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and should be repealed.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.
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 interpretive 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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