second. More importantly, the relationship of the first and second examples must be examined. The second is said to have evolved informally. It has no established grammar and vocabulary. It bears, however, a semblance of the end goal of the first type, when time and usage have allowed the first type to grow and develop with the least amount of control from the purist. The second type is what eventually the first type will be in the future when the languages have fused.

IV. Conclusion

The language provisions[67] of the 1987 Constitution read,

> The national language of the Philippines is Filipino. As it evolves, it shall be further developed and enriched on the basis of existing Philippine and other languages.
>
> Subject to provisions of law and as the Congress may deem appropriate, the Government shall take steps to initiate and sustain the use of Filipino as a medium of official communication and as language of instruction in the educational system.
>
> For purposes of communication and instruction, the official languages of the Philippines are Filipino and, until otherwise provided by law, English...

The ambiguity of the concept of Filipino under the present Constitution might have been avoided if the framers had only expressed the fact that they meant a Filipino with a nuclear basis on Pilipino. Although this intent was repeated throughout the proceedings, such was not manifested in the final draft of the Constitution. We can only surmise at what the reasons were. In any case, the crucial point has been established: Filipino with the "F" is the national language based on all existing native languages with a nucleus nesting on Tagalog or Pilipino with the "P". Hence, the observation of Edilberto Alegre is correct. Filipino with the "F" and Pilipino with the "P" are similar. This can also be the basis for the use of Pilipino as an official language and medium of instruction. But this will only hold as long as the multi-language based national language has not broken off from its Tagalog roots. If it does – in the meantime that all the obstacles preventing it from doing so are being removed under the liberal language policy – then the distinction can be rightfully made. But whether *it will* is another question.

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[67] PHILIPPINE CONST. art. XIV, secs. 6 and 7.

Disclosure of Preliminary Merger Negotiations: A Framework for Future Developments in the Philippine Capital Market*

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Introduction

In the 1980's the United States experienced an unprecedented wave of mergers and acquisitions. By 1985, the value of mergers and acquisitions had reached $125 billion, approximately four times the value of such transactions in 1979 ($34.2 billion) and nearly double the 1981 level ($67 billion).[1] Because of the rapid increase in merger activity, the importance of the disclosure requirements under Federal securities regulations was amplified. While the decisions of the various Federal Circuit Courts and the United States Supreme Court attempted to resolve the twin issues of the materiality of preliminary merger negotiations and the duty to disclose these negotiations, the results, as this paper will attempt to demonstrate, have been far from satisfactory.

Admittedly, Philippine corporate society has not reached the same level of sophistication as its American counterpart. The relevance, however, of disclosing preliminary merger negotiations may become more apparent as the decade progresses. With the increasing liber-

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[1] Noreen R. Weiss, Note, *Rule 10b-5 and the Corporation's Duty to Disclose Merger Negotiations: A Proposal for a Safe Harbor From the Storm of Uncertainty*, 55 FORDHAM L. REV 731, n. 1 (1987).

alization of our local markets, the expected inflow in foreign investments and increased foreign participation in the local economy may very well lead to a "merger frenzy" similar to that which the United States experienced. On the one hand, foreign firms may find that the quickest and most efficient way of establishing their presence in the local market is to merge with, or acquire, an established Philippine corporation. On the other hand, local firms may find that the best way to remain competitive in an increasingly saturated local market is to enter into mergers with, or to acquire, other local corporations in the same line of business or engaged in a complementary undertaking.

The objective of this paper is to analyze the different models of disclosure in the light of United States Federal securities laws, with the goal of determining what model will best suit the Philippine securities market.

