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# Sec Rule 10b-13: A Reconsideration

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# SEC RULE 10b-13: A RECONSIDERATION

*by*

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WHETHER those making cash tender offers[1] and exchange offers[2] should be permitted to purchase target company stock outside their offers in the open market has been the subject of much recent interest to the courts,[3] the Securities and Exchange Commission,[4] and the commentators.[5] One aspect of that controversy concerns open market purchases by arbitrageurs and subsequent tenders by them of securities which are the subject of a pending tender offer. The SEC recently announced that, despite an earlier staff opinion to the contrary,[6] rule 10b-13[7] does not prohibit open market purchases and subsequent tenders by arbitrageurs who sign a soliciting dealer's agreement and receive a soliciting dealer's fee for the tender.[8] The Commission's release describes the context in which the issue arose:

> Arbitrageurs in a tender offer typically make money on the differential between the market price at the time the tender offer is announced and the tender price, which normally includes a premium above market. Their purchases enable the public investor to elect to avoid the risk that the tender will not be consummated or that it will be prorated. The receipt of a soliciting dealer's fee by an arbitrageur enables him to enhance his profit by tendering his shares at the tender price plus the soliciting dealer's fee.[9]

The Commission's position was expressed as follows:

> The language of Rule 10b-13 under the Securities Exchange Act of 1934 prohibits a person making a tender offer from, directly or indirectly, purchasing or making any arrangement to purchase the securities which are the subject of the tender offer otherwise than pursuant to the tender offer. The intent of this language is to protect public investors who, if the tender offer were prorated, might lose the opportunity to tender all their shares whereas those whose shares were purchased outside the tender offer would not be prorated [*sic*]. In view of that intent, the Commission views purchases and subsequent tenders by arbitrageurs, accompanied by receipt of a soliciting dealer's fee, as permissible activities, provided that the payment of such soliciting dealer's fees is adequately disclosed in the context of the tender offer.[10]

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[1] Hereinafter referred to simply as "tender offers."

[2] The term "exchange offer" as used herein describes tender offers for any security in exchange for any consideration other than solely for cash.

[3] *See* text accompanying notes 45-56 *infra.*

[4] *See* text accompanying notes 12-19 *infra.*

[5] Goolrick, *Purchases on the Market of Target Company Stock*, 26 BUS. LAW. 457 (1970); Henry, *Activities of Arbitrageurs in Tender Offers*, 119 U. PA. L. REV. 466 (1971); Lowenfels, *Rule 10b-13, Rule 10b-6 and Purchases of Target Company Securities During an Exchange Offer*, 69 COLUM. L. REV. 1392 (1969); Comment, *The SEC's Rule 10b-6: Preserving a Competitive Market During Distributions*, 1967 DUKE L.J. 809.

[6] *See* text accompanying note 18 *infra.*

[7] SEC Rule 10b-13, 17 C.F.R. § 240.10b-13 (1972), adopted pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), provides in part: "(a) No person who makes a cash tender offer or exchange offer shall, directly or indirectly, purchase . . . any such security . . . otherwise than pursuant to such tender offer or exchange offer from the time such tender offer is publicly announced . . . ."

[8] SEC Securities Exchange Act Release No. 9395 (Nov. 24, 1971).

[9] *Id.*

[10] *Id.*

A number of questions are raised by the release,[11] but the most notable aspect of the release is the Commission's apparent position that, at least with respect to tender offers, rule 10b-13 has such a narrow purpose.

## I. DEVELOPMENT OF RULE 10b-13

In October 1968 a proposed rule 10b-13 was published for comment.[12] It applied only to tender offers and proposed that a person making a tender offer be required to purchase all tendered securities, at a price no lower than the highest price he paid during the tender offer for the purchase of securities of the same class outside the tender offer. The effect of the proposed rule would have been to require an offeror who purchased securities on the open market during the tender offer to purchase all of the tendered securities either at the tender price or at the price paid on the open market, whichever was higher.

After receiving comment, a revised proposal was published in May 1969,[13] in the form in which the rule was finally adopted. The Commission noted, and apparently heeded, the objection made to the original proposal that potentially heavy financial burdens would be imposed on companies found in violation of the rule. The revised proposal simply put a blanket prohibition on purchases outside the offer and also was extended to encompass exchange offers. As to exchange offers, the release stated, the rule was "a codification of existing interpretations under Rule 10b-6."[14] Rule 10b-6 being an anti-manipulative rule,[15] proposed rule 10b-13 thus took on an anti-manipulative cast.

