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U.S. Department of Justice

Antitrust Division

Office of the Assistant Attorney General *Washington, D.C. 20530*

January 7, 1986

Mr. Michael Bradfield
Federal Reserve System
Marriner S. Eccles Federal Reserve
Board Building
Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Mr. Bradfield:

On behalf of the Treasury and Justice Departments, I want to thank you for providing our staffs with the opportunity to inspect your proposed final "interpretation" of Regulation G relating to Purchase of Debt Securities to Finance Corporate Takeovers. As you know, we had only a limited opportunity to read the 54-page proposed document in your offices and were not provided with a copy to review more fully. We also understand the draft we reviewed was subject to additional revisions. Our views, therefore, as summarized below are necessarily preliminary, and we expect to make a more thorough assessment of the proposal after it is made available to us.

In general, while we find the revised "interpretation" to be less objectionable than the proposal issued on December 6, we continue to believe that it is unwarranted and unwise and that it appears to be a legislative, rather than an interpretative, rule. You have addressed several of the adverse comments submitted in response to the original proposal.

First, the limitation of the "interpretation" to certain specific fact situations appears to limit the scope of the original proposal and to reduce its ambiguity. Second, the revised "interpretation" will not reverse years of precedent holding that public offerings are not covered by Regulation G. Third, the revised "interpretation" makes clear that it will not change the current application of Regulation G to credit-financed acquisitions by operating companies, even when their assets, income, or net worth are considerably less than the amount of credit raised to finance the acquisition.

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Finally, we note that, by excluding circumstances where there is a merger agreement or where there is a short form statutory merger, you have limited the application of Regulation G to credit-financed acquisitions by shell corporations; however, we are concerned that this revision further illustrates the underlying bias of the "interpretation" against hostile takeovers.

While you have addressed some of our concerns with your original proposal, we cannot support the proposed "interpretation", even as redrafted. First, we continue to believe that there is simply no need for regulation in this area. Indeed, nowhere in the 54 pages of the proposed document that we read does the Board identify the benefits of the "interpretation" or explain its consistency with the congressional purposes underlying Section 7 of the Securities and Exchange Act of 1934.

Second, we are concerned with certain ambiguities that remain in the Board's proposal. In the "interpretation", the statement is made that a shell corporation is one that has "virtually no assets", while an operating corporation is described as a firm with "substantial non-margin assets." There is a significant middle ground between these two definitions, and it is unclear precisely where the margin requirements would and would not apply.

Our quick review of the draft also identified several portions of the "interpretation" relating to shell company debt that are very troubling. Much of the proposed document's commentary is based on the premise that lenders rely on margin stock to secure debt issued by a shell because there may be a significant delay between the time the debt is issued and the time the target is actually acquired. This premise, however, appears to be based on but a single recent transaction. The substantial cost resulting from the "interpretation's" disruption of the market for corporate control cannot be justified by the mere possibility that in a small percentage of the cases to which the "interpretation" will apply there might be a significant delay once the lenders are at risk.

I again stress my concern that our evaluation is necessarily preliminary because of the limited time and restricted access available to us for review of the revised

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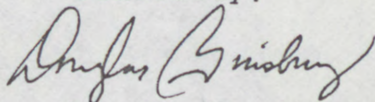
"interpretation." We, therefore, intend to conduct a more comprehensive review when the revised proposal is made available to us and to the federal agencies that were not afforded an opportunity to inspect this revision.

Sincerely,



Douglas H. Ginsburg
Assistant Attorney General

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

1. Rebalance –

2. Procedure

Effective date

Clearer than before

Can other questions arise?

Yes

Create – further Board interpretation

Commitment terms

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TO: Board of Governors

FROM: Legal Division
Division of Supervision and Regulation

DATE: January 7, 1985

SUBJECT: Final interpretation concerning application of Regulation G to certain debt securities issued to finance corporate takeovers

Attached for consideration by the Board is a draft Federal Register Notice concerning the interpretation of Regulation G proposed for public comment on December 6. The draft explains the proposed rule in detail, including an analysis of its scope of coverage. Based on the public comments, a number of changes have been proposed in the draft Notice, which are explained in the Notice.

The draft also contains a full exposition of the public comments and an analysis of these comments. Finally, the draft reviews the issue of whether the Board may adopt the proposed interpretative rule without following informal rulemaking procedures, as well as the applicability of the proposed interpretative rule to existing financing arrangements.

For the reasons that are carefully developed in the draft Notice, the staff recommends that the Board adopt the interpretative rule.

Attachments

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DRAFT

FEDERAL RESERVE SYSTEM

12 C.F.R. Part 207

[Regulation G; Docket No. R-0562]

Securities Credit by Persons Other Than
Banks, Brokers, or Dealers; Purchase of
Debt Securities To Finance Corporate Takeovers

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final interpretative rule.

SUMMARY: In response to questions directed to the Board concerning the applicability of the margin requirements in Regulation G to debt securities issued to finance the acquisition of the margin stock of a target company in a corporate takeover attempt, the Board has issued a final interpretative rule interpreting the term "indirectly secured" in the margin rules to apply to a limited class of transactions used to finance corporate takeovers. Because the debt securities at issue clearly involve "purpose credit" and are purchased by persons who may become "lenders" as defined in Regulation G and typically are not directly secured by margin stock, the margin requirements apply if the debt securities are "indirectly secured" by margin stock.

The interpretation provides that the Board is of the view that debt securities issued by a shell corporation to finance the acquisition of the margin stock of a target company

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are presumed to be indirectly secured by the margin stock for purposes of the restrictions on lending in the margin regulations. Such a shell would have virtually no business operations, no significant business function other than to acquire and hold the shares of the target company, and substantially no assets or cash flow to support the credit other than the margin stock that it has acquired or intends to acquire.

The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow. This presumption would also not apply if there is a merger agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities or in any event before the loan funds are advanced. In addition, the presumption would not apply if the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without the approval of either the shareholders or directors of the target company. Finally, the interpretation also provides

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that the Board does not presume debt securities, issued by an operating company with substantial assets or cash flow to finance the acquisition of margin stock of a target company, are indirectly secured by margin stock and thus subject to the restrictions on margin lending in Regulation G.

EFFECTIVE DATE: Immediately.

FOR FURTHER INFORMATION CONTACT: Laura Homer, Securities Credit Officer, Division of Banking Supervision and Regulation, (202) 452-2781; or James Michaels, Attorney, Legal Division, (202) 452-3582.

SUPPLEMENTARY INFORMATION: Section 7 of the Securities Exchange Act of 1934 provides that "[f]or the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board . . . shall . . . prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security . . ." 15 U.S.C. § 78g(a). The Board's Regulation G, issued pursuant to this authority, governs credit extended by a lender that is not a bank or a broker/dealer. Regulation G provides that no such lender shall extend credit for the purpose of buying or carrying a margin stock ("purpose credit"), secured directly or indirectly by margin stock in an

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amount that exceeds the maximum loan value of the collateral securing the loan.[1] 12 C.F.R. § 207.3(b). Regulation G further provides that the maximum loan value of any margin stock is 50 percent of its current market value. 12 C.F.R. § 207.7(a).

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1/ "Margin stock" includes any equity security traded on a national securities exchange. 12 C.F.R. § 207.2(i).

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I. BACKGROUND

The final interpretative rule has evolved, beginning in May 1985, from the Board's consideration of two specific petitions for interpretation of the application of the margin requirements. This process has involved staff consultations and meetings with affected parties, voluminous briefing materials submitted by these parties, extensive staff analysis, public comment and several meetings of the Board.

In May 1985, the Unocal Corporation submitted a petition to the Board requesting a determination that the margin lending restrictions in Regulation G be applied to debt securities issued by a shell corporation controlled by Mesa Petroleum Company to finance a tender offer for Unocal's

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stock. The shell corporation held substantially no assets other than the margin stock to be acquired. If the tender offer were successful, Mesa planned to merge the shell with Unocal, but even if successful, the tender offer would not have given Mesa the requisite number of shares of stock to complete a merger with Unocal immediately. Unocal argued that these securities would constitute purpose credit that would be indirectly secured by the margin stock of Unocal and thus subject to the lending restrictions of Regulation G. However, Mesa's acquisition attempt was terminated and no Board action was taken at that time on the issues raised by the petition.

In September 1985, a similar petition was filed with the Board by Revlon, Inc., seeking a determination that the lending restrictions in Regulation G applied to debt securities and other financing arrangements issued by Pantry Pride, Inc. as part of its attempt to acquire Revlon.[2/] The Pantry Pride/Revlon transaction was structured differently from the Mesa/Unocal acquisition attempt. Pantry Pride, an operating

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2/ The GAF Corporation has recently announced a tender offer for the shares of Union Carbide Corp. GAF would control a shell acquisition vehicle, but all debt securities to be issued to finance the tender offer would be issued or guaranteed by the parent corporation itself, an operating company with substantial non-margin stock assets. Together with its shell corporation, GAF, with assets of approximately $800 million and shareholders' equity of approximately $280 million, seeks to raise over $2.3 billion through issuance of debt securities.

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company with substantial non-margin stock assets, would issue nominally unsecured debt securities to fund a tender offer for Revlon's stock, which was margin stock. In addition, Pantry Pride controlled a shell corporation that would be used as an acquisition vehicle and would obtain a bank loan that complied with the margin loan restrictions applicable to loans from banks (Regulation U, 12 C.F.R. Part 221). Revlon's petition asserted that Pantry Pride proposed to obtain over $840 million in credit that could not be supported by Pantry Pride's existing assets (approximately $400 million) and net worth (about $145 million). The Board was made aware of the facts of the Pantry Pride/Revlon transaction but no action was taken on Revlon's petition.[3/]

The Board has also received requests from a number of members of Congress that the Board specifically address the applicability of the margin lending restrictions to acquisition financing arrangements, especially nominally unsecured debt securities used in corporate takeover attempts.

At meetings in September and November 1985, the Board considered the issues raised by the Unocal and Revlon petitions

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3/ After the Revlon petition was filed, the terms of the Pantry Pride offer were altered several times. Recently, Pantry Pride completed its acquisition of Revlon after Revlon's attempt to accomplish a "friendly" leveraged buyout was invalidated by a Delaware court. The petition to the Board was withdrawn.

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and the congressional requests. On December 6, 1985, the Board issued a proposed interpretation of Regulation G.

The proposed interpretation gives the Board's views with regard to whether the debt securities involved in the kind of acquisitions at issue in the Unocal and Revlon situations are indirectly secured by margin stock. The proposal is an interpretative rule that provides guidance to the financial community and to enforcement authorities as to a specific type of transaction that the Board believes, in its judgment, to fall within the scope of lending transactions that are indirectly secured by margin stock. As such, this interpretation is not intended as an exercise of the Board's rulemaking authority conferred by statute or as binding upon reviewing courts, but as descriptive of those facts that indicate a secured transaction within the meaning of the margin requirement rules. Moreover, as an interpretative rule, the Board's action is not subject to the informal rulemaking procedures required in the Administrative Procedures Act. Nevertheless, the Board provided for a short period for comment by the public in order to assure that unanticipated effects from the proposed ruling do not arise.

The Board has received 87 comments on the proposal. The comments have been carefully considered and, for the reasons stated below, the Board has determined to adopt the proposal with certain clarifications and limited modifications.

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II. BASIS OF THE INTERPRETATIVE RULE

A. The Interpretative Rule

The interpretation provides that the Board is of the view that, absent other defined circumstances described below, debt securities issued by a shell corporation to finance the acquisition of the margin stock of a target company are indirectly secured by the margin stock for purposes of the restrictions on lending in the margin regulations. Such a shell would have virtually no business operations, no significant business function other than to acquire and hold the shares of the target company, and substantially no assets or cash flow to support the credit other than the margin stock that it has acquired or intends to acquire.[4/] The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow. This presumption would also not apply if there is a merger

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4/ Other forms of business organizations such as partnerships and business trusts with these characteristics would also be deemed to be shell corporations for the purpose of the interpretative rule.

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agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities or in any event before loan funds are advanced. In addition, the presumption would not apply if the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without the approval of either the shareholders or directors of the target company. In these circumstances it is reasonable to assume that the lenders are looking to the target company's assets for repayment.

The interpretation applies only to shell companies. Thus the interpretation provides that debt securities issued by an operating company with substantial assets or cash flow to finance the acquisition of margin stock of a target company would not be presumed to be indirectly secured by margin stock.

B. Rationale for the Interpretative Rule

The purpose of this interpretative rule is to provide guidance in determining whether nominally unsecured debt securities issued to finance a tender offer for margin stock of a target company are subject to the existing margin lending restrictions in Regulation G in the situations presented in the Unocal and Revlon transactions. Regulation G describes two

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kinds of arrangements that are "include[d]" within the meaning of "indirect security" -- restrictions on the disposition of margin stock and acceleration of the maturity of the credit if margin stock is disposed of -- but further provides that these arrangements do not constitute indirect security if, among other things, the lender in good faith has not relied upon the margin stock as collateral in extending or maintaining the credit. Id. § 207.2(f)(1), (f)(2)(i)-(iv). However, since at least 1961 the Board has recognized that the meaning of indirect security as used in the Board's margin regulations encompasses a wide variety of arrangements as to collateral, other than a conventional direct security interest, that are not described in the Regulation, but that serve to some extent to protect the interest of the lender. 12 C.F.R. § 221.113(f).[5/]

It is clear that the debt securities issued by a shell corporation constitute "purpose credit" as defined in the Regulation. In addition, the purchasers of the debt securities may qualify as "lenders" for purposes of the Regulation because they purchase the debt securities in very large amounts. Although the debt securities issued by such a shell corporation

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5/ This interpretation construed the provisions in Regulation U (governing credit by banks) describing indirect security, which are the same as those in Regulation G.