I. DEFINITIONS AND LEGAL CONSIDERATIONS

A. Soft Information

The term "soft" or "future-oriented" information generally refers to three (3) types of information: (1) information that offers an explicit internal estimate of a corporation's future performance which, if disclosed, would provide the public investor with the estimates of specially knowledgeable experts, and thus relieve the investor of the need to rely solely upon his own inferences about the future from such underlying data as are publicly available; (2) information that offers estimates of the present value of illiquid assets which, if disclosed, would provide the public investor with specially knowledgeable expert inferences drawn from internal corporate information about the price to be received if the assets were sold, and thus relieve the investor of the need to rely solely upon his own inferences from available public information; and (3) information about merger negotiations in which a corporation is involved.[2] For the purposes of this paper the term "soft information" will refer solely to the third aspect.

[2] Victor Brudney, Note, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VIRGINIA L. REV. 723, n. 1 (1989).

B. Mergers and Preliminary Merger Negotiations

A merger has been defined as "the union whereby one or more existing corporations are absorbed by another corporation, which survives and continues the combined business."[3] "Preliminary merger negotiations" encompasses all overtures, communications, and discussions between the parties and/or their agents to a proposed corporate merger or other corporate stock acquisition.[4]

C. The Anti-Fraud Provisions of the United States Securities and Exchange Act of 1934

In the aftermath of the stock market crash of 1929, the United States Congress enacted two statutes designed to protect investors from the fraudulent practices which pervaded during the 1920's.[5] The Securities Act of 1933[6] had three objectives: (1) to provide investors with full disclosure of material information concerning initial public offerings of securities; (2) to protect investors against fraud; and (3) to promote ethical standards of honesty and fair dealing through the imposition of specified civil liabilities.[7] In order to protect investors regarding securities transactions occurring after initial offerings, the Securities and Exchange Act of 1934[8] was enacted. The 1934 Act regulates transactions on the securities exchanges and imposes reporting requirements on companies whose stock is listed on national exchanges and to protect the public by providing for full disclosure in securities transactions.[9] Thus, disclosure was required from all persons dealing in securities in order to create securities markets that operate with a sense of fairness and to give equal access to information among all investors.[10]

[3] JOSE C. CAMPOS, JR. & MARIA LOPEZ-CAMPOS, 2 THE CORPORATION CODE: COMMENTS, NOTES AND SELECTED CASES 441 (1990 ed.).

[4] T.A. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV 1218, 1221 n. 11 (1987).

[5] Comment, *The Basics of Disclosure: the Market for Information in the Market for Corporate Control*, 43 U. MIAMI L. REV. 1021, 1025 n. 25 (1989) [hereinafter *Basics of Disclosure*].

[6] 15 U.S.C. §§ 77a-77aa (1982).

[7] *Basics of Disclosure*, *supra* note 5, at 1025 n. 26.

[8] 15 U.S.C. §§ 78a-78lll (1982).

[9] *Basics of Disclosure*, *supra* note 5, at 1026.

[10] *Id.*

Under Section 10(b) of the 1934 Act:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange.
>
> x x x
>
> (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to this statutory provision, the United States Securities and Exchange Commission (the Commission) promulgated Rule 10b-5[11] in 1943, which provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

In the case of *Ernst & Ernst v. Hochfelder,*[12] the United States Supreme Court held that in order that an act may be considered to be in violation of both Section 10(b) and Rule 10b-5, it is necessary that the act should be committed with intent to deceive, manipulate, or defraud. According to the Court, since the Act uses the words "manipulate or deceive" in conjunction with "device or contrivance," the Act (and therefore

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[11] 17 C.F.R. § 240.10b-5 (1988).

[12] 425 U.S. 185 (1976).

the Rule) was intended to proscribe knowing or intentional misconduct.[13] Thus, before any discussion of what types of disclosure are required under Rule 10b-5, it must be remembered that without any intention to defraud or deceive, even false or misleading disclosures are not actionable nor will they result in the imposition of civil liability.