Whatever the soundness of the Commission's position concerning the applicability of rule 10b-6 to exchange offers,[16] rule 10b-6 could not under any construction apply to tender offers, there being no distribution of securities by the tender offeror. Thus, up to this point, it was the Commission's apparent position that rule 10b-13 was to have an anti-manipulative purpose, but only as to exchange offers. However, the Commission was aware that the problem of possible market price distortion occurs in tender offers as well as in exchange offers, and so made it clear that the rule was directed at price distortion in the tender offer situation as well. With respect to the purchase by the offeror of securities in the market and outside the tender offer, the release adopting rule 10b-13 stated:

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[11] For instance, the release appears to be limited to the situation where the arbitrageur signs the soliciting dealer's agreement after the purchases have been made. *But see* text following note 77 *infra*. The release also fails even to mention the contention made earlier by the SEC staff that such purchases by the arbitrageur are made on the behalf of the tender offeror.

The ruling is based on the conclusion that such purchases will not have the effect of depriving the public investors of the right to have their shares taken up in situations where the tender offer is prorated. This conclusion is open to question. By, in effect, paying arbitrageurs to buy and tender the shares of those who do not tender, those who do tender may be prejudiced. Further, this conclusion suggests that the rule applies only to those tender offers in which proration is necessary. This qualification is not contained in the rule.

[12] SEC Securities Exchange Act Release No. 8391 (Aug. 30, 1968).

[13] SEC Securities Exchange Act Release No. 8595 (May 5, 1969).

[14] *Id.*

[15] Rule 10b-6 states that it shall constitute a "manipulative or deceptive device or contrivance" for any participant in a distribution of securities to bid for or purchase any security which is the subject of the distribution. SEC Rule 10b-6, 17 C.F.R. § 240.10b-6 (1972). *See* text accompanying notes 20-27 *infra.*

[16] *See* text accompanying notes 62-65 *infra.*

Irrespective of the price at which such purchases are made, they are often fraudulent or manipulative in nature and they can deceive the investing public as to the true state of affairs. Their consequences can be various, depending upon conditions in the market and the nature of the purchases. They could defeat the tender offer, either by driving the market price above the offer price or by otherwise reducing the number of shares tendered below the stated minimum. Alternatively, they could further the tender offer by raising the market price to the point where ordinary investors sell in the market to arbitrageurs, who in turn tender.[17]

Subsequently, in September 1971, an inquiry was made of the SEC staff as to its position with regard to open market purchases by arbitrageurs who receive soliciting dealers' fees. The staff's reply, consistent with the Commission's position as it had previously been expressed, was that the Division of Trading and Markets of the SEC viewed purchases by soliciting dealers as having been made by the tender offeror and, therefore, in violation of rule 10b-13.[18] It also indicated that the rule could not be avoided simply by delaying the signing of a soliciting dealer's agreement, if the circumstances indicated that at the time of making the purchases, the arbitrageur had an intention to sign the agreement later and receive the fee. That position has now been overruled by the Commission.[19]

## II. THE LAW PRIOR TO RULE 10b-13

Rule 10b-6 was brought into being, along with rules 10b-7 and 10b-8, primarily to implement the views of the Commission concerning the kind of manipulative activity prohibited by the law existing at the time. Subsection (a)(2) of section 9 of the Exchange Act[20] was intended by Congress to deal with speculative pooling operations, "wash sales," and matched orders, but it was up to the Commission under section 9(a)(6)[21] to establish rules regulating stabilization practices. In addition, section 10(b) of the Exchange Act[22] gave the Commission power to establish regulations regarding manipulation and deception. As a result of statutory amendments made in 1936[23] and 1938,[24] section 15(c) of the Exchange Act[25] afforded over-the-counter markets at least as great a degree of protection against manipulation as was afforded the exchange markets by section 9(a).[26] Until the adoption of rules 10b-6, 10b-7, and 10b-8, the cases involving situations now governed by rule 10b-6 had been decided on the basis of the foregoing provisions along with the anti-fraud provisions of both the Securities Act of 1933 and the Exchange Act.[27]

But much uncertainty existed about how these prohibitions would be en-

[17] SEC Securities Exchange Act Release No. 8712 (Oct. 8, 1969).
[18] MSL Indus., Inc., CCH FED. SEC. L. REP. ¶ 78,320 (1971).
[19] *See* note 11 *supra*, and accompanying text.
[20] 15 U.S.C. § 78i(a)(2) (1970).
[21] *Id.* § 78i(a)(6).
[22] *Id.* § 78j(b).
[23] Act of May 27, 1936, ch. 462, § 3, 49 Stat. 1378.
[24] Act of June 25, 1938, ch. 677, § 2, 52 Stat. 1075. For a discussion of the evolution of § 15 of the Exchange Act, see Tenth Annual Report of Securities and Exchange Commission, 10 SEC ANN. REP. 68, 69 (1944).
[25] 15 U.S.C. § 78o(c) (1970).
[26] *See* Barrett & Co., 9 S.E.C. 319, 328 (1941).
[27] *See generally* Whitney, *Rule 10b-6: The Special Study's Rediscovered Rule*, 62 MICH. L. REV. 567 (1964).

