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FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

OFFICE OF
THE CHAIRMAN

December 23, 1985

William W. Wiles
Secretary
Board of Governors of the Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Mr. Wiles:

This letter is in reponse to the Federal Reserve Board's request for public comments on the Board's proposed interpretation of Regulation G under which the purchase of debt securities used to finance takeovers would be subject to the Regulation's margin requirements.

The Federal Reserve Board's margin rule, Regulation G, limits the amount of credit investors may use to finance purchases of stock and convertible bonds. The rule currently prohibits purchasers from financing more than 50 percent of a stock purchase with loans secured by that stock. In a proposed interpretation of Regulation G scheduled to take effect December 31, the Board has ruled that debt securities issued by corporations set up to facilitate tender offers are indirectly secured by the stock to be acquired and thus subject to the margin rules. This interpretation would, in effect, prohibit a corporation set up to facilitate a tender offer from using such takeover bonds to finance more than 50 percent of the cost of an acquisition.

As Acting Chairman of the Federal Trade Commission, I asked the Commission's staff to evaluate the proposed interpretation and to prepare detailed comments to be submitted pursuant to authorization by the full Commission. Unfortunately, in the short time allowed for the preparation of comments, the Commission's staff was unable to reach any final conclusions as to its merits. However, they do believe that the harm resulting from the proposed interpretation of Regulation G could be substantial because of its potential to disrupt the efficient functioning of the market for corporate control. On the other hand, they cannot discern any obvious benefits from implementing the proposed interpretation. Staff's analysis of these issues is presented below. Because I concur in this analysis, I personally urge the Board to delay implementation of the proposed interpretation of Regulation G in order to provide the Commission and other interested parties with a more complete opportunity to comment on it.

The Federal Trade Commission Staff's Analysis of the Proposed Interpretation of Regulation G

As understood by the Commission's staff, the purpose of margin requirements is not to protect borrowers against imprudently taking on too much debt. Rather, they are imposed to protect lenders, primarily banks and other financial institutions, against the risk of customer default. Even in the latter case, however, the concern about lender solvency does not so much reflect a governmental interest in the financial welfare of individual lenders as the public interest in the solvency of the overall U.S. financial system and the threat to it posed by large-scale bank failures.

In the case of corporate debt, however, there would appear to be no similar basis for concern about the magnitude of the default risk assumed by an individual lender. In the first place, investors in high yield takeover bonds are typically highly sophisticated financiers who hold these securities as part of a well-diversified portfolio and who are fully able to negotiate for a compensatory interest rate and whatever other protection is necessary and appropriate to protect them against the risk of default associated with the debt of a highly leveraged firm. More importantly, the fear that has traditionally prompted the concern about lenders' risk exposure -- that widespread default might threaten the viability of financial markets generally -- is altogether absent in the takeover bond situation. Not only is the amount of such financing extremely small, only about 4 percent of the increase in total business debt in 1984 and less than 1 percent of total outstanding business debt, but the risk of default falls entirely on individual investors.

If, on the other hand, the proposed interpretation actually is designed to protect individual borrower firms against imprudently assuming too much default risk as a consequence of "excessive" leverage, it not only appears to be an unprecedented departure from the traditional focus of margin requirements — the maintenance of lender solvency -- but, in staff's opinion, an ill-conceived departure at that. The underlying presumption is that individual firms must be protected from the possibility that they may rely too heavily on debt, rather than new equity, in financing acquisitions. But there is no such thing as a theoretically correct debt-equity ratio, applicable to all firms under all circumstances.[1] Firms issue debt when they have profitable investment opportunities and when debt represents the cheapest, most efficient, means of raising the necessary capital. Debt-equity ratios vary over time, across industries, and among companies within an industry. The best judge of the amount of debt that a given company should be permitted to take on at any point in time is the credit market. The proposed interpretation would substitute the judgement of the Board for that of borrowers and lenders as to the proper amount of credit that should be allocated to individual firms for takeover purposes. But there is no evidence that such governmental interference with credit markets is warranted.

Takeover bond financing of acquisitions does substitute debt for equity. But there is no reason to believe that this increase in debt is contrary to the interests of the shareholders of the issuing firm or to the firm's long or short-term prospects. If it turns out that a firm has, in fact, over-leveraged itself, there is nothing to prevent it from issuing new equity and using the proceeds to retire some of the outstanding debt. There is no evidence that bankruptcies are a likely result of firms increasing their leverage to finance acquisition programs. And in any event, the bankruptcy of an otherwise viable firm as a consequence of its inability to service all of its debt is not a catastrophic event requiring the firm to cease, or even suspend, operations. To the contrary, it is in the interest of everyone concerned, including the debtholders, that the firm continue normal operations while the financial claims are restructured. The specter of corporations being forced to shut down, en masse, during an economic downturn solely because they elected to use

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1 The choice of the optimal amount of debt versus equity financing is a complex problem influenced by many factors. The tax deductibility of interest payments may be the single most significant incentive to the use of debt financing, although it clearly is not the only consideration. In general, see, Jensen, M.C. and Meckling, W.H., "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," 3 Journal of Financial Economics 305 (1976).

too much debt and too little equity in financing their operations has no basis in reality. If this is the only problem, reorganization, requiring no cessation of operations, will solve the problem. Actual bankruptcies are much more likely to be due to operational inefficiency which, ironically, implementation of the proposed interpretation encourages.