1. THE DUTY TO DISCLOSE

Under Rule 10b-5, there are three (3) duties imposed upon issuers, purchasers, or sellers of securities.[14] The first duty is the "duty not to mislead," which contemplates the giving of accurate and complete accounts whenever disclosure is required. This duty also encompasses the duty to correct prior statements which become inaccurate or materially misleading due to subsequent events. The second duty is the "duty to disclose or refrain from trading." This precludes anyone, including the company, from purchasing or selling a security while in possession of material, non-public information concerning the security. The third disclosure obligation arises where the corporation makes no representations but is under a duty to speak. The "affirmative duty to disclose" obligates the issuer to disclose to the public all available information which is material to investment in the issuer's securities. This affirmative duty may be found only if there is some special relationship between the parties which creates a duty to speak because silence, absent a duty to disclose, is not misleading under Rule 10b-5.

2. MATERIALITY

The duty to disclose is not without limits. Materiality of the facts is another standard used in determining whether the obligations imposed under the 1934 Act, as well as Rule 10b-5 have been violated. Mere failure to disclose does not necessarily place one in violation of the 1934 Act and Rule 10b-5 if the facts of which disclosure is being considered are not material.[15] The question of whether a particular fact must be disclosed under Rule 10b-5 requires the analysis of two (2) distinct issues: first, is there a duty to disclose the fact; and second, is the fact material.[16]

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[13] *Id.*

[14] Barbara J. Lano, *When Silence Is Not Golden: Disclosure of Preliminary Merger Negotiations By Closely-Held Corporations*, 38 DRAKE L. REV. 405, 408-9 (1988-89).

[15] Gabaldon, *supra* note 4, at 1240.

[16] *Basics of Disclosure, supra* note 5, at 1022 n. 4.

II. The Disclosure of Preliminary Merger Negotiations in the Context of Rule 10B-5

At present, the leading case regarding the duty to disclose preliminary merger negotiations is *Basic, Inc. v. Levinson.*[17] However, prior to *Basic,* there was a wide disparity among courts in the United States with regard to the event which would trigger the duty to disclose these negotiations, *i.e.*, whether preliminary merger negotiations are to be considered material information. In order to fully understand the ramifications of the *Basic* case, it would be instructive to delve into the various rules on disclosure prior to 1988.

A. *Rules of Disclosure Prior to* Basic, Inc. v. Levinson

Prior to 1988, the various federal courts in the United States had generally found merger negotiations to be immaterial at various preliminary stages.[18] The most prominent case of the pre-*Basic* era was the case of *Greenfield v. Heublein, Inc.*[19] In this case, the Third Circuit Court of Appeals held that preliminary merger negotiations, as a matter of law, are immaterial until an "agreement in principle" is reached,[20] and "agreement in principle" was understood to mean that stage in the merger negotiations where an agreement as to price and structure had been fundamentally agreed upon.[21] The considerations which led to this decision were: (1) negotiations were considered too speculative and premature disclosure might mislead investors into believing their outcome was more certain than it actually was; (2) premature disclosure might frustrate completion of a transaction because investor activity following disclosure might change circumstances so as to make completion of the transaction economically unfeasible; and (3) a corporation could be subject to liability for premature disclosure of contingencies which fail to come to fruition.[22] With regard to the duty to disclose arising only when agreement in both price and structure were reached, the Court offered: first, that

[17] 99 L. Ed. 2d 194 (1988).

[18] Gabaldon, *supra* note 4, at 1224.

[19] 742 F.2d 751 (3d Cir. 1984).

[20] *Id.* at 756-57.

[21] *Id.*

[22] Note, *The Basic Rules of Disclosure,* 62 ST. JOHN'S L. REV. 704, 709-10 [hereinafter *The Basic Rules*].

price and structure are two critical factors of any merger; second, that agreement as to price and structure provides concrete evidence of a "mature understanding between the negotiating corporations; third, that the price and structure rule provides a usable and definite measure for deciding the time for disclosure; and fourth, that once price and structure are agreed upon, there is minimal chance that disclosure will disrupt the transaction or mislead the investing public.[23]

It must be noted, however, that *Greenfield* involved the issuance of a no corporate development statement by Heublein, denying rumors of merger negotiations with the Reynolds Corporation which had resulted in an uncharacteristic rise in the trading of Heublein shares in the New York Stock Exchange. In effect, the Third Circuit ruled that since preliminary merger negotiations were immaterial until agreement in principle is reached, the statement of Heublein denying that merger negotiations were being held was not misleading because there was no omission of a material fact.[24] Logically, one would think that the case should have been decided against Heublein for violating its duty not to mislead. But since preliminary merger negotiations were held as immaterial, there was, according to the Third Circuit, no affirmative duty to disclose the information, and thus, no violation of the law.

