

## Statement No. 3

# The Federal Reserve Ruling on Junk Bonds

February 14, 1986

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 special 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the Fed has itself suggested that that very statutory power serves no necessary or essential purpose and should be repealed.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 managements of large corporations to be protected from the possibility of takeover by the managements of smaller corporations. This limitation upon the operation of the market for corporate control is not justified by any evidence of 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.