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are by their terms not directly secured by margin stock, the Board believes, for the reasons stated below, that in the limited situation described these debt securities would be "indirectly secured" by the margin stock to be acquired within the meaning of the provisions of Regulation G.

C. Lenders' Reliance on Margin Stock.

As the interpretative rule set out at the end of the Notice points out, the Board is of the opinion that in the narrow situation described in the interpretation, the purchasers of the debt securities issued by the shell corporation to finance the acquisition of margin stock of the target can be viewed reasonably as relying on the margin stock as collateral for the credit, regardless of the lack of a conventional direct security agreement.

As the interpretative rule points out, under a prior interpretation of the margin regulations, loans to an investment company, the assets of which consist almost entirely of stock, are regarded as indirectly secured by that stock, since the lenders could not in good faith lend to the company without reliance on the stock. Federal Reserve Regulatory Service ¶ 5-917.12. The Board believes that the rationale of this prior ruling applies to the debt securities issued by the type of shell acquisition vehicle involved in the Mesa/Unocal transaction.

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As described in the interpretative ruling, such a shell would have virtually no business operations, no significant business function other than to acquire and hold the shares of the target company, and substantially no assets or cash flow to support the credit other than the margin stock that it has acquired or intends to acquire. In this situation, the Board believes that the only significant asset available to support the credit is the margin stock and, therefore, the lender must be relying on that stock as collateral to secure repayment.

The fact that, as a number of comments point out, the shell corporation intends to vote its shares of the target company to merge with the target does not, in the Board's view, change the result. In the Mesa/Unocal transaction, which forms the basis for the interpretation, the tender offer would not have sought to acquire a sufficient number of shares of stock of the target company to permit a "short-form" merger between the target and the shell corporation. Nor was there a merger agreement between Mesa and Unocal at the time the loans were committed. If the target company were to oppose the merger in this situation, the shell corporation may be unable to consummate the acquisition immediately or possibly at all and the shell may be forced to hold the margin stock for a significant period of time. During this time, the Board believes that the lenders could only rely on the margin stock,

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not the assets of the target, as security for the credit. Disclosures pursuant to the securities laws made by acquiring firms in these situations support this view by stating that the proposed merger may not take place for an extended period of time or at all.[6/]

For purposes of the margin regulations the Board regards the time a commitment to extend credit is entered into as the point at which a determination is made whether the margin lending restrictions apply. See Federal Reserve Regulatory Service ¶ 5-306. Accordingly, in the Board's opinion, at that time the lender can be viewed as relying on the margin stock as collateral for the credit. This position is supported by the fact that the lenders to the shell corporation described above will, at the time of commitment of their loan, be unable to predict the length of time during which the shell would hold no significant assets other than margin stock.

D. Practical Restriction on Disposition.

The Board's presumption that in the shell corporation situation the lenders are relying for repayment on the margin

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6/ See, *e.g.*, Schedule 14D-1 filed by Mesa Partners II and Mesa Eastern, Inc. to acquire stock of Unocal Corp., at 21 (April 8, 1985); Offer by Coach Acquisition Inc. to Purchase Securities of MidCon Corp., at 28 (Dec. 16, 1985).

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stock is further supported by practical limitations on disposition of the margin stock by the shell corporation. Regulation G includes within the scope of "indirectly secured" any arrangement in which there is a restriction on the borrowers' legal right or practical ability to dispose of margin stock owned by the borrower during the life of the credit. 12 C.F.R. § 207.2(f)(l)(i). Where credit is extended to a shell corporation whose basic purpose is to acquire and hold margin stock of a particular company, as in the Mesa/Unocal transaction, the Board is of the view that there is a practical restriction on the ability of the shell corporation to dispose of that margin stock. The Board believes that it would be reasonable to assume that lenders would not extend credit to such a shell acquisition vehicle unless there were an understanding that it will hold the stock of a particular company. This understanding, as a practical matter, would discourage the shell corporation from disposing of the target's stock in order to replace it with other assets.

However, under Regulation G, even if there is a restriction on the disposition of margin stock or other evidence of indirect security, credit is not indirectly secured by margin stock if the lender in good faith did not rely on margin stock as collateral in extending credit. Accordingly, the presumption contained in the interpretation would, of course, not apply where there is specific evidence that the

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purchasers of the debt securities in good faith have not relied on the margin stock to be acquired by the shell corporation as collateral. There are certain specific situations where the Board believes this would be true as a general matter and these situations where the presumption would not apply are set out in detail in Section III. B. below.

III. COVERAGE OF INTERPRETATIVE RULE

A. Limited Scope of Coverage

The interpretative rule is intended only to provide guidance as to whether the term "indirectly secured by margin stock" as used in Regulation G would apply to the shell corporation financing arrangements of the type presented in the Mesa/Unocal transaction. Credit transactions involving different facts are not covered by this interpretation; they will continue to be covered by existing law, regulations and interpretations.

Nevertheless, certain comments raised questions about whether various classes of acquisitions would be included within the scope of the interpretation. The Board wishes to note that four general types of acquisition transactions -- those involving (a) operating companies with substantial assets or cash flow, (b) guarantees of borrowing by companies with substantial assets or cash flow, (c) agreed-upon mergers, and (d) statutory "short-form" mergers -- are not covered by the presumption made with respect to shell companies. These four

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exclusions are based on the Board's view that the rationale supporting the interpretation -- reasonable cause to believe that the lenders are relying for repayment on the margin stock -- would not cover these types of acquisition arrangements, even if debt securities are issued by a shell corporation that is employed as an acquisition vehicle. The Board believes that, even where a shell corporation is involved, lenders would not be relying on margin stock where the loan is guaranteed by an operating company with substantial assets or cash flow or where the borrower is an operating company with the same characteristics. Similarly, the lender would not be relying on the margin stock if there is a merger agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities or in any event before the loan funds are advanced. The same is true where the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without the approval of either the shareholders or directors of the target company. These exclusions from the application of the presumption are described in detail in the following two sections.

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B. Debt Securities Issued or Guaranteed by Operating Companies.

The interpretative rule makes clear the Board's view that, as in the Pantry Pride/Revlon transaction, where nominally unsecured debt securities are issued by an operating company with substantial non-margin stock assets or cash flow to finance acquisition of margin stock, the debt securities are not presumed to be indirectly secured by the margin stock. Since the debt securities are issued by a company with a history of ongoing business operations, the Board believes that a presumption that the lenders are relying on the margin stock as a source of repayment for the credit would not be reasonable. For the same reasons, the Board reaches the same conclusion in the situation where there is borrowing by a shell corporation which is guaranteed by an operating parent or other company with substantial non-margin assets or cash flow.

Since the Board is dealing only with the question of whether a presumption of reliance on the margin stock should be made, there is no reason to include additional comment, as provided in the last sentence of paragraph (h) of the proposed interpretation, on the scope of the application of Regulation G when the presumption is not applicable. Accordingly, the last sentence of paragraph (h) is not necessary to the interpretation and that sentence has been deleted.

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A number of comments questioned, however, whether debt securities issued by operating companies to finance tender offers for margin stock might be covered by the interpretation, if the amount of securities to be issued significantly exceeds the assets of the operating company. Conversely, commentators also raised questions about the kinds of acquisition vehicles that would be considered a shell corporation within the meaning of the interpretation, as well as how much assets or cash flow would be necessary for the acquiring company to fall outside the rebuttable presumption.

As explained above, the Board does not presume debt securities issued by an operating company with substantial assets or cash flow to be indirectly secured by the margin stock purchased with the proceeds of the debt securities. Guidance as to the Board's views has already been noted insofar as it considers both the acquisition proposals made by the operating companies involved in the offers made by Pantry Pride and by GAF.[7/] The Board does not consider these arrangements as falling within the presumption of indirect security contained in the interpretative rule adopted today.

Moreover, with respect to the characteristics of a shell corporation that falls within the scope of the presumption, the Board has already noted that such a

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7/ See Section I. above.

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corporation would have (1) virtually no operations; (2) no significant business function other than to acquire and hold the margin stock of the target company; and (3) substantially no assets or cash flow to support credit extended to it other than the margin stock that it has acquired or intends to acquire. The Board also notes that the controlling principle of the interpretation is that credit to a shell corporation is presumed to be indirectly secured by margin stock in the relatively limited circumstance where the non-margin stock assets or cash flow of the shell corporation is so insubstantial that a lender could not in good faith rely on it in extending credit to the shell corporation.

In view of the narrow scope of the proposed interpretation, the Board does not anticipate that extensive additional interpretation will be necessary to delineate the scope of the shell corporation concept contained in the interpretative rule or the margin rules as a whole. While the Board and the staff, as in the past, are prepared to provide views on the compatibility of proposed transactions with these rules, the Board expects that the interpretative rule should reduce the need for individual interpretations such as those requested in the Mesa/Unocal, Revlon/Pantry Pride and GAF/Union Carbide situations. Questions concerning application of the interpretation to individual fact situations cannot, of course,

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be excluded, and can be expected to arise in conjunction with litigation on other matters between companies involved. The Board has had a longstanding policy that, where the parties are involved in litigation, the Board would refrain from comment that might affect this litigation. Moreover, this policy is fully consistent with the longstanding position of the Board that a private right of action under the margin requirements is an important mechanism for effective resolution of margin requirements issues in particular factual situations.

Paragraphs (b) and (h) of the proposed interpretation have been redrafted to emphasize that the Board's views are limited to the types of fact situations involved with the Unocal and Revlon transactions.

C. Merger Agreements and Short Form Mergers

The rationale of the presumption would not apply in the case of the financing of a merger transaction, even if a shell corporation is employed to effect the merger if, at the time the financing is committed or, in any event before the loan funds are advanced, a merger agreement has been executed or the merger may be accomplished by operation of law. As explained above, the Board's presumption of indirect security is premised on its judgment that in the narrow fact situation presented there is uncertainty as to whether the shell corporation would be merged promptly with the target company. However, this rationale would not apply if there is a merger

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agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities. In this case the surviving corporation can immediately succeed to the assets and liabilities of the subsidiary and the target company and the surviving corporation becomes a wholly owned subsidiary of the holding company. Thus, in this situation, the Board believes that it is reasonable to assume that purchasers of any debt securities issued by the shell corporation would be relying on the assets of the target company, not its stock, as the source of repayment for the credit.

Similarly, the Board also regards the rationale of the interpretation as not applying if the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without approval of the shareholders or directors of the target company (e.g., Delaware General Corporation Law, section 253, and New York Business Corporation Law, section 905). The Board believes that, as some commentators have pointed out, a lender extending credit to finance a tender offer in these circumstances could rely on the assets and earnings of the target corporation, not its stock, as the source of collateral and repayment of the credit. The interpretative rule has been

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amended to reflect the judgments contained in this paragraph and the preceding paragraph.

D. <u>Applicability to Bank Loans</u>

Commentators have asked whether bank loans (governed by Regulation U) to the kind of shell corporation described in the interpretation would similarly be "indirectly secured" by margin stock. Regulation U applies margin lending restrictions to purpose loans made by banks that are directly or indirectly secured by margin stock and defines "indirectly secured" in the same manner as Regulation G. 12 C.F.R. §§ 221.3(a); .2(g). As with other interpretations of "indirectly secured," the Board would regard this interpretation as applying interchangeably to credit covered by either Regulation.[8] However, in cases coming to its attention, the Board notes that bank loans tend to be structured so as to provide security, including negative pledge clauses, that fall specifically within the scope of Regulation U, in contrast to credit extended by Regulation G lenders that purchase debt securities. This interpretation is not likely to have a significant impact on bank loans governed by Regulation U.

8/ Regulation T, governing credit by brokers and dealers, prohibits a broker/dealer from extending purpose credit on an unsecured basis or on any collateral other than securities. However, a broker/dealer acting as an investment banker may arrange such credit if it does not violate Regulations G or U. 12 C.F.R. § 220.13.

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E. Applicability to Lenders in Public Offerings of Debt Securities

The proposed interpretation stated that for purposes of this interpretation, there is no distinction between privately placed and publicly distributed debt securities. Thus, under the proposed interpretation, a person who purchases a sufficient amount of debt securities of the kind described in the interpretation to qualify as a lender under Regulation G would be regarded as subject to the margin lending restrictions, regardless of whether the debt securities were purchased in a public offering or in a private placement.

Several commentators state that if debt securities that are issued in public offerings are viewed as purpose credit that is subject to the margin lending restrictions, then serious operational problems would result in assuring compliance with those rules. For example, purchasers of publicly issued debt securities in the secondary market may not have access to the disclosure statements required by the securities laws and thus may not be aware that the proceeds of the debt securities were used to purchase margin stock and that the securities would be subject to the margin rules. Questions have also been raised about the consistency of the proposal in this area with past Board practice.

This provision in the proposed interpretation was intended at least in part to address the kind of nominal public

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offering of debt securities involved in the Pantry Pride/Revlon transaction, in which acquiring firms registered the debt securities with the SEC as a public offering, but sold the securities in minimum amounts of $2.5 million, so that the sale in actual practice resembled a private placement. Although the staff has stated that publicly offered debt securities are not subject to the margin regulations, the staff opinions assumed bona fide public offerings for the purposes of applying the margin requirements.[9]

The Board believes that in this case questions of whether purchasers of publicly issued debt securities should be treated as lenders for purposes of the margin rules are best dealt with in the context of a formal amendment to the provisions of Regulation G, since such an action would not involve an interpretation of words used in the existing provisions of Regulation G. Accordingly, the Board is not adopting paragraph (i) of the proposed interpretation at this time and, with the caveat noted above, staff opinions may continue to be relied on.