Despite the categorical statement by the Third Circuit that preliminary merger negotiations were immaterial as a matter of law, the decision in the *Greenfield* case was criticized for failing to distinguish between cases involving false or misleading statements, and cases which involve mere silence on the part of the issuer.[25] The Commission, for one, argued that merger negotiations cannot be held as immaterial as a matter of law, rather the materiality of merger negotiations should be decided on a case-to-case basis.[26] It took the position that a "no corporate development" statement issued when there are ongoing merger negotiations is misleading; thus, while the SEC believed that there was no duty to disclose merger negotiations *per se*, once they become material

[23] *Greenfield,* 742 F 2d at 757.

[24] Anne L. Barragar, Comment, *Disclosure of Preliminary Merger Negotiations Under Rule 10b-5,* 62 WASH. L. REV. 81, 89 (1987).

[25] The Third Circuit based its decision in *Greenfield* on the earlier case of *Staffin v. Greenberg,* 672 F.2d 1196 (3d Cir. 1982). In the *Staffin* case, the issuer had made a tender offer for its own shares without disclosing that it was, at that time, considering a merger. (*see Id.* at 88 n. 48).

[26] *Id.* at 89.

to the shareholders and management chooses to make a statement (as in *Greenfield*), the negotiations should be disclosed.[27]

In addition, some commentators were of the belief that the Third Circuit had made no effort to determine whether there was a substantial likelihood that the reasonable investor would consider information regarding merger negotiations as important.[28] If one was to consider that the shareholders of the target corporation would naturally be interested in the possibility of a merger with another corporation in deciding whether they are going to sell their shares in the target or not (since the acquiring corporation usually offers a price above market value), clearly preliminary merger negotiations are material.[29] Finally, it was posited that the Third Circuit's statement that news of the merger negotiations would necessarily boost the market price of the shares of the target is a clear indication that preliminary negotiations are material.[30]

B. *The* Basic *Rule of Materiality*

The "agreement in principle" standard established in *Staffin* and *Greenfield* was ultimately rejected by the Unites States Supreme Court when it granted *certiorari* in the case of *Basic*. In this case, the plaintiff, Max Levinson, sold his shares in Basic Inc. following Basic's public announcement denying the corporation's involvement in any merger negotiations. When a subsequent merger between Basic Inc. and Combustion Engineering, Inc. was consummated, Levinson sued Basic Inc. alleging a violation of Rule 10b-5 for falsely responding to inquiries concerning the merger negotiations. The plaintiffs allegedly sustained a loss through sale of their Basic stock as a result of a market artificially depressed by Basic's public denial of merger negotiations. The Court of Appeals for the Sixth Circuit rejected the district court's ruling that merger negotiations were immaterial as a matter of law holding instead that negotiations, which may have been immaterial prior to any disclosure, are rendered material by virtue of a statement denying their existence.

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[27] *Id.* at 90.

[28] Gabaldon, *supra* note 4, at 1245.

[29] This criticism was based on the holding of the Supreme Court in the case of *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) which dealt with material misstatements in a proxy statement. According to the Supreme Court, materiality involved "the significance of an omitted or misrepresented fact to a reasonable investor." *Id.* at 445.

[30] Gabaldon, *supra* note 4, at 1246.