forced; therefore, adoption of rules 10b-6, 10b-7, and 10b-8 was deemed appropriate in order that there would be "basic principles on paper instead of in the brain cells of a comparatively few people."[28] The new rules, however, were not a one-sided codification of the views of the Commission. There was considerable discussion with representatives of the industry and, by the time the final version was decided upon, "the differences between the Commission's staff and industry were greatly reduced."[29] The rules were designed to provide functional definitions of the activities proscribed by the Act.[30]

The regulatory effect of rule 10b-6 is directed exclusively at market activities during a distribution. All bidding and purchasing by those distributing is flatly prohibited since the rule is premised on the view that bidding and purchasing under those circumstances are for the proscribed purpose.[31]

> The rule [10b-6] is based on the sound premise that bids and purchases of a security by a person engaged in the distribution of securities of the same class constitute actual or apparent active trading in such security by others. It has long been an accepted premise that all market activities in a security by a person engaged in the distribution of a security of the same class are effected for the purpose of inducing others to buy the distributed security.[32]

A power to grant exemptions on an ad hoc basis was retained for situations where the Commission feels the purchase will not be manipulative and is motivated by legitimate corporate purposes. When exemptions are granted, certain conditions are imposed which are calculated to minimize the market impact of the purchases.[33] There is no differentiation between exchange and over-the-counter market transactions though these markets are subject to regulation under separate sections of the statute.[34]

Prior to the time that rule 10b-6 became important in the tender offer, exchange offer, and merger areas, its application by the Commission was directed at more or less classic manipulation situations. For example, in *Gob Shops of America, Inc.*[35] and *Bruns Nordeman & Co.*,[36] a distributing broker-dealer

[28] Demmler, *How Shall We Amend the SEC Acts?*, 178 COM. & FIN. CHRON. 2361, 2438 (1953).

[29] Foshay, *Market Activities of Participants in Securities Distributions*, 45 VA. L. REV. 907, 919 (1959).

[30] [R]ule 10b-6 specifies those transactions encompassed by the prohibition in section 9(a)(2) against 'actual and apparent active trading.' When adopted, it was both a codification of 'principles which . . . [had] been generally followed' prior thereto, and an interpretation, on the basis of the general anti-manipulative provisions of section 10(b), of the phrase 'actual and apparent active trading' in section 9(a)(2).

Weiss & Leibowitz, *Rule 10b-6 Revisited*, 39 GEO. WASH. L. REV. 474, 476 (1971).

[31] Violations of the rule have, on occasion, been found to be "willful," however. *See, e.g.*, C.A. Benson & Co., SEC Securities Exchange Act Release No. 7044 (Mar. 26, 1963).

[32] Weiss & Leibowitz, *supra* note 30, at 477.

[33] *Id.* at 482. The authors, officials of the SEC's Division of Trading and Markets, suggest that typical conditions are limitations on the volume of securities purchased and the price paid for them, the requirement that all purchases be made through a single broker, and a prohibition against use of typical manipulative techniques, such as engaging in the opening transactions in the securities on the exchange and purchasing shortly before closing of the exchange. *Id.* at 483.

[34] Securities Exchange Act of 1934, § 9, 15 U.S.C. § 78i (1970), applies only to national exchanges. Section 15 of that Act, *id.* § 78o, is applicable only to over-the-counter markets.

[35] 39 S.E.C. 92 (1959).

[36] 40 S.E.C. 652 (1961).

placed progressively higher bids for a security, despite the fact that he was still engaged in its distribution. Holding that rule 10b-6 was violated, the Commission held that the rule applied whenever the offering was significant in terms of dollars and in terms of the selling effort employed to market it.[37] And, in *SEC v. Scott Taylor & Co.*,[38] the defendants were distributing a security and, instead of purchasing the stock themselves, had a broker-dealer enter bids for it on their behalf. The court found that all had violated rule 10b-6 and that the broker-dealer had violated the rule not only as a principal because he participated in the distribution, but as an aider and abettor of the violation by those distributing.[39] In *Shearson Hammill & Co.*[40] a broker-dealer who engaged in bidding for securities of the class being distributed was held in violation of rule 10b-6 despite the contention that legitimately motivated dealers also submitted bids at a similar price level. In none of these, or other court and Commission actions, is there any indication that rule 10b-6 was intended to regulate any activities but those which by their nature were clearly designed to maintain artificially the market price of a security in preparation for or during a distribution of that security to the public.