9/ A court reviewing Panty Pride's securities laws disclosures with respect to compliance with the margin regulations stated that, while obliged to defer to the existing interpretation of the Board's staff, the argument that the debt securities issued by Panty Pride were not exempt from the margin rules had much to commend it. Revlon, Inc. v. Pantry Pride, Inc. No. 85-497 JJF (D. Del. Sept. 12, 1985), slip op. at 22-24.

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IV. ANALYSIS OF COMMENTS

The Board received a total of 87 public comments. More than half of the comments were supportive of the proposal. These commentators favored the proposed interpretation for a number of reasons, including (1) its probable effect of protecting small investors by discouraging risky investment by pension funds and other trustees, (2) its help in restoring integrity in the nation's financial markets, and (3) its effect as a curb on speculation and the excessive use of debt for speculative purposes. The unfavorable comments, including those of the Department of Justice and other government departments, reflected concerns with justification and underlying rationale for the proposed interpretative rule as well as with respect to whether the Board had followed the proper procedure in issuing the proposed interpretation.

More specifically, the comments, both pro and con, addressed issues in the following areas:

(1) The policy implications of the proposed interpretation;

(2) Whether the proposed interpretation has any basis in fact; whether it is consistent with the purposes of margin regulation; whether it is consistent with prior Board and staff rulings; and whether it would put the Board in an unprecedented regulatory role;

(3) Whether the Board had complied with the Administrative Procedure Act in proposing the interpretation;

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(4) Whether certain situations and transactions would be covered by the proposed interpretation; and

(5) What transactions would be covered by the grandfather provisions of the proposed interpretation.

Some of the comments have already been addressed in the preceding material discussing the basis and scope of the interpretative rule. The following sections address other issues raised by the comments.

A. Policy Considerations

Many commentators addressed policy issues relating to the advisability of regulating corporate acquisitions and debt generally. Some commentators supported the Board's interpretation on the grounds that the recent growth of debt-financed corporate acquisitions should be curbed and the excessive debt for speculation in stocks should be restrained. These commentators also argue that such financing diverts capital flows away from productive purposes and reduces credit available to such borrowers, results in excessive corporate debt that impairs the financial condition of the issuing corporations and increases the potential for major bankruptcies, results in corporate funds being diverted to repay debt rather than being used for productive growth, requires emphasis by management on short-term results to the detriment of sound corporate growth, results in higher cost of capital, which in turn is passed on to consumers, and results

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in distortions that impair the integrity and stability of the national securities markets.

On the other hand, many comments, including those of the Department of Justice, for itself and on behalf of a number of government agencies, and the Federal Trade Commission, opposed the interpretation, contending that governmental regulation of corporate acquisitions is not in the public interest. These comments state that corporate acquisitions have productive economic effects, such as removal of inefficient management, and increases in the value of corporate stock, and that there is no evidence that the level of corporate debt is excessive or would be adversely affected by debt securities issued to finance corporate acquisitions. Among the other points raised in these comments are assertions that the interpretation frustrates the congressional objective of neutrality with regard to corporate takeovers expressed in the Williams Act and the Hart-Scott-Rodino Act, would have a disparate effect on competition for corporate control by shifting the balance that presently exists to favor large corporations over smaller ones, would discriminate in favor of foreign firms that may borrow abroad to finance the takeover of U.S. companies without being limited by the margin regulations, would increase acquisition costs, and will have an adverse effect on economic efficiency and financial markets.

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A number of comments argue that the interpretation is not necessary to accomplish the basic objectives of the Board's authority to set margin requirements. Drexel Burnham Lambert, Inc. and other commentators state that there is no regulatory need to protect the purchasers of the debt securities involved, who are financially sophisticated, and that the issuance of the debt securities neither diverts credit from other uses nor produces excessive price fluctuations in the market. Other commentators, however, believe that the interpretation will carry out the purposes for which the margin-setting authority was enacted. For example, a comment submitted by twelve members of the House of Representatives states that the interpretation addresses many of the same concerns that led Congress to enact the margin authority -- "speculation leading to unstable markets and an undermined public confidence in the soundness of publicly traded" securities.

The comments also discuss a Federal Reserve Board staff study, transmitted to Congress in January 1985, evaluating federal margin regulation,[10] which concluded that there are serious doubts about the need for continuing federal regulation to foster the objectives originally sought by Congress in enacting the legislation. Drexel Burnham and other commentators assert that the extension of the margin

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10/ A Review and Evaluation of Federal Margin Regulation.

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regulations embodied in the interpretation is inconsistent with the Board's recognition of the general inefficiency of margin regulation. On the other hand, some members of Congress and others point out that whatever questions the Board has about the continuing need for margin requirement law and regulations, the existing margin law and regulations must be enforced and, unless the existing regulations are amended by the Board, they must apply equally to all transactions covered by their terms.

The Board recognizes the conflicting public policy issues concerning highly leveraged mergers, and does not believe rulemaking or interpretations of margin regulations are appropriate means for settling such issues, which are properly matters for Congressional consideration. Moreover, the Board does not believe the interpretation set forth here is likely to substantially alter, in itself, the level of merger activity or amount of debt created. Rather, the interpretation is intended to make clear the Board's view that a specific narrow class of acquisition financing transactions falls within the requirements of the margin regulations as currently written. The Board believes that the interpretation is consistent with the purposes of Section 7 of the Securities Exchange Act of 1934. This conclusion is in no way undermined by the staff study which focuses on recommendations for legislative consideration for future action and not on administration of existing law so long as that law is in place.

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In conjunction with Regulations T and U, Regulation G was adopted by the Board to carry out the purposes of Section 7 of the Securities Exchange Act of 1934, inter alia, to prevent excessive use of credit for stock market speculation. The interpretative rule simply applies Regulation G to one kind of fact situation in a manner in which the Board believes is consistent with the purposes Congress had in mind in adopting the margin requirement legislation and which is covered by Regulation G. In doing so, it carries out the intention of Congress as embodied in Section 7 and in the margin regulations. While the Board carefully considered the policy arguments made by the commentators and others that the margin requirements should not be applied to the facts covered by the interpretative rule, on balance the Board decided that fair and uniform administration of existing law requires that the margin regulations be applied in situations where it is reasonable to conclude that purpose credit is being extended that is indirectly secured by margin stock. Proposals for fundamental changes in the margin requirements are properly addressed to Congress, not to the Board, which must interpret the law as Congress has enacted it. As noted in a number of comments and by the Board itself in setting out the proposed interpretation, the Board would welcome such Congressional review.

With respect to the contentions that the interpretation would result in disparate treatment of various

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classes of transactions and parties, for example, between foreign and domestic lenders, large and small acquiring and target companies, and hostile and friendly acquisitions, the Board believes that considerations of this kind do not, and cannot, preclude adoption of an interpretation applying existing regulatory requirements to a particular financing transaction. On the contrary, fair application of the margin rules requires that they be applied to a fact situation that comes within the scope of those rules. Although margin regulations by their very nature impose a greater burden where there is a greater need to borrow or a lack of other assets to support the borrowing, this burden is the inevitable product of the enactment of margin authority by Congress designed to limit borrowing for speculative purposes.[11] In applying the definitions contained in these rules, the interpretation subjects all acquiring and target companies to the same standards provided for under existing law and rules.

Other commentators have suggested that the proposal contravenes governmental policy of neutrality toward takeovers

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11/ Proposals to amend the securities laws to apply Section 7 to foreign bidders have been considered by Congress but have thus far not been adopted. On October 13, 1981, the House of Representatives approved a bill (H.R. 4145) that would have made foreign borrowers obtaining credit to purchase U.S. securities from non-U.S. lenders subject to same margin requirements applicable to U.S. persons. 127 Cong. Rec. 23762. A similar bill (S. 289) was not acted upon by the Senate.

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and other acquisitions embodied in the Williams Act amendments to the Securities Exchange Act (15 U.S.C. 78m (d-e)) and the Hart-Scott-Rodino Anti-trust Improvements Act of 1976 (15 U.S.C. 18a). Even before the Williams and Hart-Scott-Rodino Acts, it had been a longstanding position of the Board that the margin regulations apply to a loan to purchase a controlling interest in a corporation (12 C.F.R. § 221.110, 45 Fed. Res. Bull. 256 (1959); Federal Reserve Regulatory Service ¶ 5-815) and there is no evidence that those Acts in any way exempted takeover attempts from the margin requirements. The interpretation is predicated on a Board policy of administering the margin regulations fairly and equally with respect to all market participants. Moreover, the Board does not believe there is any conflict between the narrow interpretative rule and the other statutes cited by the commentators.

B. Factual Basis for Interpretative Rule

A number of comments addressed the factual basis of the interpretation, i.e., that the purchasers of the debt securities issued by the shell corporations look to the margin stock, not the assets of the target as the source for repayment of the credit. For example, some commentators stated, without offering any specific evidence, that in their experience lenders to the shell corporation look to the assets and cash flow of the target company as the source of repayment, since

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the shell corporation holds margin stock only as an interim step in the planned acquisition of the target company. These comments further state that, in many cases, financing arrangements are contingent on acquisition of legal control of the target and that the shell corporation is not analogous to an investment company, because, unlike the shell, an investment company does not exercise long-term control over the companies in which it invests.

On the other hand, a number of comments supported the interpretation. For example, the National Association of Manufacturers and twelve members of the U.S. Senate stated that, in the circumstances described in the interpretation, the shell corporation would hold no assets other than margin stock to which the lenders would have recourse. Dillon, Read & Co., an investment banker, stated that debt securities issued by a shell corporation "from a practical standpoint . . . are indirectly secured by stock of the target corporation."

The Board believes that the comments of Drexel Burnham and other investment bankers on acquisitions generally do not undermine the reasonableness of the conclusion that in the limited circumstances described in the interpretation the debt securities should be regarded as indirectly secured by margin stock. The general comments do not consider the particular circumstances raised by the Mesa/Unocal transaction -- that the target company's efforts to oppose the acquisition could

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significantly delay or prevent consummation of the merger and the specific admissions in securities disclosure materials that this could, in fact, be the case.

As explained above, this circumstance would not cover, and the interpretation is not intended to cover, situations where it is clear that when the shell corporation acquires margin stock it will be able to effect an immediate merger with the target. In addition, in the situation identified in the interpretation, the Board believes that the shell corporation should be viewed as the equivalent of an investment company, since until the merger with the target is actually accomplished, the Board believes that the shell corporation would not exercise effective control over the target company.[12]

C. Consistency with Margin Rules

Several comments assert that the interpretation is inconsistent with the provisions in Regulation G relating to indirect security. These comments state that under the Regulation, in order for credit to be indirectly secured by

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12/ One commentator argues that the high rate of interest paid on the debt securities issued by the shell corporation is necessary to compensate the lenders for extending credit that is truly unsecured. However, no evidence has been produced that the lenders are in fact relying on this characteristic of the debt instrument to the exclusion of the margin stock. On the other hand, the fact that the shell corporation has no other assets or cash flow to permit repayment suggests at least partial reliance on the margin stock.

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margin stock, there must be a restriction on the disposition of margin stock, some provision for acceleration of the maturity of the credit if margin stock is disposed of, or at a minimum some "arrangement" between the lender and borrower and that none of these factors are present in the case of the shell corporation's debt securities described in the interpretation.

The Board is of the view that this argument is not consistent with the plain language of the Regulation, which provides that "[i]ndirectly secured" includes any arrangement with the lender under which the borrower's right or ability to dispose of margin stock is in any way restricted. 12 C.F.R. § 207.2(f)(1)(i). The Board is of the view, as explained above, that in the shell corporation situation outlined in the interpretation, there is a restriction on the ability of the shell corporation to dispose of the margin stock of the target company within the scope of this definition. The Board also believes that the use of the term "includes" in Regulation G means that the factors identified in the Regulation are intended to be illustrative of the circumstances in which debt may be found to be indirectly secured by margin stock but not a comprehensive recital of such circumstances. It should be noted that a longstanding interpretation of the analogous provision in Regulation U states that indirect security may be found in "a variety of circumstances." 12 C.F.R. § 221.113(f). The Board notes that, as indicated by the

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investment company interpretation described above, purpose credit has been found to be indirectly secured by stock based solely on the asset structure of the borrower, where neither of the factors identified in the Regulation[13/] were present. Federal Reserve Regulatory Service ¶ 5-917.12.

D. Prior Staff Opinions

Several comments cite a series of prior opinions by the Board's staff and the staff of the Federal Reserve Bank of New York, each of which concluded, based on the facts involved, that credit extended to a shell corporation to finance a tender offer for margin stock of a particular target company was not indirectly secured by the margin stock to be acquired.[14/] Drexel Burnham and Merrill Lynch & Co. assert that the interpretative rule is a departure from these existing staff opinions and that no explanation for this has been provided.

13/ The comments of the Department of Justice cite several staff interpretations relating to indirect security that turn on the existence of restrictions on the disposition of margin stock. While the staff's analysis of this question often focuses on restrictions on disposition, nothing in the cited interpretation (or in any other interpretation) states that this factor is determinative for purposes of applying the regulatory provision relating to credit indirectly secured by margin stock.

14/ Federal Reserve Regulatory Service ¶¶ 5-917.15; 5-357.1; 5-357.21; staff letters dated March 19, 1982, April 13, 1984, May 1, 1984, Jan. 11, 1985.