On appeal to the Supreme Court, Justice Blackmun, writing for the majority, expressly adopted the *TSC* materiality standard[31] used in evaluating proxy solicitation provisions under Section 14(a) of the 1934 Act. According to the Court, *preliminary merger negotiations are material and thus must be disclosed if there is "a substantial likelihood that a reasonable investor would consider the existence of such negotiations important in deciding how to invest."* [underscoring ours] The Court rejected the "bright-line" test based on the existence of an agreement in principle in determining the materiality of merger negotiations by using as a guiding principle the "fundamental purpose" of the various Securities Acts. According to the Court, the 1933 and 1934 Acts sought to substitute a philosophy of full disclosure for the philosophy of caveat emptor and achieve a high standard of business ethics in the securities industry; thus the materiality requirement is meant to filter out useless information that "a reasonable investor would not consider significant, even as part of a larger mix of factors to consider in making his investment."[32] In addition, the importance which both parties to the merger attached to secrecy was dismissed by the Court as "irrelevant to an assessment whether [merger negotiations] is significant to the trading decision of a reasonable investor."[33] Finally, while the Court conceded that the "bright-line" rule is easier to follow, ease of application should not be used as an excuse for ignoring the purpose of the 1933 and 1934 Acts.

Unfortunately, the *TSC* standard applied by the Court did not provide guidance as to whether and when a reasonable investor would consider preliminary merger negotiations significant in investment decisions. The *Basic* Court, however, tried to address this problem, recognizing that materiality will depend upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity, approving the balancing test adopted by the Second Circuit Court of Appeals in the case of *SEC v. Texas Gulf Sulphur Co.*[34] and its underlying policy as the appropriate test in deterring materiality of preliminary merger negotiations. The more probable a takeover or the greater its potential magnitude, the more likely it is that the information will have

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[31] *See* note 29.

[32] *Basic*, 99 L.Ed. 2d at 210.

[33] *Id.*

[34] 401 F. 2d 833 (2d Cir. 1968).

to be disclosed. The Court thus endorsed a case by case, fact-intensive materiality inquiry. The ruling of the Sixth Circuit that otherwise immaterial factors become material upon issuing a statement denying their existence was rejected by the Court. The Court remanded the case to the Sixth Circuit for a ruling on when the merger discussions became material in this particular case.[35]

C. *The* Basic *Aftermath*

While the *Basic* case purported to resolve the question of when preliminary merger negotiations become material, it merely confronted only one facet of the duty to disclose, i.e., the materiality issue,[36] without determining exactly when this duty must be performed. Arguably, *Basic* should be considered in the narrow light of the duty not to mislead. In fact, the Court refused to consider the question of when the duty to disclose arises.[37] As for the affirmative duty to disclose preliminary merger negotiations, there is still no consensus on whether this should be imposed or not. On the one hand, there are those who believe that it should be left to the business judgment of the target company's board of directors,[38] and generally courts have limited the scope of the affirmative duty to instances when insider trading occurs, the corporation engages in self-dealing, or when the company is the source of leaks or rumors pertaining to merger negotiations.[39] On the other hand, there are those who believe that to leave the final decision on whether to disclose or not to corporate management would necessarily be prejudicial to the shareholders as well as to investors in general.[40] They point out that the management of a target corporation usually has a vested interest in the negotiations, especially with regard to the possibility of their retention as part of management after the merger or, if not, negotiating a generous severance package ("the golden parachute").[41]

[35] *Basic*, 99 L. Ed. 2d at 215.

[36] *The Basic Rules*, *supra* note 22, at 714.

[37] *Basic*, 99 L. Ed. 2d at 211.

[38] *The Basic Rules*, *supra* note 22, at 714 n. 55.

[39] Weiss, *supra* note 1, at 737-38. It would seem that these are cases applying the duty not to mislead and the duty to disclose or refrain from trading.

[40] Gabaldon, *supra* note 4, at 1281.