It was not until 1966 that there was any formal expression of the SEC's opinion regarding applicability of rule 10b-6 to the acquisition of one corporation's securities by another by tender offer, exchange, or merger. In *SEC v. Georgia-Pacific Corp.*[41] the SEC took the position that open market purchases by a corporation of its own shares for employee stock bonus plans, and by its shareholders for investment, were in violation of rule 10b-6 because the corporation was then engaged in the acquisition of other corporations by means of an exchange of stock. Under the terms of some of the acquisition agreements, the amount of stock which Georgia-Pacific would have to relinquish was dependent upon the market price of Georgia-Pacific stock during certain periods. The SEC charged in its complaint[42] that these purchases were made in such a manner as to avoid or reduce the number of shares Georgia-Pacific would otherwise be required to issue in connection with those acquisitions. Georgia-Pacific consented to a judgment which outlined the conditions under which such market activity in the future might be carried out. The final order provided, *inter alia*, that there would be no bidding or purchasing by the defendant corporation or the defendant shareholders[43] while the corporation was distributing securities or during the period when the terms of an acquisition agreement with another firm were being established. Similarly, in an informal proceeding reported in the prospectus of Genesco, Inc., dated May 10, 1966,[44] Genesco agreed to discontinue open-market purchases of its stock for two stock

[37] *See also* F.S. Johns & Co., SEC Securities Exchange Act Release No. 7972 (Oct. 10, 1966), *aff'd sub nom.* Dlugash v. SEC, 373 F.2d 107 (2d Cir. 1967); Hayden Lynch & Co., SEC Securities Exchange Act Release No. 7935 (Aug. 10, 1966); J.H. Goddard & Co., SEC Securities Exchange Act Release No. 7618 (June 4, 1965).
[38] 183 F. Supp. 904 (S.D.N.Y. 1959).
[39] *Id.* at 909.
[40] SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965).
[41] [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,692 (S.D.N.Y. 1966).
[42] Excerpts reprinted *id.* ¶ 91,680.
[43] Presumably, any such prohibition as to shareholders could only be directed to those with some "control" status.
[44] Reprinted in part in [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,354.

purchase plans and a retirement trust during the course of merger or exchange offer transactions. In addition, the prospectus disclosed possible contingent liabilities arising out of purchases made during previous exchange offers and mergers.

The courts have also had occasion to deal with these problems. In *Miller v. Steinbach*[45] the plaintiff was a stockholder of Baldwin-Lima-Hamilton Corporation, which had negotiated a merger with Armour & Co. During the negotiations, Armour was conducting a rights offering to its shareholders, and Armour's underwriters made purchases of some of the rights at the beginning and at the end of the subscription period. The plaintiff, a Baldwin shareholder, had been unaware of the rights offering and claimed that the underwriter's purchases of the rights gave artificial support to the market price of Armour stock, which resulted in his receiving a lesser package of securities than he would have received had the Armour stock not been thus over-valued. The court found that a claim under rule 10b-6 had been stated, and denied a motion to dismiss the complaint, stating, "[t]he purpose of Rule 10b-6 is to prohibit trading activity which might affect the price of the securities being offered and thus create unnatural market levels."[46]

Since that decision, three court rulings have been handed down dealing specifically with attempted enforcement of the prohibition now embodied in rule 10b-13 by placing reliance on rule 10b-6. In *Armour & Co. v. General Host Corp.*[47] General Host made an exchange offer for the common stock of Armour, and Armour sought to enjoin the exchange, alleging among other things that one or more of the defendants had participated in market purchases of Armour stock after the effective date of its registration statement for the exchange offer. The court denied the injunction and noted that there was evidence supporting the defendants' contention that the purchases were exempted by the rule as "brokerage transactions not involving solicitation of the customer's order."[48] The court also indicated that there was a substantial question whether subsection (b) of rule 10b-6 "applied to the stock of the 'target' corporation, as well as that of the distributor."[49]