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However, since at least 1959, the Board has consistently made clear its view that the margin lending restrictions apply to credit used to acquire a controlling interest in a corporation by purchasing the stock of that corporation where the credit meets the criteria specified in the Regulation.[15/] The staff has also made clear that it regards credit extended to an investment company, substantially all of whose assets are composed of margin stock, as indirectly secured by the stock,[16/] and that an exception from the term "indirectly secured" does not apply when margin stock is the only asset of a shell corporation.[17/] As explained above, the Board finds that the rationale of these opinions is directly applicable to the shell corporation situation which is the subject of this interpretative rule.

The comments suggest, however, that seven prior opinions of the staff express the view that purpose credit extended to a shell corporation to finance the acquisition of margin stock was not indirectly secured by margin stock.

15/ Federal Reserve Regulatory Service ¶ 5-815. This opinion applies to a bank loan made under Regulation U, but applies equally to Regulation G which uses the same "indirectly secured" language.

16/ *Id.*, ¶ 5-917.12.

17/ *Id.*, ¶ 5-917.17.

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Those staff opinions did not focus on the factors which the Board has identified in this interpretation as essential to a determination of whether the debt issued by a shell corporation to finance the acquisiton of a company's stock could be presumed to be indirectly secured by this stock.[18/] This new essential factor -- the potential for indefinite holding by the shell corporation of the target's stock -- was explicitly raised only for the first time in the Unocal petition to the Board. Thus, where this factor is present, the prior staff opinions are not relevant to a determination of whether the presumption contained in the Board's interpretation applies.

E. Role of the Board in Reviewing Specific Cases

Finally, some commentators assert that adoption of the interpretation will place the Board in the unprecedented and unauthorized role of reviewing the financing arrangements of takeovers generally and that this review will increase the costs of regulatory compliance. The Board notes that it has long been placed in the position of making such interpretations in response to requests from lenders and others. It is for

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18/ The Board also notes that the staff interpretations were limited to hypothetical facts presented and involved a variety of financing techniques and other factors, such as guarantees of the shell corporation's debt, as well as proposals to acquire all of the stock of the target company that could have resulted in the same findings with respect to indirect security as would occur under the interpretative rule.

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that very reason -- specific requests for clarification of the rules applicable to shell companies -- that the Board is prepared to adopt this interpretative rule. The Board believes that adoption of this rule should, in fact, reduce uncertainty and reduce the need for future interpretations. Moreover, the interpretation is designed to deal with a limited class of acquisition financing transactions -- those in which debt securities are issued by a shell corporation and, accordingly, is not expected to apply to a large number of acquisition transactions. Thus, administrative review of a large number of transactions should not be necessary and the number of requests related to the narrow financing arrangements described by the interpretation should be limited in number. Finally, the Board has noted in Section III. B. of this Notice the important role that the courts play in applying margin rules to the factual issues arising in specific cases.

V. PROCEDURAL ISSUES

A. The Administrative Procedure Act

Several comments expressed the view that adoption of the proposed interpretation would violate the Administrative Procedure Act ("APA") because the Board has not followed all of the procedures for rulemaking set forth in that Act. However, the action taken by the Board here is interpretative and is adopted in accordance with the provisions of the APA.

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The APA provides that in promulgating "legislative" or "substantive" rules, an agency must provide notice of proposed rulemaking, opportunity for public comment, a statement of the basis and purpose of the rule, and a delayed effective date. 5 U.S.C. § 553(b)-(d). Congress has, however, specifically provided that these requirements do not apply to "interpretative rules." 5 U.S.C. § 553(b)(A), (c)(2). A legislative or substantive rule is issued pursuant to a specific grant of authority to an agency to make rules having the force of law.[19/] A rule is interpretative if it is not issued pursuant to specific delegated rulemaking power or if the agency intends the rule to be no more than an expression of its construction of a statute or rule.[20/] The Congressional authorization to issue interpretative rules without public notice and comment reflects its awareness that the public interest in expediting the administrative process, in complex situations involving application of existing law, required flexibility to permit agencies to interpret that law

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19/ E.g., Batterton v. Francis, 432 U.S. 416, 425 at n.9 (1977); Chamber of Commerce of the United States v. OSHA, 636 F.2d 464, 468 (D.C. Cir. 1980).

20/ E.g., Chamber of Commerce of the United States v. OSHA, supra 636 F.2d at 468.

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without adhering to the rulemaking procedures that had to be applied when their actions involved creating new legal obligations.[21]

While the outer boundaries of the distinction between legislative and interpretative rules have not been fully clarified by the courts, numerous decisions have established certain general principles for distinguishing between the two types of rules. An interpretative rule (1) does not exercise delegated legislative authority; (2) is not binding on reviewing courts, although they will defer to administrative expertise; (3) is intended by the promulgating agency as interpretative and non-binding; and (4) advises the public of the agency's construction of the statutes and rules which it administers by clarifying or explaining an existing statute or rule. An agency's statement that it is adopting an interpretative rule is given great weight in the judicial

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21/ See Senate Comm. on the Judiciary, Administrative Procedure Act, Legislative History, S.Rep. No. 248, 79th Cong., 2d Sess. 18 (1945); Koch, Public Procedures for the Promulgation of Interpretative Rules and General Statement of Policy, 64 Geo. L. J. 1027, 1053-54 (1976). Koch recommends that the interest in public participation and the interest in administrative flexibility should be reconciled in the case of interpretative rules by use of "abbreviated public procedures tailored to particular situations . . . ," exactly what the Board has done in this case. In fact, the notice and public comment procedure followed by the Board in this case conforms in substance to the APA requirements for informal rulemaking.

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process, but is not controlling. If the court determines the rule "creates new law, rights, or duties," it will be held to be legislative in character.22/

An interpretation of a term in a statute or in a legislative rule is clearly an interpretative rule. As the Court stated in Batterton v. Marshall:

> An interpretative rule serves an advisory function explaining the meaning given by the agency to a particular word or phrase in a statute or rule it administers. As this court explained in Gibson Wine Co. v. Snyder, 194 F.2d 329 (D.C. Cir 1952):
>
> > 'An interpretative rule is one which does not have the full force and effect of a substantive rule but which is in the form of an explanation of particular terms in an Act. If you had an expression in a statute such as "Interurban Railway," the query might come up as to what is an "interurban railway." A particular agency may adopt a rule defining an interurban railway. That, in a sense, may be called an interpretative rule.'23/

Based on these principles, the Board finds that the interpretation is an interpretative rule that is exempt from the rulemaking procedures of the APA. First, the Board intends

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22/ E.g., General Motors Corp. v. Ruckelshaus, 742 F.2d 1561, 1565 (D.C. Cir. 1984), cert. denied, 105 S.Ct. 2153 (1985); American Postal Workers Union v. United States Postal Service, 707 F.2d 548, 558-59 (D.C. Cir. 1983), cert. denied. 465 U.S. 1100 (1984).

23/ 648 F.2d 694, 705 (D.C. Cir. 1980).

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to adopt an interpretative rule that sets forth the agency's views on the meaning of the existing provision in Regulation G -- "indirectly secured by margin stock" -- as applied in the situations involved in the Mesa/Unocal and Pantry Pride/Revlon transactions. The Board does not, and does not intend to, create new law or impose new duties beyond those already contained in the existing Regulation. Second, by its terms, the interpretation merely expresses the Board's views on what "indirectly secured by margin stock" means in specific fact situations. The interpretation is not itself intended to have, and does not have, any binding effect on the courts or carry the force of law. The interpretation merely utilizes a presumption that debt securities issued by a shell acquisition vehicle in certain circumstances are indirectly secured by the margin stock of the target company and expressly recognizes that an affected party may provide additional evidence that lenders are in good faith not relying on margin stock as collateral. § 207.112(f).

Thus, the interpretative rule fits squarely within the scope of the Congressionally-sanctioned exemption from the public notice and comment rulemaking procedures as established by Congress and interpreted by the courts. Any other conclusion would be a matter of considerable concern to the Board with respect to its ability to carry out effectively its functions under the margin regulations and other delegations of administrative authority by the Congress.

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In its administration of the margin requirements, the Board has relied extensively on the practice of issuing interpretations and advisory staff opinions. In fact, the various precedents relied upon by the commentators in urging that the interpretative rule violates previous Board policy are, in fact, in themselves interpretations, mainly opinions issued by the staff.

If the interpretative rule adopted by the Board here is not an interpretative rule but a legislative rule, then the many other interpretations adopted by the Board and the staff in the past must also be legislative rules and would be invalid because they have been adopted without meeting the requirements of the APA for notice and public comment. This is not merely a logical point, but has important consequences for effective administration of laws delegating administrative authority to the Board, including those concerning margin requirements. The submission of all interpretative rules for public notice and comment would have severe effects on the administrative process and on the public's ability to operate effectively under these rules and regulations. This is precisely the reason why Congress specifically provided that interpretative rules would not be subject to these requirements, and the Board believes that the interpretative rule adopted today fully meets the requirements established by law for interpretative rules.

The Department of Justice and Drexel Burnham argue that the interpretation is a legislative rule because it

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effects a change in law or policy. Some courts have characterized agency action as a legislative rule if it changes existing policy by altering provisions of an already existing _legislative_ rule.[24/] In this case, the Board does not believe it is altering existing policy or a legislative rule; rather it is interpreting a term in existing law with respect to a fact situation that has not been explicitly covered by the Board or the staff. In any event, to the extent it might alter anything, the interpretation may change a prior _interpretation_ by the staff. While it may make good sense to require that changes in legislative rules be made only after compliance with public notice and comment, this rationale does not apply to an interpretative rule to which these requirements are not applicable.

The Justice Department and Drexel Burnham claim the interpretation changes a legislative rule because it conflicts with the provisions in Regulation G relating to "indirectly secured" (12 C.F.R. § 207.2(f)(1)). They suggest that Regulation G requires some restriction on the disposition of margin stock or some "arrangement" between a lender and borrower as a prerequisite to a finding that indirect security exists. As explained above, the Board believes that in the

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24/ _E.g._, _Gosman_ v. _United States_, 573 F.2d 31, 39 (Ct. Cl. 1978).

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situation described in the interpretation, there is a restriction on the ability of the shell corporation to dispose of margin stock of the target company. The Regulation explicitly provides only that "indirectly secured" "includes" such arrangements; it is not on its face limited to such arrangements. By longstanding interpretation, the Board has made clear that a variety of circumstances, not described in the Regulation, could result in a finding that a particular credit is indirectly secured by margin stock.[25/] The Board's interpretation, therefore, does not conflict with the provisions of Regulation G. On the contrary, it is fully consistent with these rules. Thus, the interpretative rule is not a legislative rule on the basis that it changes the policy or rule contained in Regulation G.[26/]

25/ In 1981, the staff made clear that in certain cases at least credit extended to an investment company the assets of which consisted primarily of stock was indirectly secured by the stock. And the argument that credit extended in a tender offer context to a corporation with no assets other than margin stock could be indirectly secured by margin stock was noted even earlier in a legal analysis of the margin regulations. Herzel & Rosenberg, Loans to Finance Tender Offers: The Bank's Legal Problems, 96 Banking L. J. 676 (1979).

26/ The Justice Department also asserts that the interpretation would reverse prior staff opinions on whether publicly offered debt securities are subject to the margin regulations. Since the Board is deferring consideration of this issue, the Department's contentions on this question need not be addressed at this time.

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The Justice Department also argues that the interpretation effects a change of policy that may be implemented only by legislative rule because the interpretation contemplates case-by-case Board review of the financing of takeover transactions. Even if this characterization of the effect of the Board's interpretation were accurate, the perceived ad hoc approach in administering the margin regulations clearly represents no change in policy. Indeed, the Board's longstanding and universally understood practice has been precisely to provide the informal guidance of either the Board or staff on a case-by-case basis, limited to particular facts presented, including those situations involving the financing of corporate acquisitions.[27/] As noted above, if the Board were precluded from expressing its views on the applicability of the margin regulations other than in potentially time-consuming and costly rulemaking proceedings, the effect would be to undermine seriously effective administration of the Act and seriously burden those who are subject to the regulation. The objective of the interpretative rule is, however, the same as that advanced by the commentators -- to reduce the need for administrative opinions by carefully clarifying the scope of existing rules.

27/ E.g., 12 C.F.R. § 221.110; Federal Reserve Regulatory Service ¶ 5-942.11.

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The Board is, in fact, responding to the various requests for interpretation of these rules.

Comments submitted by the GAF Corporation contend that the Board's action is a legislative rule because it would have a substantial impact. However, as noted in Section III. B., the proposal made by GAF would not be covered by the presumption contained in the interpretative rule. More generally, while the test of "substantial impact" on private parties has been employed by a few courts to determine if a rule is legislative in nature, a growing number of other courts and legal commentators reject the "substantial impact" test on the grounds that impact is not relevant to the standard established by the Supreme Court for deciding whether a rule is legislative in nature -- whether the rule was issued pursuant to a delegated grant of rulemaking authority. They point out that some truly interpretative rules could have substantial impact.[28] In any event, even under the substantial impact test, the Board's interpretation is not a legislative rule, because it deals with a narrow class of financing transactions, and merely expresses a rebuttable presumption that the Board would view certain debt securities as subject to the

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28/ E.g., Cabais v. Egger, 690 F.2d 234, 237 (D.C. Cir. 1982); Energy Reserves Group, Inc. v. Department of Energy, 589 F.2d 1082, 1093-98 (Temp. Emer. Ct. App. 1978). In this case, the Court stated succinctly: "The weight of persuasive and controlling legal authorities does not support application of this substantial impact test." 589 F.2d at 1094.

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margin regulations when particular facts are present. Any "substantial impact" flows from the margin authorization enacted by Congress and from Regulation G, not from the interpretation of these rules adopted by the Board.