[41] *Id.*

Also, the standard used by *Basic* is not highly favored by corporate managers. Under this fact-based materiality test, corporate managers will not know how to act. They are left without a clear guideline as to when preliminary merger negotiations must be disclosed and are left in the dark to determine the potential for possible civil and criminal liability consequences of their acts. This situation creates a disincentive for corporations and/or corporate managers to enter into merger negotiations or to entertain merger proposals. The *Basic* Court suggested, in the magnitude component of the test, that managers should consider the size of the merging corporate entities and the potential stock price premium. Regarding the size of the corporate entity, there are numerous factors which may be considered in determining this. For instance, the measurement can be based on the number of employees, the number of shareholders, the amount of gross earnings, or the value of corporate assets. In the same vein, the measurement of potential takeover premium can be determined either on the basis of the dollar amount of price fluctuation from the pre-disclosure price or the percent ratio of change in original stock price after the disclosure. And since the basis of any possible merger is offering a price per share at an attractive premium over market price, any merger offer would be material.[42]

In the end, *Basic* created more questions than answers regarding disclosure requirements for preliminary merger negotiations. While ease of application may not be a primary concern of the Securities Acts, the uncertainty faced by managers would ultimately affect the shareholders and investors as well since management is the easiest and cheapest source of information on corporate matters.[43]

More ominously, the *Basic* standard does not prevent the flourishing of insider trading. The case-to-case determination leaves insiders time to act on their non-public information as the Commission will not have the benefit of bright-line enforcement guidelines. Corporate managers can easily say that their pre-disclosure trading activities cannot automatically be considered as insider trading as each case is different from the other.[44]

[42] *Basics of Disclosure*, supra note 5, at 1047.

[43] Gabaldon, *supra* note 4, at 1237.

[44] *Basics of Disclosure*, supra note 5, at 1050.

Finally, the failure to impose any semblance of an affirmative duty on corporate managers to disclose preliminary merger negotiations prior to agreement in principle necessarily results in the absence, theoretically, of such a duty even after an agreement principle has been reached for as long as the facts are not considered by corporate managers as such that would require disclosure. Since the act of disclosing is generally left to the business judgment of the directors, even if there is bad faith or fraudulent intent on their part, the burden would still be upon the investor to overturn the presumption of good faith which is the corollary of the business judgment rule. Thus, the very purposes of the Securities Acts cited by the *Basic* Court as justifying the rejection of the agreement in principle test could be subverted by the failure of the Court to impose clear standards as to when a duty to disclose preliminary merger negotiations must be complied with.

III. THE PHILIPPINE CONTEXT

A. The Revised Securities Act[45]

The Philippines' securities laws have been transplanted directly from the United States. The provisions of the Revised Securities Act regarding fraudulent transactions[46] as well as on manipulative and deceptive devices[47] have been copied practically verbatim from those of the United States. Thus, the law provides:

> Sec. 27. Manipulative and deceptive devices. – It shall be unlawful for any person, directly or indirectly by the use of any facility of any exchange
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale of any security registered on a securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> (b) To use or employ, in connection with the purchase or sale of any security, any manipulative or deceptive device or contrivance.
>
> x x x

[45] B.P. Blg. 178 (1982).

[46] Id. at § 29.

[47] Id. at § 27.

> Sec. 29. Fraudulent transactions.—(a) It shall be unlawful for any person, directly or indirectly, in connection with the purchase or sale of any securities—
>
> (1) To employ any device, scheme, or artifice to defraud, or
>
> (2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, transaction, practice, or course of business which operate as a fraud or deceit upon any person.
>
> x x x

B. S.E.C. Disclosure Regulations

Pursuant to the regulatory powers granted to it by the Revised Securities Act, the Securities and Exchange Commission (the SEC) has promulgated rules on what matters must be disclosed by corporations whose securities are listed in any stock exchange or registered/licensed under the Revised Securities Act.[48] According to the Regulation:

> 1. To Disclose Every Material Fact. – Every corporation whose securities are listed and traded in any stock exchange in the Philippines or registered/licensed under the Securities Act, shall make a reasonably full, fair and accurate disclosure of every material fact relating to or affecting it which is of interest to investors. A fact is material if it induce or otherwise affect (sic) the sale or purchase of its securities, and shall include the following:
>
> x x x
>
> e. Executing contract of merger, consolidation, or joint venture
>
> x x x
>
> k. Any other important event or happening.