In *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*[50] Chris-Craft and Bangor Punta Corporation both sought control of Piper, each making competing exchange offers for its shares. Chris-Craft sought to enjoin Bangor Punta from voting the Piper stock it had acquired outside the exchange offer. Its argument was based on the revised proposal of rule 10b-13 and the release accompanying it which stated that, as to exchange offers, the then-proposed rule represented a codification of existing interpretations under rule 10b-6.[51] The court analyzed rule 10b-6 and concluded that it could find no support for the SEC's claim that such interpretations existed, and stated, as to Bangor Punta's purchases of Piper stock, that "[a]ny increase in the price of Piper shares as a result of

[45] 268 F. Supp. 255 (S.D.N.Y. 1967).
[46] *Id.* at 280.
[47] 296 F. Supp. 470 (S.D.N.Y. 1969).
[48] *See* SEC Rule 10b-6(a)(3)(v), 17 C.F.R. § 240.10b-6(a)(3)(v) (1972).
[49] 296 F. Supp. at 476 n.18.
[50] 303 F. Supp. 191 (S.D.N.Y. 1969), *aff'd in part and rev'd in part sub nom.* Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970).
[51] *See* text accompanying notes 14, 15 *supra.*

these transactions would obviously serve only to make Bangor Punta's exchange offer appear less desirable to Piper shareholders."[52]

On appeal, the Second Circuit reversed the ruling in a split decision.[53] The majority read the language of rule 10b-6 as precluding such purchases because it prohibits purchases of "any right to purchase such security"[54] as well as purchases of the security to be distributed. Since target stock carried the right to purchase the exchange offeror's securities, said the court, purchases of target company stock are prohibited. This construction has been criticized,[55] but it is not of much significance now in light of the adoption of rule 10b-13, which clearly applies to such purchases. More importantly in terms of this analysis, the court undertook to respond to the claim of Bangor Punta that its purchases had, by raising the price of the target company's stock, decreased the probabilities of success of the offer, and, therefore, had an effect opposite to that which it claimed rule 10b-6 was intended to prevent. The court responded:

> [T]his argument overlooks the decided benefits that purchases of target company's stock can produce for the initiator of an exchange offer. If the price of the target company's stock does increase in response to cash purchases by the exchange offeror after the offer has been announced, many shareholders in the target company are likely to assume that the price increase results solely from the bullish effect of the exchange offer on the market. Small investors especially would be likely to assume that the exchange offer was receiving serious attention and approbation from larger more knowledgeable investors than they . . . .
>
> Prevention of this kind of manipulation seems well within the spirit of Rule 10b-6.[56]

The court's reasoning has prompted criticism, but the critics are not consistent.[57] They have suggested: (1) that more sophisticated, not less sophisticated, investors would be encouraged to tender as a result of a price increase in target company stock;[58] (2) that a price increase in target company stock will diminish the prospects for success of the exchange offer because arbitrage, where it can operate, is the main force in the market place and it cannot operate in the absence of a suitable spread between the prices of each security;[59] (3) that a price increase in target company stock would increase the probabilities of success of the offer because it would encourage sales in the open market where the shares would be purchased by arbitrageurs buying with the expectation of tendering;[60] (4) that, in any event, the court's reasoning is at odds with that in another Second Circuit decision where it was stated, as to market

[52] 303 F. Supp. at 198.

[53] Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970).

[54] *See* SEC Rule 10b-6(a)(3), 17 C.F.R. § 240.10b-6(a)(3) (1972).

[55] 426 F.2d at 579 (dissenting opinion); *see* Lowenfels, *supra* note 5, at 1399.

[56] 426 F.2d at 577.

[57] In addition, all of the critics noted here ignore the fact that the court said only that purchases of target company stock *can* produce benefits for the offeror and, rather than asserting that its theory was correct to the exclusion of all others, seems to suggest that Bangor Punta's theory was not entitled to that consideration.

[58] Henry, *supra* note 5, at 476.

[59] Goolrick, *supra* note 5, at 463; O'Boyle, *Changing Tactics in Tender Offers*, 25 BUS. LAW. 863, 866 (1970).

[60] Henry, *supra* note 5, at 476; also adopted in SEC Securities Exchange Act Release No. 8712 (Oct. 8, 1969).

purchases by a competing offeror opposing an exchange offer, that it was "reasonable to conclude" that a resulting price rise would induce target company shareholders not to tender, but to retain what was apparently an increasingly valuable investment.[61]

