions, and I will be pleased to respond to your questions.

Thank you.