B. Need for Additional Public Comment

Although not required to do so by the APA, the Board provided notice and a period for public comment on the interpretation in order to assure that the focus of the interpretation would remain narrow and that unintended effects would not arise. Several commentators, including the Department of Justice and the SEC, expressed the opinion that public policy considerations require the Board to follow even more extensive procedures than those provided. As noted at the outset, the Board has had this matter under consideration since May 1985. There have been consultations and meetings with affected parties, voluminous briefs have been submitted, extensive staff papers have been prepared for Board analysis, and the Board has reviewed this matter on several occasions. In addition, although not required by law, public notice has been given and public comment received and analyzed.

The Board believes that the notice of the proposed interpretations fairly apprised the public of the issues involved, that the the record in this matter has provided sufficient information to determine that the interpretation, as clarified, would not have unintended effects, and that additional factual development is unnecessary, since the ruling

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is limited to the specific facts presented. Thus, there has been ample opportunity for public participation in the interpretative process, and although not required by law, in substance the notice and public comment provisions of the APA have been fully met.

Moreover, the Board finds that the benefit of additional procedures is outweighed by necessity to provide guidance to active financial markets and to remove promptly any uncertainty about the limited nature and scope of the Board's action. Further delay will allow transactions to be rescheduled to avoid the interpretation in derogation of fair and uniform administration of the margin law.

VI. APPLICABILITY TO EXISTING FINANCING ARRANGEMENTS

Several comments address the Board's statement in the request for comments on the proposed interpretation that, if adopted, the proposed interpretation would not apply to written contracts to extend credit entered into prior to the effective date of the interpretation. These comments asserted that since the action is intended merely to provide the Board's views on the meaning of the term "indirectly secured by margin stock" in the existing regulations, it should govern all financing arrangements, regardless of when they were entered into.

The Board recognizes that its action is interpretive in nature and that, accordingly, any legal obligations arise from the legislative rule being construed and not from the interpretation. However, the Board also recognizes that the

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scope of "indirect security" as used in the margin regulation is not, as the Board has made clear (see 12 C.F.R. § 221.113(f)), capable of precise definition in every situation. While, as explained above, the Board believes that based on past interpretations of that term the public should have been aware, prior to this action, that at least in some cases purpose credit extended to a shell acquisition vehicle could reasonably be viewed as indirectly secured by margin stock, it is possible that some parties could have in good faith relied on a different construction of the term as applied in acquisitions situations. The Board is of the view that a subsequent agency interpretation clarifying the scope of a potentially ambiguous regulation should not be applied retroactively to parties that were unaware of the Board's constructions of the regulation prior to the agency interpretation. Accordingly, in the Board's view the interpretation adopted today does not apply to written contracts to extend credit entered into prior to this date, January 8, 1986.[29/]

29/ The interpretation does not apply to financing commitments entered into prior to today, if they are subject only to the usual contingencies and conditions typical in financing agreements. In addition, the GAF Corp. has requested that the Board exclude from the interpretation any acquisitions by a company that held 5 percent or more of the target company's stock on the effective date of the interpretation. The Board is of the opinion, however, that such a provision is inconsistent with an action that merely provides the Board's views on the scope of a regulatory provision.

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LIST OF SUBJECTS IN CFR PART 207 Credit, Margin Requirements, Reporting and Recordkeeping Requirements, Securities:

Pursuant to the Board's authority under Sections 7 and 23 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78g and w) the Board adopts the following interpretation and amends 12 CFR 207 by adding a new § 207.112 to read as follows:

§ 207.112--Purchase of Debt Securities to Finance Corporate Takeovers

(a) Petitions have been filed with the Board raising questions as to whether the margin requirements in Regulation G apply to two types of corporate acquisitions in which debt securities are issued to finance the acquisition of margin stock of a target company.

(b) In the first situation, the acquiring company, Company A, controls a shell corporation, that would make a tender offer for the stock of Company B, which is margin stock (as defined in section 207.2(i)). The shell corporation has virtually no operations, has no significant business function other than to acquire and hold the stock of Company B, and has substantially no assets other than the margin stock to be acquired. To finance the tender offer, the shell corporation would issue debt securities which, by their terms, would be unsecured. If the tender offer is successful, the shell corporation would seek to merge with Company B. However, the

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tender offer seeks to acquire fewer shares of Company B than is necessary under state law to effect a "short form" merger with Company B, which could be consummated without the approval of shareholders or the board of directors of Company B.

(c) The purchase of the debt securities issued by the shell corporation to finance the acquisition clearly involves "purpose credit" (as defined in section 207.2(l)). In addition, such debt securities would be purchased only by sophisticated investors in very large minimum denominations, so that the purchasers may be "lenders" for purposes of Regulation G. See 12 C.F.R. § 207.2(h). Since the debt securities contain no direct security agreement involving the margin stock, applicability of the lending restrictions of the Regulation turns on whether the arrangement constitutes an extension of credit that is secured indirectly by margin stock.

(d) As the Board has recognized, "indirect security" can encompass a wide variety of arrangements between lenders and borrowers with respect to margin stock collateral that serve to protect the lenders' interest in assuring that a credit is repaid where the lenders do not have a conventional direct security interest in the collateral. See 12 C.F.R. § 221.113. However, credit is not indirectly secured by margin stock if the lender in good faith has not relied on the margin stock as collateral in extending or maintaining credit. See 12 C.F.R. § 207.2(f)(2)(iv).

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(e) The Board is of the view that, in the situation described in (b) above, the debt securities would be presumed to be indirectly secured by the margin stock to be acquired by the shell acquisition vehicle. The staff has previously expressed the view that nominally unsecured credit extended to an investment company, a substantial portion of whose assets consist of margin stock, is indirectly secured by the margin stock. See Federal Reserve Regulatory Service ¶ 5-917.12. This opinion notes that the investment company has substantially no assets other than margin stock to support indebtedness and thus credit could not be extended to such a company in good faith without reliance on the margin stock as collateral.

(f) The Board believes that this rationale applies to the debt securities issued by the shell corporation described above. At the time the debt securities are issued, the shell corporation has substantially no assets to support the credit other than the margin stock that it has acquired or intends to acquire and has no significant business function other than to hold the stock of the target company in order to facilitate the acquisition. Moreover, it is possible that the shell may hold the margin stock for a significant and indefinite period of time, if defensive measures by the target prevent consummation of the acquisition. Because of the difficulty in predicting the outcome of a contested takeover at the time that credit is

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committed to the shell corporation, the Board believes that the purchasers of the debt securities could not, in good faith, lend without reliance on the margin stock as collateral. The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow. This presumption would also not apply if there is a merger agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities or in any event before loan funds are advanced. In addition, the presumption would not apply if the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without the approval of either the shareholders or directors of the target company. In these two situations where the merger will take place promptly, the Board believes the lenders could reasonably be presumed to be relying on the assets of the target for repayment.

(g) In addition, the Board is of the view that the debt securities described in paragraph (b) above are indirectly

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secured by margin stock because there is a practical restriction on the ability of the shell corporation to dispose of the margin stock of the target company. "Indirectly secured" is defined in section 207.2(f) of the regulation to include any arrangement under which the customer's right or ability to sell, pledge, or otherwise dispose of margin stock owned by the customer is in any way restricted while the credit remains outstanding. The purchasers of the debt securities issued by a shell corporation to finance a takeover attempt clearly understand that the shell corporation intends to acquire the margin stock of the target company in order to effect the acquisition of that company. This understanding represents a practical restriction on the ability of the shell corporation to dispose of the target's margin stock and to acquire other assets with the proceeds of the credit.

(h) In the second situation, Company C, an operating company with substantial assets or cash flow, seeks to acquire Company D, which is significantly larger than Company C. Company C establishes a shell corporation that together with Company C makes a tender offer for the shares of Company D, which is margin stock. To finance the tender offer, the shell corporation would obtain a bank loan that complies with the margin lending restrictions of Regulation U and Company C would issue debt securities that would not be directly secured by any margin stock. The Board is of the opinion that these debt

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securities should not be presumed to be indirectly secured by the margin stock of Company D, since, as an operating business, Company C has substantial assets or cash flow without regard to the margin stock of Company D. Any presumption would not be appropriate because the purchasers of the debt securities may be relying on assets other than margin stock of Company D for repayment of the credit.

Board of Governors of the Federal Reserve System, January _, 1986.

William W. Wiles
Secretary of the Board

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December 31, 1985

TO: Board of Governors SUBJECT: Summary of Comments

FROM: Division of Banking Supervision and Regulation
Legal Division

The full summary of comments, which we noted was in preparation in our memorandum to the Board of December 27, has now been completed and is enclosed. The memorandum summarizes, in categories related to the major issues raised, the 87 comments received from the public.

Also as mentioned in the December 27 memorandum, a staff analysis of the issues, together with a draft Federal Register Notice, will be distributed to Board members on Friday, January 3.

Enclosure

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DRAFT

SUMMARY OF COMMENTS

PROPOSED INTERPRETATION OF
REGULATION G

DOCKET NO. R-0562

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NUMBER AND NATURE OF COMMENTS

As of the close of the comment period, there were a total of 87 public comments. More than half of the comments were strongly supportive of the proposal, and reflected the views of a broad spectrum of society, including 25 members of Congress, a number of small investors, Salomon Brothers, the National Association of Manufacturers, the AFL-CIO, the Business Roundtable, stock market professionals, brokerage firms, and large and small corporations (e.g. Phillips Petroleum, Unocal Corporation, Champion International Corporation, Universal Foods Corporation, Apache Corporation and Control Data). These commenters favored the proposed interpretation for a number of reasons, including (1) its probable effect of protecting small investors by discouraging risky investments by pension funds and other trustees, (2) its help in restoring integrity in the nation's financial markets, and (3) its effect as a curb on speculation and the excessive use of debt for speculative purposes.

Generally unfavorable comments were received from Drexel Burnham Lambert, the Department of Justice, and the Securities and Exchange Commission, as well as from corporations currently engaged in takeover attempts, securities firms, and academics. These comments reflected concerns with respect to whether the Board had followed the proper procedure in issuing the proposed interpretation and took issue with the Board's public policy views on acquisition financing.

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Some comments were neutral in nature, as they merely requested guidance with respect to the applicability of the proposed interpretation to specific fact situations.

The comments, both pro and con, addressed issues in the following general areas:

(1) The policy implications of the proposed interpretation;

(2) Whether the proposed interpretation has any basis in fact; whether it is consistent with the purposes of margin regulation; whether it is consistent with prior Board and staff rulings; and whether it would put the Board in an unprecedented regulatory role;

(3) Whether the Board had complied with the Administrative Procedure Act in proposing the interpretation;

(4) Whether certain situations and transactions would be covered by the proposed interpretation; and

(5) What transactions would be covered by the grandfather provisions of the proposed interpretation.

A list of the commenters begins on page 41 of this memorandum.

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I. POLICY ISSUES

The Board received comments from a broad spectrum of the public in support of its proposed interpretation. These commenters included a number of private investors, the National Association of Manufacturers, the AFL-CIO, 25 members of Congress, market professionals, the Business Roundtable, brokerage firms, and large and small corporations. From a policy standpoint, supporters of the proposal argued that (1) it is a much needed step toward ensuring the integrity of the nation's financial markets; (2) it will help "cool off" the speculation that has given constructive corporate acquisitions a bad name; (3) it will discourage risky investments by pension funds, bank trust departments and insurance companies and therefore protect the small investor; and (4) it will curb the excessive use of corporate debt. Twelve members of the House Banking Committee fully support the proposed interpretation. They believe the recent wave of junk bond financing has diverted capital from productive uses. The Congressmen are also concerned about the increasing rate of debt growth--the amount of low grade bonds has increased from $37 billion in 1983 to well over $100 billion in 1985. The members believe that in order to ward off possible suitors, many corporations are taking on additional debt that they would otherwise shun, thus creating a disturbing trend in corporate finance.

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The Justice Department and Federal Trade Commission (FTC) argue that the proposed interpretation will increase time, legal, and financing costs associated with corporate takeovers, and that the Board has failed to identify any benefits to be derived from adopting the interpretation. The Justice Department, the FTC, and Drexel Burnham Lambert (DBL) also argue that corporate takeovers are desirable and serve economically useful purposes. The Justice Department states that competition for corporate control, like other areas of competition, yields net social benefits. Other commenters have noted that these benefits include increased stock prices for shareholders and more efficient utilization of corporate resources. The FTC notes that 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.

Other commenters believe that corporate takeovers detract from a strong economic system. A number of commenters expressing support for the proposed interpretation discussed negative factors associated with corporate takeovers.

The Business Roundtable objects to accumulated debt financing because the high debt service costs associated with such financing affects managements' ability to compete by causing management to operate in a risk adverse manner;

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furthermore, the Business Roundtable argues that the accumulation of debt increases the probability of business failure, as did a number of other commenters who objected to the substitution of debt for equity on the balance sheets of an ever-increasing number of corporations.

The Apache Corporation noted that the increased use of debt financing is unfair to existing debt holders because credit impairment results in lowered credit ratings, lowered debt prices, and greater risks. On the other hand, the FTC argues that: "Actual bankruptcies are much more likely to be due to operational inefficiency which, ironically, implementation of the proposed interpretation encourages."

The AFL-CIO notes that corporate takeovers are not necessarily done for productive purposes; in certain instances corporate takeovers can be motivated by persons seeking net operating loss credits rather than productive capacity. The AFL-CIO and others noted instances where corporations have endangered themselves by issuing debt in the course of fighting off hostile tender offers. Finally, the AFL-CIO argues that new jobs are rarely, if ever, created by takeovers and notes that historically, many businesses are dismantled after being acquired.