Surely, no one of these theories is always correct and the others always wrong. More likely, all of these theories are correct at different times, with respect to different investors. This fact demonstrates the futility of attempting to fit the regulatory scheme of rule 10b-6 to purchases of target company stock by tender and exchange offerors. It will be recalled that rule 10b-6 was based on the "accepted premise that all market activities in a security by a person engaged in the distribution of a security of the same class are effected for the 'purpose of inducing' others to buy the distributed security."[62] Is there such an accepted premise about the purpose of purchases of target company stock by the offeror during a pending tender or exchange offer? The diversity of opinion as to the possible effects of Bangor Punta's purchases of target company stock and the resulting rise in market price demonstrates that the nature of these effects is speculative at best. Being speculative, there could certainly be no "accepted premise" that the purchases were actually intended by the offeror to produce any particular result.[63] Even more, although purchases by one engaged in an ordinary distribution are difficult to explain,[64] purchases of target company stock by an offeror are often prompted by the totally non-manipulative purpose of attempting to insure that the offeror obtains sufficient votes to carry a merger, or to defeat a merger proposed by the target's management with a third corporation.[65] On this basis, it seems clear that where purchases of target company stock are concerned, rule 10b-6 concepts of regulation are inapposite.

This is not to say that regulation in the area is unwarranted.[66] It was said in connection with the development of rule 10b-6 that "[t]he decision of a potential investor whether or not to purchase should be predicated on normal rather than exceptional circumstances."[67] This principle is equally applicable where a tender offer or exchange offer is made. The decision of the target company shareholder should be predicated on normal rather than exceptional circumstances. When the tender or exchange offeror goes outside the offer and makes, directly or indirectly, purchases of target company stock in the

[61] Goolrick, *supra* note 5, at 463; Henry, *supra* note 5, at 481, citing Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969).

[62] *See* Weiss & Leibowitz, *supra* note 30, at 477, quoted in text accompanying note 32 *supra.*

[63] Note that the word "manipulate" is defined in WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1376 (1965) as "to control, manage, or play upon by artful, unfair or insidious means . . . ."

[64] One limited exception to this, suggested by Foshay, *supra* note 29, at 933, is purchases for an employee stock purchase plan. Yet, the *Georgia-Pacific* and *Genesco* proceedings demonstrate that such purchases may, nonetheless, be a vehicle for manipulation.

[65] Often the management of the target company will seek a "defensive merger." *See* Schmultz & Kelly, *Cash Take-Over Bids—Defense Tactics,* 23 BUS. LAW. 115, 132-33 (1967).

[66] *But cf.* Lowenfels, *supra* note 5, at 1406, where it is stated that prohibition of target company purchases outside the exchange offer constitutes "an unnecessary encroachment upon the functionings of a free market . . . ." No commentator has spoken in favor of prohibition of such purchases, all choosing to criticize both the Second Circuit and the SEC.

[67] Foshay, *supra* note 29, at 928.

market, it creates exceptional circumstances by suggesting a demand for target company stock which is, in fact, artificial. And, according to the theories mentioned earlier,[68] a price rise in target company stock significantly influences public investor reaction to the offer.

In order to deal effectively with the problem, it must be analyzed in its proper perspective. First, since the market purchases by the offeror cannot, in fact, be presumed to be manipulative, as in the situations for which rule 10b-6 is designed, the Commission should no longer maintain the untenable position that rule 10b-13 represents in any way an application of that rule. It would be more plausible for the Commission to base the prohibition on its power under section 10(b) of the Exchange Act to regulate deceptive devices. This approach would avoid the necessity of demonstrating that the target company purchases were made with any particular public investor reaction in mind, which a claim of manipulation would require. The SEC's argument would be that despite a lack of specific intent to raise the market price of target company stock or to induce target company shareholders to act in any particular way, an artificial demand for target company stock is itself deceiving. Thus, the creation of such a demand by the offeror is a deceptive device in connection with the purchase or sale of a security.[69]

The strongest statutory basis for restriction of purchases of the target company stock lies, however, in section 14(e) of the Exchange Act, which served, in part, as the SEC's statutory basis for rule 10b-13.[70]

> It shall be unlawful for any person to make any untrue statement of a material fact . . . necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this sub-section, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.[71]

The language is quite broad in its scope and on the basis of the expressed statutory intent of the Williams Act[72] to provide the target company share-

[68] *See* notes 58-61 *supra*, and accompanying text.

[69] Note that in adopting § 13(e) of the Exchange Act, 15 U.S.C. § 78m(e) (1970), enacted in 1968 as part of the Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968), Congress recognized that target company repurchases of its shares during a pending tender or exchange offer may be deceiving. *See* HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, DISCLOSURE OF CORPORATE EQUITY OWNERSHIP, H.R. REP. NO. 1711, 90th Cong., 2d Sess. ¶ D, at 5 (1968). Rule 13e-1, adopted in SEC Securities Exchange Act Release No. 8370 (July 30, 1968), and amended in SEC Securities Exchange Act Releases Nos. 8392 (Aug. 30, 1968) and 8556 (Mar. 24, 1969), requires disclosure of the purchases; and proposed rule 13e-2, SEC Securities Exchange Act Release No. 8930 (July 13, 1970), would limit such purchases as to timing and amount in order to minimize their impact on the purchase price.