As one may note from reading the provisions of the rule promulgated by the SEC, there is no disclosure requirement for preliminary merger negotiations. The rule explicitly used the word "executing,"

[48] Approved on February 8, 1973.

which necessarily contemplates that an agreement has actually been reached. According to Mr. Salvador Marquez, the former Chief of the Brokers & Exchange Department of the Securities Exchange Commission, disclosure is necessary only when the merger has been finalized. He added that this was viewed as a necessary precaution against the use of disclosures of preliminary merger negotiations which may be undertaken as a means to have the price of shares increased, *i.e.*, as a manipulative device camouflaged by alleged compliance with disclosure requirements.

It is interesting to note that the definition of what is considered as material contained in the Regulation is similar to that which underlies the standard of materiality adopted by the U.S. Supreme Court in *Basic*. However, unlike in the United States, the Regulation specifies an event which would require the corporation concerned to comply with the disclosure requirements contained in the Regulation – the execution of the merger agreement.

C. *Recommendations*

Although it may be said that the discussion on the disclosure of preliminary merger negotiations is not appropriate in the Philippine setting because the SEC regulation requires disclosure only when the agreement to merge has been finalized, it would still be advisable to determine the disclosure model for preliminary merger negotiations appropriate for this country. Should the Philippine capital market reach the level of activity reached by its American counterpart, it would be necessary to safeguard the rights of investors without experiencing the confusion undergone by the American corporate world, which it is still experiencing at present, in determining the model which best suits what is required under Section 10 of the 1934 Act and Rule 10b-5 — and by analogy Philippine securities regulations.

The ideal disclosure model should have the following characteristics: (1) addresses several concerns; (2) provides a clear definition of materiality that can be easily followed by corporate managers; (3) ensures equal access to information among all investors; (4) limits the time that insiders and market professionals can benefit from their non-disclosed information and thereby eliminate the prevalence of insider trading; and (5) promote investor confidence by the fair and efficient operation of the securities markets[49]

[49] *Basics of Disclosure, supra* note 5, at 1024.

In order to determine the ideal model for the Philippine capital market, it is necessary to first assess the merits of the different disclosure models proposed by commentators in the United States. The first disclosure model originally considered by many Unites States court is the agreement-in-principle model. Under this theory, preliminary merger negotiations were considered to be immaterial as a matter of law until there was "an agreement in principle encompassing fundamental terms," that is, until the price and structure of the transaction had been determined.[50] This is the disclosure model which the SEC advocates at present, but seems to overly favor corporate managers. Under this model, they are given a clear guideline as to when they have to comply with the duty to disclose and thereby easily determine the consequences of their action.

Given, however, that the fundamental purpose of any disclosure requirement is the protection of the investing public, the SEC would be remiss if it were to adhere to its current rule – which is based on the "agreement in principle" doctrine. The "agreement in principle" rule, as stated earlier, does not consider that equal access to all material information is what would best protect investors from fraudulent or manipulative practices. Even prior to any agreement in principle being reached, merger negotiations may be considered as important by the "reasonable investor," especially the shareholders of the target corporation. Late disclosure of the merger would, in all probability, prejudice those investors who sold their shares in the target without the benefit of the "total mix" of information available.

The *Basic* doctrine, while addressing the issue that preliminary merger negotiations cannot be considered immaterial as a matter of law even prior to an agreement in principle, has not settled the issue of precisely when these negotiations should be disclosed. Because of this void left by the *Basic* theory, insiders are still given the opportunity to benefit from the non-public information they possess. Insider trading, therefore, is not effectively deterred even if this disclosure model is more consistent with the intent of safeguarding investor's interest. Another factor against the *Basic* disclosure model is the possibility that the investors will be flooded with irrelevant information. Uncertainty regarding when negotiations should be disclosed may lead corporate managers to disclose all information within their knowledge, in order

[50] *Id.* at 1053.

to protect themselves from possible civil and criminal liability, although the information thus released may not necessarily be material. The absence of a bright-line rule thus renders ineffective any attempt to protect investors from fraudulent practices by desensitizing them from material information due to the possible flood of any and all information which corporate managers may deem ripe for disclosure – regardless of whether they are in fact material or not.

