Shadow Financial Regulatory Committee
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Statement of the

Shadow Financial Regulatory Committee

on

The Federal Reserve Ruling on Junk Bonds

February 14, 1987

In the view of the Shadow Financial Regulatory Committee, the interpretive ruling issued by the Federal Reserve Board on January 10, 1986, dealing with financing takeovers through debt issued by shell corporations was not justified in empirical, theoretical or legal terms.

On an empirical and theoretical level, the Fed made no case to justify the proposition that current leverage ratios should be a matter for concern. The risk of a business enterprise is determined by the nature of its assets and activities; that risk is then distributed among debt and equity holders in proportion to the size and priority of their claims. The Fed made no effort at all to demonstrate that the present structure should be a matter of especial concern at this time.

Legally, the Fed made use of a source of regulatory authority -- its control over margin requirements in the trading markets -- to reach an end only tangentially related to its statutory power. Indeed, the Fed has itself suggested that very statutory power serves no necessary or essential purpose and should be repealed. Its use in this context suggests an attempt to serve an entirely different objective: a politically expedient response to Congressional pressures generated by the desire of the management of large corporations to be protected from the possibility of takeover by the management of smaller corporations. This limitation upon the operation of the market for corporate control is not justified by any evidence or reasoned discussion offered by the Fed in issuing its ruling.

The shortcomings of the justifications for the Fed's action were no doubt exacerbated by its refusal to follow the procedures of the Administrative Procedure Act for notice and adequate opportunity for public comment on regulations. Had the Fed not chosen to follow the shortcut procedure for an interpretive rule, its action might have been better considered.

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FOR IMMEDIATE RELEASE

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Federal Reserve junk bond ruling questioned

"...not justified in empirical, theoretical or legal terms," concluded the new Shadow Financial Regulatory Committee (SFRC) in a policy statement concerning the recent intepretive ruling issued by the Federal Reserve Board on the financing of takeovers through debt issued by shell corporations.

SFRC is a market oriented group of leading economists and former regulators that monitors regulation of the financial services industry. "This limitation upon the operation of the market for corporate control is not justified by any evidence or reasoned discussion offered by the Fed in issuing its ruling," charged the group.

"Legally, the Fed made use of a source of regulatory authority--its control over margin requirements in the trading markets--to reach an end only tangentially related to its statutory power," said the policy statement. So why the ruling? "...a politically expedient response to congressional pressures generated by the desire of the management of large corporations to be protected from the possibility of takeover by the management of smaller corporations," suggested the committee.

Attachment: SFRC policy statement

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