[70] Sections 13(e) and 23(a), 15 U.S.C. §§ 78m(e), 78w(a) (1970), also served as a basis for the rule.

[71] 15 U.S.C. § 78n(e) (1970).

[72] *Id.* The Williams Act was described in H.R. REP. NO. 1711, *supra* note 69, at 2, as an act which:

> [A]mends the Securities Exchange Act of 1934 by requiring the disclosure of pertinent information and would afford other protections to stockholders (1) when a person or group of persons seeks to acquire a substantial block

holder the opportunity of making an informed judgment whether he should accept the take-over offer[73] and the addition in 1970 of the final sentence of this subsection,[74] the Commission is afforded a broad basis for regulating market activities of tender and exchange offerors. In doing so, no sufficient reason appears why the Commission should have to rely on concepts of deception or manipulation that have developed in other contexts.[75]

## III. THE SEC'S POSITION: RELEASE NO. 9395

Returning now to the SEC's recently announced position regarding the activities of arbitrageurs, it is necessary to determine whether it furthers the goal of insuring the presence of "normal rather than exceptional circumstances"[76] on the basis of which the decision of the target company shareholder to tender or not to tender will be made.

The SEC's release states that it is permissible for an arbitrageur who has purchased securities in the open market to tender those securities to a tender offeror and receive a soliciting dealer's fee, providing payment of the fee is disclosed "in the context of the tender offer."[77] Narrowly reading the release, it is not clear whether one who is already acting as a soliciting dealer may make purchases of the target company stock which it will later tender, though a distinction on that basis would be difficult since, except in very unusual cases, the arbitrageur buys with a view to tendering the stock so purchased irrespective of when the soliciting dealer's agreement is signed.

In an exchange offer, an arbitrageur will simultaneously buy shares of the target company and sell short the securities of the offeror for which the target company's stock is exchangeable. Upon the expiration of the offer, he will exchange his shares of target company stock for the securities of the offeror and these will be used to cover his prior short sales. In a tender offer, the arbitrageur will buy target company shares in the open market and tender them for cash on the closing date, profiting by the price differential between his cost and the price specified by the tender offeror.[78]

Obviously, the arbitrageur adds a good deal of liquidity to the market for the stock of target company shareholders who may wish to sell their shares in

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> of equity securities of a corporation by a cash tender offer, alternately called a 'takeover bid,' or through open market or privately negotiated purchases, or (2) when a corporation repurchases its own equity securities.

[73] *See* H.R. Rep. No. 1711, *supra* note 69, ¶ A, at 2.

[74] Act of Dec. 22, 1970, Pub. L. No. 91-567, § 5, 84 Stat. 1497, *amending* 15 U.S.C. § 78n(e) (1970).

[75] *But cf.* the suggestion in Lowenfels, *supra* note 5, that rule 10b-13 is invalid unless some application of rule 10b-6 is possible.

Note that there is no intent to deal here with the question of whether a total ban on market purchases by offerors during the offer is a more desirable means of regulation than restrictions on such purchases like those set forth in proposed rule 13e-2, SEC Securities Exchange Act Release No. 8930 (July 13, 1970), as to target company repurchases.

[76] *See* note 67 *supra*, and accompanying text.

[77] SEC Securities Exchange Act Release No. 9395 (Nov. 24, 1971). The release sheds no light on the meaning of this phrase, but presumably all that would be required is a general statement in the offer itself that such fees would be paid.

[78] See an excellent treatment of this subject in Henry, *supra* note 5. *See also* N.Y. Times, Dec. 8, 1971, at 96, col. 3, which notes that the Commission's position in Release No. 9395 came as a surprise to the investment community.

the open market during the pendency of the offer.[79] As it is estimated that in tender and exchange offers over fifty per cent of all shares tendered come through tenders by arbitrageurs,[80] they are clearly a quite dominant force in these offers. Because both the target company shareholder and the arbitrageur appraise the value of target company stock with reference to the same economic facts, such as the cash tender price or the market value of the securities offered in exchange, the arbitrageur is in one sense simply another investor in the market place. But if the arbitrageur is allowed to receive a soliciting dealer's fee upon tender, he is thereby enabled to pay more than other potential investors would be willing to pay for the stock in the market. Indeed, as the SEC's release itself noted: "The anticipation of receipt of the soliciting dealer's fee may induce the arbitrageur to purchase the stock to be tendered at prices up to, and possibly even in excess of, the tender price."[81] The not unlikely rise in market price resulting from purchases by those anticipating receipt of the fee will be exactly what the court and the SEC attempted to deal with in the *Bangor Punta* case.[82] As in that case, the rise in market price of target company stock results from the operation of artificial market forces.[83]