Another disclosure model suggested by the Basic court, is the "no comment" policy. The *Basic* Court stated that:

> [a] steadfast 'no comment' policy regarding merger talks might be considered an acceptable response to inquiries in certain cases. Silence, absent a duty to disclose, is not misleading under Rule 10b-5. 'No comment' statements are generally the functional equivalent of silence.[51] [emphasis ours]

However, the Court did not specify when there would be a duty to disclose thus rendering this type of disclosure subject to the ultimate discretion of corporate management. Furthermore, this type of disclosure would leave the investors without the necessary information for them to make intelligent investment moves. Corporate managers, as well as professionals are left with more time to make use of information not disclosed. This would conflict with the duty not to mislead for it would allow corporate managers to refuse to provide information which may otherwise be material. What should be kept in mind is that the disclosure requirement is for the protection of investors and should not be tailored for the convenience of corporate managers.

The last model proposed by American commentators is one where disclosure is necessary only upon the occurrence of certain events common to all takeovers. This theory requires disclosure in the event of the concurrence of any two elements in merger negotiations. These events include: (1) board resolutions; (2) instructions to investment bankers; (3) actual negotiations between principals or their intermediaries; (4) retention of counsel for the purpose of the proposed merger; (5) arrangements for financing; (6) the signing of a confidentiality agreement; and (7) the sharing of confidential information or projec-

[51] *Id.* at 1066.

tions. Commentators are of the opinion that the occurrence of any two of the above elements creates a rebuttable presumption that negotiations have become material due to the greater possibility that the merger will be entered into.[52]

This disclosure model sets a middle ground between late and early disclosure models. Under this model, the benefits of both the late and early disclosure model are combined. On the one hand, corporate managers are provided with a bright line rule to aid them in their actions. On the other hand, investors are not left in the dark to determine whether they should sell or buy. Due to the difficulties encountered in determining precisely when disclosure is required, this model balances the interests of both corporate managers and investors. By setting precise standards to determine both materiality and the duty to disclose, it affords management adequate guidelines to be kept in mind when entering any merger negotiations. By creating a presumption of materiality, it protects investors by removing the possibility of corporate managers hiding behind the business judgment rule – either they disclose when any of the two factors occur or they do not – and shareholders are given the benefit of a clear guideline of when to demand compliance with the disclosure duty. Further, this would facilitate administrative control and oversight by the SEC, thereby making enforcement of disclosure guidelines less difficult.

It is the belief of the authors that this last model should be adopted as part of our securities regulations. The possibility of increased merger activity in the near- to medium-term makes it imperative that the SEC adopt disclosure rules which will address the concerns of both corporate managers and investors. Since the Philippines is not a common law jurisdiction, we do not have the luxury of relying on judicial pronouncements of when and how disclosure should be made. There is a need for definite administrative regulations which will clearly set forth the duty to disclose preliminary merger negotiations. An added factor is that the local securities exchange oftentimes trades on the basis of rumor and insider information. Setting forth clear disclosure rules would reduce these practices and level the playing field for all investors.

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[52] *Id.* at 1077.

IV. CONCLUSION

In the final analysis, the authors would like to stress the importance of the timing of disclosure. Not only must corporate managers disclose material facts, they must also disclose these within the time necessary. This is essential in order to deter insider trading and to aid investors in their competition with market professionals for stock premiums. The underlying philosophy of our securities is to prevent unscrupulous issuers, purchasers, or sellers from competing in the market with an undue advantage – in other words, to level the securities playing field. Only by establishing clear and adequate disclosure guidelines, not only with respect to preliminary merger negotiations, but for all levels of corporate activity, will this goal be achieved.

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