Furthermore, the National Association of Manufacturers and Dillion, Read & Co., Inc. both expressed concerns about the potential negative effects of excessive leverage in the

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securities markets. The National Association of Manufacturers argues that the interpretation is necessary to ensure that securities markets are not subject to abrupt distortions because of excessive leverage in stock transactions.

Shearson/Lehman American Express noted that leveraged buyouts are beneficial, but hostile takeovers are not. Accordingly, Shearson/Lehman and others recommended that the interpretation should not apply to director and management supported leveraged buyouts. Shearson argues that in such cases, there is little risk that the shell will be holding margin stock for an indefinite period of time and more reliance will be placed upon the assets of the corporation to be acquired. Merrill Lynch also made this recommendation.

Some proponents of the interpretation see the diminished ability of smaller corporations to acquire larger corporations as a positive benefit. The Phillips Petroleum Company views hostile takeovers as an abusive practice by corporate raiders in that the high amount of leverage employed allows them to operate with little or none of their capital at risk.

Some commenters took issue with the premise upon which the interpretation is based, i.e., lenders rely on the stock held by a shell corporation containing no other assets and established solely for the purpose of obtaining control of a target corporation. The Department of Justice and DBL argue that purchasers of debt securities rely upon the cash flow and assets of the combined companies for repayment--not upon the

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stock of the company to be acquired. Furthermore, it is argued that lenders make their decisions based upon an assessment of the underlying assets, cash flow and likelihood that the proposed acquisition will be consummated.

On the other hand, many of the commenters who favor the interpretation express agreement with the Board's reasoning that investors purchasing debt securities issued by a shell corporation do in fact indirectly rely upon the only assets of the corporation, i.e., margin stock.

The Alliance for Capital Access (ACA) maintains that adoption of the interpretation could discriminate against smaller companies in raising funds for growth and acquisition. The ACA stated that when its members seek to go through friendly acquisitions, they spend weeks working very carefully with the management of the company to be acquired arranging the terms of the transaction and the financing. If the interpretation requires an offeror to file with the Federal Reserve for an opinion that the acquisition is not indirectly secured by margin stock, the delay in ACA's view could expose the companies in question to hostile bids by much larger companies that could raised money much more easily and avoid Regulation G. Finally, ACA notes that many investors in its members' debt securities are institutions with fiduciary responsibilities; there is a fear that if these investor institutions have any uncertainty as to whether purchasing such bonds would result in legal violations, the investors would choose not to invest.

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II. ALLEGATIONS THAT THE INTERPRETATIVE RULE HAS NO BASIS IN FACT, IS CONTRARY TO THE PURPOSES OF MARGIN REGULATION, IS INCONSISTENT WITH PAST RULINGS, AND PUTS THE SYSTEM IN AN UNPRECEDENTED REGULATORY ROLE

(a) Factual basis for finding that lenders are looking to the stock rather than assets of the target

Regulation G applies to credit extended for the purpose of purchasing or carrying margin stock ("purpose credit") if the credit is secured, directly or indirectly, by margin stock.

The law firm of Sullivan & Cromwell agreed with the Board's position that there was a basis in fact for finding that lenders are looking to the stock of the target for repayment. Sullivan & Cromwell supported this contentions by citing the case of GAF's current attempt to acquire Union Carbide, in which there is no question that holders of GAF notes (junk bonds) will look to Union Carbide common shares (margin stock) for repayment. This reliance on Union Carbide's shares, in Sullivan & Cromwell's view, constitutes "indirect security" under the margin regulations.

Dillon, Read believes that from a practical standpoint, so called "junk takeover bonds" are indirectly secured by the stock of the target corporation.

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The Unocal Corporation stated that by recognizing that economic reality determines whether a junk bond loan is "indirectly secured" within the meaning of Regulation G and by presuming that the margin rules apply to junk bonds issued by a shell corporation, the Board has taken a big step toward putting an end to the evils engendered by the current junk bond financed takeover craze. Those evils - the creation and fostering of speculative fever in the stock markets, the diversion of credit from productive uses, and the growing trend toward dangerous over-leveraging by American corporations - are in Unocal's view, the very evils that the margin provisions of the Securities Exchange Act were designed to prevent; and by requiring takeover attempts to be financed with more equity and less debt, the Board's interpretation will make it that much more likely that takeover contests will be decided on their economic merits.

Twelve members of the U.S. House of Representatives stated that it clearly strains credibility to argue that junk bond lenders are not relying on the target company's stock as the primary source of repayment, since the issuer's assets, net worth and income could not possibly support the debt incurred.

In opposing the Board's proposed interpretation, some commenters argued that purpose credit used to effect corporate acquisitions through the vehicle of junk bonds is not indirectly secured by the underlying assets of the target corporation. A finding of such indirect security is the basis for the Board's

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applying Regulation G to junk bond financings. The commenters believe that the purchasers of typical junk bonds are not looking to the margin stock of the company to be acquired as the source of repayment, but rather to the assets and earning power of the target once the merger is consummated. (See letters from Professor E. Allen Jacobs, MIT Sloan School of Management; Thomas H. Lee Company; Kellner DiLeo Partnership, Members, NYSE; Cohen Feit & Co; Caronan Partners; the SEC; Drexel Burnham Lambert; Hyponex Corporation; Rosencranz & Company; EF Hutton; Farley/Northwest Industries, Inc.). Merrill Lynch and others argued that the proposed interpretation would undermine the so called "good faith" exception to a finding of indirect security insofar as it would establish a negative presumption to the effect that credit extended to a shell corporation to purchase margin stock would be viewed as a covered transaction under Regulation G.

The Department of Justice believes the concern over stock-secured credit that lies at the heart of Regulation G is inapplicable to acquisition financing in that firms engaged in takeovers are really looking toward acquisition of the target company's assets, not its stock.

Related to this issue is Justice's concern that the proposed interpretation would create uncertainty and thereby impose substantial costs on all acquiring firms. Under the Board's proposed interpretation, a purpose credit will be deemed indirectly secured by margin stock if "at the time the debt

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securities are issued, the shell corporation has substantially no assets to support the credit other than the margin stock that it has acquired ... and has no significant business function other than to hold the stock of the target company in order to facilitate the acquisition." The Justice Department believes this language will cause uncertainty if the shell corporation has some other assets or some other business functions. It also asks how one would determine whether those assets are "substantial" or the business functions "significant." Other examples of uncertainty pointed out by Justice relate to what constitutes "specific evidence" which would rebut the presumption that junk bond credit is indirectly secured by margin stock. Justice believes that one of the most significant unresolved questions is whether the Board proposes to apply Regulation G to operating companies on the basis of fixed ratios of debt to income or asset value, and if so, what those ratios are. If ratios are not proposed, Justice asks if the Board will use other standards. Justice believes that the business community must be informed of the Board's position on these issues prior to implementation if the market for corporate control is to function in an efficient manner.

The Securities and Exchange Commission questioned the appropriateness of the proposed interpretation's presumption that those who lend to acquirors in fact look to the stock of the target as collateral. In the SEC's view, lenders may actually be looking to the assets of the company to be acquired for security,

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rather than to its stock. The Commission believes this issue warrants further analysis.

(b) Reconciling the interpretation with prior staff opinions.

The law firm of Sullivan & Cromwell believes the proposed interpretation is entirely consistent with the prior Board and staff views in the analogous situation of loans to investment companies which were found to be indirectly secured by margin stock since the only assets of an investment company, like those of a shell corporation, are the shares of stock which it owns.

Midcon Corporation also believes the proposed interpretation in consistent with past interpretations. Midcon states that the Board has repeatedly held that loans are "indirectly secured" by margin stock if credit is extended to a shell corporation which holds securities and nothing else. In Midcon's view, the proposed interpretations should come as a surprise to no one in light of the Board's prior stance, the published views of practitioners, and court decisions to the effect that loans can be indirectly secured by stock without the presence of any traditional security interest. Since the Board's release simply reiterates past law on this subject, Midcon contends that it is impossible to accuse the Board of fashioning a new and unforseen legal standard.

Some commenters believe that the proposed interpretation is contrary to prior staff opinions. (Merrill Lynch; Kellner DiLeo;

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Caronan Partners; the SEC; Drexel Burnham Lambert; the Department of Justice) These commenters generally state that the Board's proposed interpretation ignores the administrative precedent established by prior staff rulings which appear to conclude there is no indirect security involved in junk bond financing. Drexel Burnham Lambert (Drexel) believes that prior Board staff letters reached the conclusion that loans to shell corporations would not be indirectly secured by margin stock within the meaning of Regulation G and that the margin requirement was inapplicable. Drexel states that the basis of these letters and opinions is that a shell corporation organized to facilitate the acquisition of another company resembles a holding company, which the Board has concluded is not presumptively subject to margin rules because the purchaser owns the stock of the target with a view to operating a going concern. In Drexel's view, this "holding company" model has been distinguished from the "investment company" model upon which the Board has relied in its proposed interpretation. Drexel believes that the Board's reliance on the investment company model as a basis for its rationale rather than the holding company model relied upon previously in several opinions cited by Drexel is inappropriate.

<u>The Department of Justice</u> believes the proposed interpretation constitutes an arbitrary rejection of prior staff rulings which, among other things, hold the view that purchasers of debt securities in public distributions are not "lenders"

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within the meaning of Regulation G. In this regard, Justice points to recent litigation in which a court, relying on prior Board staff interpretations, ruled that public debt offerings are "exempt" from Regulation G, basing its ruling on prior Board staff interpretations. Justice believes the proposed interpretation's apparent "reversal" of such precedent reflects a fundamental shift that the Board should have afforded the lengthier notice and comment period provided for in the Administrative Procedure Act for formal rulemaking.

The Justice Department also believes that the proposed interpretation is inconsistent with the Board staff's prior opinions indicating that debt offerings of shell corporations formed to effectuate takeovers are not directly or indirectly secured by margin stock in the absence of agreements legally restricting the borrower's right to dispose of the stock.

(c) Reconciling the interpretation with the purposes and intent of the Board's margin authority

Some commenters argued that the proposed interpretation is contrary to the purpose and intent of section 7 of the Securities Exchange Act of 1934, which gives the Board authority to promulgate the margin regulations. (Kellner DiLeo; City Capital Corporation; EF Hutton; Department of Justice; and Federal Trade Commission). Generally, these commenters believe that the

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application of the margin rules to tender offers for public companies do not carry out the purposes of Congress in enacting Section 7, which were to curb speculation in the stock markets and to prevent the destabilization of stock prices.

The law firm of Sullivan & Cromwell believes that the relevant question is not whether the margin regulations should be used to regulate takeovers. Rather, the question is whether a transaction which subverts the basic purpose of the margin regulations should nonetheless be exempt merely because it involves a takeover. Sullivan & Cromwell recognizes that the Board has recently considered its continuing role the area of margin regulation and whether the regulations are necessary to effectuate the purposes for which they were originally implemented. Sullivan & Cromwell believes, however, that until the Board determines to change the overall scope of the regulations, they must apply equally to all transactions covered by their terms. The law firm noted that the broad issue of the general usefulness of the margin regulations was raised by the Board at a time when relatively limited debt was being used to finance stock purchases and prudent business considerations constrained its use and that the situation has changed drastically within the last 18 months, as billions of dollars of debt are pouring into the market to finance takeover transactions.

City Capital Corporation argues that the margin rules were enacted to protect unsophisticated investors and the securities

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markets from excessive speculation and that any attempt to graft an anti-takeover purpose onto what is principally a retail credit provision should be approached with substantially more study and input from the business community.

EF Hutton pointed out that in his January 11, 1985 letter to Members of Congress, Chairman Volcker identified the three primary objectives of the margin rules; i.e., to constrain the diversion of credit into stock market speculation from uses in commerce, industry and agriculture; to protect unsophisticated investors; and to forestall excessive price fluctuations in the stock market. Hutton believes the Board's proposal accomplishes none of these objectives, since the credit extended by purchasers of junk bonds is not used for speculative purposes, but for effecting business combinations. In addition, Hutton points out that junk bond purchasers are extremely sophisticated investors, capable of judging credit risks without the help of the Board.

Drexel Burnham Lambert argues that the proposed interpretation is an unwarranted expansion of the Board's margin authority and that it encroaches on other Congressional prerogatives, namely the Williams Act and the Hart-Scott-Rodino Act. Drexel points out that the Williams Act was adopted by Congress to insure that investors faced with tender offers and other substantial acquisitions of securities would receive full and fair disclosure of all facts necessary to make informed investment decisions. Drexel stated that Congress plainly intended the

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disclosure provision of the Williams Act to provide a neutral scheme that favored neither the offeror nor incumbent management of the target company. Drexel also argues that the Hart-Scott-Rodino Antitrust Improvements Act of 1976, which requires advance notification to the FTC of substantial stock acquisitions, also expresses a Congressional desire for neutrality in takeover bids. Drexel believes that the Board's proposed interpretation would frustrate this neutrality because in Drexel's view, the interpretation would assist target companies by eliminating tender offers financed by acquisition subsidiaries' issuance of debt and would also tend to favor inefficient incumbent management.

Midcon, on the other hand, stated that the Williams Act expresses a federal policy of "neutrality" toward tender offers -- not an affirmative preference for tender offers that overrides other federal statutory policies.

The Department of Justice believes the proposed interpretation is an ineffective means of serving any of the concerns at which Congress directed Section 7 of the Securities Exchange Act of 1934. Justice believes that unless the Board can relate is proposed view of acquisitions by operating companies to the Congressional concerns that underlie Section 7, it is not clear that Section 7 gives the Board the authority to impose margin requirements on the basis of its evaluation of the financing arrangements with respect to individual acquisitions.