The Commission suggests that requiring disclosure of payment of the fee will counteract the deceptive influence of these price rises. But if market price distortion exists, the only really helpful disclosure would be what the actual market price is, and that is effectively obscured. Two officials of the SEC's Division of Trading and Markets have stated with regard to the market price distortion caused by manipulation: "[T]he deleterious effects of the prohibited activities are impervious to disclosure."[84] The Commission itself in response to a suggestion that disclosure rules be substituted for a prohibition against manipulation has observed that "[a]ny proposal which would weaken the prohibition against manipulation in any aspect would deprive investors of the most important safeguard afforded them by the Act."[85]

By its terms, rule 10b-13 prohibits "arrangements to purchase" the security for which the tender or exchange offer is made. A literal reading of this language alone seems to prohibit payment of soliciting dealers' fees to dealers who tender shares that were purchased during the offer and in response to the proffered bonus for so doing.[86] In view of the fact that the net result of pay-

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[79] One reason for a sale in the market is suggested in the text accompanying note 60 *supra*.

[80] O'Boyle, *supra* note 59, at 866.

[81] SEC Securities Exchange Act Release No. 9385 n.1 (Nov. 24, 1971).

[82] Presumably, the most significant price effects would be exerted near the tender price and near the expiration date of the offer.

[83] See that portion of the release quoted in the text accompanying note 17 *supra*, where the Commission itself recognized the impact of a rise in market price on the success of a tender offer.

[84] Weiss & Leibowitz, *supra* note 30, at 477. Weiss and Leibowitz note that disclosure is called for in rule 10b-7 but point out that the strict limitations on trading imposed by that rule are what provide the actual protection.

[85] REPORT OF S.E.C. ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, 77TH CONG., 1ST SESS. 50 (H.R. Comm. Print 1941).

[86] *Cf.* SEC v. Scott Taylor & Co., 183 F. Supp. 904 (S.D.N.Y. 1959). Rule 10b-13 applies to a narrower class of persons than does rule 10b-6, and, thus, the arbitrageur could not be liable as a principal as was the broker-dealer in the *Scott Taylor* proceedings. But he might well be, as the SEC staff had suggested in the *MSL* matter, liable as an aider and

ment of the fee can be expected to be a market for the security which is structured under exceptional circumstances, the necessity for prohibition of payment of the fee is clear.[87] In 1934 Congress realized the necessity for outlawing "every . . . device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage."[88] Though its concern in that instance was with intentional price distortion, the ban should have equal force here.

But as indicated above, this is not an all-or-nothing proposition. Without getting into the question of whether, as a matter of fairness, the fee should ever be paid to a dealer owning the shares,[89] payment of the fee could still be permitted as to shares in the dealer's inventory prior to the time that rule 10b-13 is applicable.[90]

## IV. CONCLUSION

It seems clear that the problems associated with open market purchases by tender and exchange offerors outside their pending offers deserve further analysis. The Commission has attempted to deal with the problem as one of manipulation, but its position is unsupportable. The critics of the Commission's efforts to date seem to suggest that the market distortion caused by the offeror is not necessarily objectionable because it is not clear who will benefit from the deception. Yet because the market distortions caused by this market activity are deceiving to target company shareholders, regulation of this market activity under section 14(e) of the Exchange Act is appropriate, and no reliance on any previous interpretation or determination under rule 10b-6 is either necessary or appropriate. Because the payment of soliciting dealer's fees to arbitrageurs will be the likely source of the same kind of market price distortion which rule 10b-13 should preclude, such payments should not be permitted as to shares purchased in response to a tender or exchange offer, whether or not the soliciting dealer's agreement is signed before the purchases are actually made.

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abettor of rule 10b-13 violations by the offeror. *See* notes 38, 39 *supra*, and accompanying text.

[87] *See* text accompanying note 67 *supra*.

[88] SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 54 (1934).

[89] Both former SEC Chairman Cohen and General Counsel and now SEC Commissioner Loomis thought it was discriminatory that professionals should get the commission for shares they tender from their own accounts while private investors could not. *Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 199-209 (1967).

[90] The rule, by its terms, comes into play at the time the tender offer or exchange offer is publicly announced or otherwise made known by the person making the offer.