Adverse Impact on the Market for Corporate Control

By restricting the financing options of bidders, the proposed interpretation could have a significantly adverse impact on beneficial takeover activity. Corporate acquisitions, including those resulting from hostile tender offers, have the potential to shift assets to higher-value uses, allow firms to realize economies of scale and distribution, and spur managerial excellence. These benefits are reflected in the value of the shares of the companies that are parties to mergers and acquisitions. For example, target firm shareholders on average earn premiums of about 30 percent in tender offers and 20 percent in mergers.[2] Thus an open and competitive market for the control of corporate assets benefits shareholders and can help promote the most productive employment of national resources.

Hostile tender offers, which the proposed interpretation might significantly deter, may well be the class of acquisitions that result in the greatest gains to the economy. Many large American companies are economically mature: their traditional markets have stopped growing or are shrinking. These companies

2 In contrast, share values tend to decline following an unsuccessful tender offer. For a thorough survey of the numerous studies that demonstrate net shareholder benefit from takeover activity, see Jensen & Ruback, "The Market for Corporate Control: The Scientific Evidence," 11 Journal of Financial Economics 5 (1983) and Jensen, "Takeovers: Folklore and Science," 62 Harvard Business Review 109 (1984).

often generate more cash flow than can be reinvested productively in their traditional businesses. But rather than distribute this cash to shareholders as dividends, it appears that corporate executives sometimes continue to make unprofitable investments in mature markets or diversify into new businesses with which they are unfamiliar and in which they perform poorly.[3] This creates profit opportunities that can be realized by means of hostile takeovers aimed at acquiring control of such firms and eliminating these inefficiencies.[4]

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3 The shift toward greater reliance on debt financing may well be a market response to this phenomenon. Unlike common stock, the dividends on which can be withheld at management's discretion, debt calls for regular periodic interest payments. This reduces management's discretion with regard to use of the firm's cash flow and constrains its ability to continue to use retained earnings to pursue unprofitable growth or diversification strategies. Moreover, increased reliance on debt financing may result in the firm's stock ownership being concentrated in the hands of fewer individuals, each with a significant economic interest in how the firm is managed. This may lead to the more general resolution of the problems traditionally associated with the so-called "separation of ownership and control." Thus, independent of the utility of takeover bonds as a means of financing acquisitions, these considerations portend real and significant efficiency gains from the increased use of debt financing, in and of itself.

4 Socially inefficient corporate diversification may be due more to tax incentives created by the double taxation of cash dividends than to managerial incompetence or self-dealing. We express no opinion as to their relative contributions. But to the extent that tax policy is to blame, the Board's proposed interpretation of its margin requirement will obviously do nothing to remedy the problem. Nor is the threat of a takeover a deterrent to tax motivated corporate diversification. Because it represents a rational private response to tax incentives, no matter how socially perverse, it benefits the firm's shareholders and thus creates no profit-opportunities for a tender-offeror. On the other hand, diversification motivated by managerial inefficiency is detrimental to shareholders and hostile takeovers represent a market mechanism for eliminating this inefficiency. Thus, the proposed interpretation may have the counter-productive effect of eliminating an effective constraint on inefficient diversification.

The use of takeover bonds has made large companies, previously protected by their size, much more vulnerable to takeovers. Prior to the advent of takeover bonds, only other large companies could raise the cash necessary for a takeover. Takeover bonds enable small firms and individual investor groups to participate in the bidding. The proposed interpretation would tilt the balance of power in favor of embattled target managements, deny shareholders the economic benefits derived from the ability to sell their shares to the highest bidder, and hamper the market forces that lead to the replacement of poor managements and the breaking up of inefficiently large or diversified companies.

Conclusion

Because the Federal Trade Commission staff has been unable to identify any obvious benefits that would result from implementation of the proposed interpretation of Regulation G, and because the proposed interpretation may have a substantial adverse impact on the market for corporate control, I urge the Board to delay its implementation long enough to allow the Commission and other parties a more complete opportunity to provide the Board with detailed comments.

Sincerely,

Terry Calvani

Terry Calvani
Acting Chairman