Justice cited the findings of a recent Board staff study on the margin regulations indicating that the rules were not

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effective or necessary to meet the objectives of the legislation. In light of this study, Justice believes it would be anomalous for the Board to assert that expanding the scope of its margin requirements meets those Congressional concerns. Justice believes that in any event, the Board could not assert such a public benefit from its proposed expansion of Regulation G unless there is evidence that the transactions covered by its proposal were diverting credit into stock market speculation and away from investment in commerce, industry or agriculture, harming unsophisticated investors, or creating excessive price fluctuations in the stock market. Justice is unaware of the existence of any such evidence, does not believe the Board's notice addresses such concerns and points to Chairman Volcker's January 11, 1985, letter to Members of Congress as a measure which undercuts any reliance on these effects.

The Federal Trade Commission believes the purpose of the margin requirements is not to protect borrowers against imprudently taking on too much debt, but to protect lenders, primarily banks and other financial institutions, against the risk of customer default. The FTC believes that in the case of corporate debt, there would appear to be no basis for concern about the magnitude of the default risk assumed by an individual lender. The FTC stated that if the proposed interpretation is designed to protect individual borrower firms against imprudently assuming too much default risk as a consequence of "excessive" leverage, it appears to be an unprecedented and ill-conceived departure from what the FTC views as the traditional focus of

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margin requirements -- the maintenance of lender solvency. The FTC believes the best judge of the level of debt a given company should be permitted to incur is the credit market, not the Board. The FTC does not believe governmental interference with credit markets is warranted in the area of corporate acquisitions.

(d) The effect of the interpretation on the Board's regulatory role

Thirteen United States Senators expressed their view that it is entirely appropriate to subject junk bond financing to the Board's margin requirements. (See joint letter from Senators Domenici, Dodd, Dixon, Stafford, Ford, Murkowski, Proxmire, Eagleton, Weicker, Boren, Sarbanes, and Nickles, December 20, 1985, a letter from Senator Gorton and a joint letter from twelve Members of the House Banking Committee, December 23, 1985). The Senators were concerned, however, that the Board's proposed interpretation may not be explicit enough. In the Senators' view, the Board's interpretation should not be circumvented merely by the parent of the shell corporation guaranteeing the junk bonds or by issuing the junk bonds directly when the stock to be acquired is relied upon as security by the holders of the junk bonds. The Senators suggested that the Board make this point very clear when it adopts the interpretation. The Senators pointed out that the Congress has delegated to the Board the authority and the responsibility to adopt and interpret the margin rules and that until and unless the statutory basis for the rules is altered by the Congress, or the text of the rules is

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changed in a procedurally proper way by the Board, the existing margin rules remain in effect, and the Board must interpret and apply them in accordance with their terms and purposes. In their view, it would be an abdication of the Board's statutory and regulatory responsibility to fail to adopt the proposed interpretation.

Midcon rejects the assertion that the proposed interpretation will embroil the Board in complex factual questions and encumber the tender offer process. The legal principles applicable to shell companies are, in Midcon's view, the same legal principles which the Board has applied for decades in closely related contexts. Midcon believes there is no basis for concern over the definition of "shell corporation" A corporation that has no sbustantial assets or earnings of its own, and which can obtain credit <u>only</u> by virtue of the margin stock which it seeks to acquire, is the focus of the Board's interpretation. The standard applicable to "operating companies" is the same standard which now appears in 12 C.F.R. 207.2(f)(i), and could not engender any litigation complexities not already present in the law.

Beyond this, Midcon asserts that there is no need for either the Board or the SEC to serve as the arbiter of the application of the margin regulations in doubtful cases. Midcon suggested a private implied right of action will permit parties to seek injunctive relief in court in cases involving genuine disputes over the applicability of the margin requirements. And

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from time to time, as it has done for decades, the Board may continue to issue interpretative releases as they prove to be necessary to illuminate recurring legal questions.

Other comments were received to the effect that the proposed interpretation would result in the Board's assuming an unprecedented regulatory role in the area of corporate acquisitions. (Fred S. McChesney, Associate Professor, Emory University School of Law; Carl L. Reisner, Esquire; Mesa Petroleum; Drexel Burnham Lambert; Alliance for Capital Access). These commenters generally expressed the opinion that the adoption of the proposed interpretation would cause the Board to involve itself in a new area of regulation where it does not belong. Carl L. Reisner is concerned about the Board's apparent case-by-case approach to regulation in this area and the lack of any concrete guidance about the circumstances in which Regulation G will apply. He believes that such an approach will lead to legal uncertainty which lenders and borrowers should not have to face in large transactions. Mr. Reisner believes that the Board will find itself increasingly drawn into contested takeover battles if the proposed interpretation is adopted and that the case-by-case approach will invite the possibility of disparate treatment and increased transaction costs.

Fred S. McChesney does not feel it necessary for the Board to move into an area which he believes is outside its expertise, and an area that is already scrutinized closely by the SEC.

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<u>The Department of Justice</u> believes the proposed interpretation constitutes a substantial change in Regulation G's application and would "drastically" expand the Board's power and add a new intrusive layer of regulation to the market for corporate control regardless of whether transactions are 'friendly' or 'hostile'." It appears to Justice that the Board contemplates playing an active role, on a case-by-case, in reviewing the financing of takeover transactions. Justice believes that as a result, the Board could be perceived as a regulator of takeovers, in which role it would decide which companies attempting to finance takeovers had "enough" assets other than margin securities to quality for exemption from Regulation G. Justice believes the Board interpretation would invite litigation by any party unhappy with the transaction and also have a chilling effect on extensions of credit.

<u>The Securities and Exchange Commission</u> believes the proposed interpretation creates uncertainties with respect to its application; i.e., what is a "shell" corporation, and what relevant "circumstances" and "specific evidence" will the Board consider in determining whether a lender has relied upon margin stock as collateral. In the Commission's view, these uncertainties could result in the Board's or the Commission's having to review a large number of acquisitions, at the request of either party in a takeover attempt. This review would focus on the "highly abstract" issue of whether the value of the company to be acquired could be argued to be the basis for the

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extension of credit or whether the securities or assets of that company are, in fact, the collateral. The Commission does not believe the Board intends to embroil itself in such controversies and is concerned that its own role as the enforcer to the margin regulations could be unduly complicated, and its ability to secure prompt and consistent remedies for violations frustrated.

(e) Other Issues

(i) Exemption for Short-Form Mergers

The Committee on Securities Regulation of the Association of the Bar of the City of New York believes that the proposed interpretation should exempt from its terms those transactions involving so-called "short form mergers" since lenders typically would not be relying on the stock of the target for repayment. State corporation laws generally contain provisions permitting a corporation owning a requisite percentage of the shares (usually 90%) of another corporation to merge the latter with the parent corporation without any action by the board of directors or shareholders of the owned corporation. The Committee believes that a lender extending credit to finance a tender offer that is conditioned on receipt of the percentage of shares of the target corporation required under state law to permit the acquiring corporation to cause a merger could in good faith rely on the assets and earnings of the target as support for the credit.

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(ii) <u>The Proposed Interpretation Does Not Apply to Foreign Borrowers Who Use Foreign Credit Sources, and Therefore Provides Them with an Advantage Over U.S. Persons Subject to the Margin Requirements</u>

Several commenters pointed out that because the margin regulations do not apply to foreigners who borrow from non-U.S. sources, the proposed interpretation would effectively provide such persons with an advantage over U.S. bidders, (Drexel Burnham Lambert; the SEC; Department of Justice; Rosencranz & Company; Hyponex Corporation; Caronan Partners; Merrill Lynch). The commenters are concerned that the interpretation could result in an increase in foreign ownership of domestic companies, and discriminate against potential domestic acquirors who would otherwise issue junk bonds to finance corporate acquisitions.

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III. PROCEDURAL ISSUES

(a) Overview

Less than a third of the letters commented on the Board's procedures for adopting the proposed interpretation, including comments submitted by the Department of Justice, the Securities and Exchange Commission and Drexel Burnham. A significant number of commenters (25 members of Congress, the law firm of Sullivan & Cromwell, Midcon Corporation, and Dillion, Read & Co.) believe that, as a procedural matter, the Board acted properly in issuing its proposed interpretation. Eight letters (including the Department of Justice, Drexel Burnham and GAF Corp.) suggest that the Board's proposed interpretation represents a change in law or policy which requires the Board to act under the rulemaking procedures of the Administrative Procedure Act ("APA"). Eleven letters (including the Securities and Exchange Commission and the Commodity Futures Trading Commission) comment that the proposal raises complex and important issues and, as a policy matter, suggest the advisability of extended notice and comment procedures to permit additional time for public comments as well as additional time for the Board to consider the issues raised by the comments.

(b) The Administrative Procedure Act (APA)

The law firm of Sullivan & Cromwell stated that the proposed interpretation does not represent a change in the law, but merely clarifies that debt securities issued by a shell

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corporation are indirectly secured. Sullivan & Cromwell indicated that as such, an interpretation is the proper administrative approach.

MidCon Corp., a corporation that is the target of a hostile tender offer that would be financed with junk bonds, comments that the Board's clarification of Regulation G should be "promptly finalized." Midcon points out that the Administrative Procedure Act (APA) makes clear that the notice and comment provisions do not apply to interpretive rules such as the Board's proposed clarification of Regulation G. Midcon stated that at any rate, the Board has had the full benefit of public comment on its proposed interpretation because it has received literally hundreds of pages of analysis from both supporters and opponents of the interpretation. Under these circumstances, Midcon believes that there is no basis for contending that the Board has acted without considering the views of interested members of the public.

The Department of Justice concludes that the Board's proposal is legislative rather than interpretative, and that the APA notice and comment procedures must be followed, which would require an extension of the comment period for the Board's proposal. The Justice Department acknowledges that interpretative rules are exempt from the APA notice and comment procedures, but disagrees that the Board's proposal is only an interpretation of the existing regulation. The Justice Department believes that the interpretation effects a change in

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the existing legislative rule and, therefore, is itself a legislative rule. The Department of Justice raises three points to demonstrate that the Board's proposal expands and changes the existing legislative regulation and, therefore, must be adopted in compliance with the APA requirements.

First, the Department of Justice notes that Regulation G would become applicable, under certain circumstances, to publicly offered debt securities. The Department of Justice concludes that a consistent series of Federal Reserve Board staff opinions have stated that purchasers of publicly offered debt securities are not "lenders" within the meaning of Regulation G. In addition, the Department of Justice notes that recently, the Federal District Court in Delaware relied on the staff opinions in ruling that public debt offerings are "exempt" from Regulation G.[1/]

Second, the Department of Justice notes that the proposed interpretation would also effect a substantive change in the regulation's existing definition of "indirectly secured." The Department of Justice asserts that, presently, the regulation provides that a loan is indirectly secured <u>only</u> if the loan agreement includes some legal restriction impairing the borrower's rights as owner of the stock. The Justice

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1/ <u>Revlon, Inc. v. Pantry Pride, Inc.</u>, Fed. Sec. L. Rep. (CCH) ¶ 92,348 (D. Del. 1985).

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Department concludes that the new interpretation proposes a new test--whether there is a practical restriction upon the ability of the shell corporation to dispose of the margin stock of the target company. The Department of Justice concludes that the proposed rule would extend the coverage of Regulation G and would constitute an abrupt, substantive change in the well-established policy governing the use of debt securities in takeovers.

Third, the Department of Justice notes that the extension of Regulation G to debt securities issued by operating companies on a case-by-case basis would be a substantial change in the application of Regulation G. The Department of Justice states that the Board seems to be asserting the right to engage in ad hoc review of debt-financed acquisitions by operating companies and concludes that this aspect of the Board's proposal does not merely "clarify" existing law, but instead adds a new intrusive layer of regulation to the market for corporate control and drastically expands the Board's power.

(c) Public policy considerations

Dillion, Read & Co., Inc., believes that because the interpretation is carefully crafted to deal with a specific abuse, it is unlikely to have significant unanticipated consequences, as claimed by opponents of the proposal. Twelve United States Senators and twelve members of the U.S. House of Representatives suggested that the Board is compelled to issue

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the proposed interpretation until and unless the statutory basis for the margin rules is altered by Congress and that the proposed interpretation is merely a lawful exercise of authority delegated to the Board. A number of commenters suggest that sound public policy dictates that the Board allow significantly longer periods for the submission of comments and for consideration by the Board of the comments submitted. For example, the Securities and Exchange Commission suggests that, at a minimum, the proposed interpretation should be republished to provide adequate time for careful consideration and review of the implications of the proposal. The Commission states that the 17-day comment period has been inadequate, for example, to assure that the interpretation will not have any unanticipated effects. The SEC also notes that the proposal raises complex factual issues, for example: whether it is appropriate to presume that the purchasers of the debt securities in fact look to the stock of the company to be acquired as collateral; and whether there are any practical restrictions on the shell's ability to dispose of the stock. The SEC suggests that these questions and others require further study which could not be done within the proposal's existing comment period. Also, the Commission notes that the proposal could have a number of substantial economic consequences that have not been adequately explored.

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Similarly, the Commodity Futures Trading Commission comments that it has not had time to study the Board's proposal in detail. The CFTC seeks a thirty-day extension of the comment period so that the Commission will have the opportunity to consider the proposal.

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IV. COVERAGE OF THE PROPOSED INTERPRETATION

(a) Applicability to banks (Reg U) and brokers (Reg T)

Alliance for Capital Access wants to know if the Board will tolerate an acquiring company's arranging for a shell company to borrow 50% of the acquisition funds from Regulation G lenders, pledging to them all of the acquired stock, while borrowing the balance of the acquisition funds from banks on an ostensibly unsecured basis.

Drexel Burnham Lambert says the interpretation fails to identify how it will affect the interrelationship of Regulation G with Regulations T and U. If the interpretation applies to T, will the public/private offering distinction remain? Will broker-dealers be precluded from dealing in public debt securities?

The California Bankers Association is concerned with the situation where a natural person, a customer of the commercial bank, applies for a loan for the purpose of purchasing junk bonds. CBA fears that inadvertent violations of Regulation U may occur.

Merrill Lynch expresses concerns that a broker-dealer involved in the various stages of each takeover attempt will have to determine whether its purchase or sale of the bonds might constitute an unlawful arrangement of credit in violation of Regulation T.

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(b) Applicability to friendly takeovers

Caronan Partners requests that the interpretation not apply to a friendly acquisition where there is a signed merger agreement that provides for a first-step tender offer.

Drexel Burnham Lambert says the interpretation will affect friendly takeovers ("virtually every acquisition involving the issuance of debt").

Farley/Northwest Industries opposes the Board's interpretation because of concerns that it will have an adverse effect upon companies involved in friendly transactions where tender offers are used.

The Thomas H. Lee Company states that companies engaged in the issuance of high-yield debt securities to finance acquisitions will be directly and significantly harmed by the Board's interpretation. The Board's interpretation is based on misconceptions. Investors purchase these securities because they will be financed by assets and earning power of the target. The high rate of interest merely reflects the new more highly leveraged capital structure.

Carl Reisner comments that the interpretation should be revised so that borrowing will not be deemed to be indirectly secured where an acquisition is made to facilitate a merger of the borrower and the issuer of the margin stock, even if this requires a two-step process.

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(c) <u>Applicability to one step mergers or leveraged buyouts</u>

<u>Caronan Partners</u> requests that the interpretation not apply to a hostile tender offer conditioned on acquiring sufficient control to force a merger under state law. <u>Caronan Partners</u> also asks for a clarification that the interpretation does not apply to the usual leveraged buy-out situation.

<u>E F Hutton</u> feels that leveraged buyouts could be severely restricted, as well as traditional methods of business combinations such as acquisition bv a newly formed subsidiary.

<u>Alliance for Capital Access</u> asks if the interpretation applies to leveraged buyouts.

<u>Carl Reisner</u> says the interpretation should not apply in one-step mergers. It should also not apply when the funding is conditioned on the borrower's obtaining sufficient voting power to effect the merger, and the borrower does obtain such power. In this case the lender is looking to assets, not stock.

<u>Merrill Lynch</u> questions whether one step tender offers are intended to be covered by the proposed interpretation. Depending upon the structure of a transaction, it is possible that the shell corporation formed to facilitate an acquisition would hold the stock of the target company for at least an instant. Technically, such transactions would be covered by the proposed interpretation.

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(d) When does the shell have substantially no assets other than margin stock?

Mesa Petroleum questions what is a shell corporation. Will a shell with a large dollar amount of equity contributed by a parent but no other operating assets fall under this new interpretation?

The Securities and Exchange Commission finds the shell corporation concept unduly broad and ill-defined. The SEC feels that income is not a relevant consideration and suggests a focus on assets and cash flow.

Drexel Burnham Lambert says this is a crucial question left unclear by the Board's proposal.

(e) Is an operating company a shell if the amount of debt dwarfs its size

City Capital Corporation finds this aspect to be the most dangerous. The fact that the Board hints at a case-by-case approach was said to benefit only entrenched management and their lawyers.

Drexel Burnham Lambert says the rule appears to apply if the target has substantial assets relative to the acquirer, and that the case by case approach is unsuitable in the market.

Unocal Corp. suggests that the interpretation be extended to cover junk bonds issued by or guaranteed by operating companies

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where the economic reality indicates that the bonds are indirectly secured by stock of the takeover target.

Merrill Lynch indicates that given the uncertainty as to what the Board regards as substantial, it is likely that the proposal will have an adverse effect upon the ability to structure transactions with the assurance that the margin regulations will not be applied.

(f) Can a partnership or an employee trust ever be a shell

Mr. Terry Larkin raises the question whether such a proposal would affect buyouts by employees of corporations.

(g) What is meant by a guaranty

Control Data Corporation states that the Board should interpret the regulation broadly so that speculators cannot easily evade it. Simply guaranteeing the junk bonds or putting modest assets into the shell should not necessarily be enough to avoid falling under the interpretation.

Phillips Petroleum Company comments that a guaranty of the shell corporation must be from a company whose size is substantial in relation to the size of the obligations being guaranteed.

Sullivan & Cromwell believes that a guaranty is inadequate if the amount of debt to be incurred exceeds the assets and

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exceeds the shareholders' equity by substantial multiples, and the debt service exceeds the previous year's net income by substantial multiples.

Cohen Feit & Co. wants to know circumstances other than a guaranty which will rebut the presumption that bonds are indirectly secured by margin stock.

Hogan & Hartson (on behalf of GAF) seeks clarification that the interpretation does not apply where the debt is issued or guaranteed by an operating company with substantial non-margin stock assets and earnings in spite of Paragraph (h) of the interpretation.

Alliance for Capital Access asks how a third-party guaranty or credit support of a shell company will be treated.

Mesa Petroleum asks if a guaranty by an operating subsidiary of the parent will suffice.

Gallagher and Beaumont suggests that the interpretation should specify the types of qualifying guarantee arrangements which would put the transaction outside the scope of the Regulation. For example, they queried whether a third-party guaranty from an insurer or other financial institution, procured by or on behalf of the parent, or which supports a direct guarantee from the parent, would suffice in putting the acquisition outside the Regulation.

(h) Guaranty by parent is itself a loan

13 U.S. Senators believe that the Board should make clear that if the target stock is being relied on in any way, a

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guaranty by the parent is not enough to avoid the interpretation, nor would having the parent issue the debt be sufficient.

(i) Applicability to debt securities traded in secondary market

Merrill Lynch suggests the Board consider the regulatory implications of secondary market transactions in such bonds before the takeover and merger of a target company are consummated. A purchaser in the secondary market might not have the disclosure documents required by the Securities Act of 1933. In addition, they question whether this secondary market transaction would constitute a transfer of credit within the meaning of 12 CFR Section 207.3(1).

(j) Other issues

The National Association of Manufacturers comments that in the case where a large percentage of stock continues to trade for some time after the tender offer, the risk of large liquidations causing a destabilizing effect on the stock is greater where the shell has little or no equity capital.

The Securities and Exchange Commission comments that Paragraph (h) of the interpretation suggests that the Board may extend the application of the shell margin rules to acquisition financing beyond the shell corporation situation without delineating the relevant circumstances.

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The Coddington Corporation is concerned about the effect on insurance companies. State regulations often prohibit insurance companies from incurring debt, necessitating a holding company structure. The holding company has only stock to pledge while other corporations can pledge assets and thus avoid the interpretation.

City Capital Corporation says the the fact that the stock of the target constitutes all of the assets of the acquirer immediately after a takeover is not relevant and cited to the Alaska Interstate case to show indirect security exists if the purpose credit lender is put in a preferred position ahead of other creditors with respect to the margin stock.

Irell & Manella thinks that Paragraph (h) was broader than other language that purports to limit the interpretation to situations involving a shell corporation.

Mr. Royal Little, founder of Textron Inc., is concerned with the applicability of this interpretation to entrepreneurial start ups.

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V. Grandfathering

Three comments addressed the statement in the notice of the proposed interpretation that if adopted, the interpretation would not apply to written contracts to extend credit entered into prior to the effective date of the interpretation. Union Carbide Corp. and Mid-Con Corp., both of which are currently subject to leveraged hostile teacher offers, stated that since the proposed action is an interpretation of an existing regulation not a new rule, it can only explain the meaning of existing law and cannot impose new objections or change the current law. These comments argue, therefore, that the interpretation, by merely clarifying existing law, would necessarily govern all financing arrangements, regardless of when entered into. Union Carbide further states that if the Board elects to retain the December 31 grandfather date, only financing contracts that are binding, unconditional and complete on that date should be viewed as grandfathered, in order to prevent attempts to initiate and complete highly leveraged takeover attempts prior to the announced effective date.

Finally, GAF Corporation, which is making the tender offer for Union Carbide, states that the grandfather provision should be revised to exclude all acquisitions in which the acquiring firm held 5 percent or more of the voting securities of the target company on the effective date of the interpretation. GAF notes that the recently enacted New York State anti-takeover law follows this

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approach in grandfathering takeover attempts, and would more effectively exclude acquisitions that were underway when the proposal was announced.

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ALPHABETICAL LIST OF COMMENTERS

No.	Commenter	Location
1.	AFL-CIO	(Washington, DC)
2.	Allen, John	(Oakland, NJ)
3.	Alliance for Capital Access	(Washington. DC)
4.	Anthony, Sarah J.	(Tulsa, OK)
5.	Apache Corporation	(Minneapolis, MN)
6.	Assoc. of the Bar of the City New York (Committee on Sec. Reg.)	(New York, NY)
7.	Baird, Chester A.	
8.	Bass, James K.	(Tulsa, OK)
9.	Berg, William H., Jr. (Mrs.)	(Verona, PA)
10.	Bicksler, James L. (Prof. of Finance, Rutgers Grad. Sch. of Business)	(Newark, NJ)
11.	Black, Kenneth N.	(Tulsa, OK)
12.	Business Roundtable	(New York, NY)
13.	California Bankers Association	(San Francisco, CA)
14.	Caronan Partners	(New York, NY)
15.	Champion International Corp.	(Stamford, CT)
16.	City Capital Corporation	(Los Angeles, CA)
17.	Coddington Corporation	(Newport, RI)
18.	Cohen Feit & Co.	(New York, NY)
19.	Commodity Futures Trading Comm.	(Washington, DC)
20.	Control Data Corporation	(Minneapolis, MN)
21.	Department of Justice	(Washington, DC)
22.	Dillon, Read & Co., Inc.	(New York, NY)
23.	Domke, Martin R.	(Carmel Valley, CA)
24.	Drexel Burnham Lambert	(New York, NY)
25.	Economics Laboratory, Inc.	(St. Paul, MN)
26.	Emrie, Debra E.	(Springfield, MO)
27.	Farley Industries	(Chicago, IL)
28.	Farley/Northwest Industries, Inc.	(Chicago, IL)
29.	Federal Trade Commission	(Washington, DC)
30.	1st Farmers & Merchants Nat'l Bank	(Columbia, TN)
31.	1st National Bank in Bartlesville	(Bartlesville, OK)
32.	Ford, Nancy M.	(Nashua, NH)
33.	French, M. R., Jr.	(Kingwood, TX)
34.	Fund For Stockowners Rights	(Vienna, VA)
35.	Gallagher & Beaumont	(Summit, NJ)
36.	Ginsberg, Barbara W.	(Denver, CO)
37.	Goldstein, Simeon H. F.	(New York, NY)
38.	Goodman, Irving	(Utica, NY)
39.	Hinds, Dan H., Jr.	(Houston, TX)
40.	Hogan & Hartson	(Washington, DC)
41.	Hutton (E F) & Company	(New York, NY)
42.	Hyponex Corporation	(Fort Wayne, IN)
43.	Irell & Manella	(Los Angeles, CA)
44.	Itel Corporation	(Chicago, IL)
45.	Jacobs, E. Allen (Asst. Prof. of Management, M.I.T.)	(Cambridge, MA)
46.	Jensen, Michael C. (Prof. of Bus., Harvard Bus. Sch.)	(Boston, MA)

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47. Kehl, Marcia A. (Lakewood, CO)
48. Kellner, DiLeo & Co. (New York, NY)
49. Kocur, John A. (Wayzata, MN)
50. Larkin, Terry (Takoma Park, MD)
51. Latham, Watkins & Hills (Washington, DC)
52. Lee (Thomas H.) Company (Boston, MA)
53. Little, Royal (Providence, RI)
54. Mason, A. J. (Tulsa, OK)
55. McChesney, Fred S. (Assoc. Prof. of Law, Emory Univ.) (Atlanta, GA)
56. Merrill Lynch & Co., Inc. (New York, NY)
57. MESA Petroleum Co. (Amarillo, TX)
58. Mayer, Brown & Platt (Chicago, IL)
59. Moran, John L.
60. National Assoc. of Manufacturers (Washington, DC)
61. Nichols, David K.
62. Perrault, George, Jr. (Salem, OH)
63. Phillips Petroleum Company (Bartlesville, OK)
64. Reisner, Carl L. (New York, NY)
65. Risk Arbitrage Monitor (New York, NY)
66. Rooney, James A. (Lenexa, KS)
67. Rosenkranz & Company (New York, NY)
68. Rountree, Brooks (Collinsville, OK)
69. Securities and Exchange Commission (Washington, DC)
70. See, Henry W. (Wayzata, MN)
71. Seligman (J. & W.) & Co., Inc. (New York, NY)
72. Seitz, Thomas G.
73. Shearson Lehman Brothers (New York, NY)
74. Skadden, Arps, Slate, Meagher & Flom (Washington, DC)
75. Salomon Brothers Inc. (New York, NY)
76. Stangl, David W. (Tulsa, OK)
77. Sullivan & Cromwell (Washington, DC)
78. Tolone, James J. (Chicago, IL)
79. U. S. House of Representatives (Washington, DC)
80. U. S. Senate (sub.- Alfonse D'Amato) (Washington. DC)
81. U. S. Senate (sub.- Slade Gorton) (Washington, DC)
82. U. S. Senate Committee on Banking, Housing and Urban Affairs (Washington, DC)
83. University Foods Corporation (Milwaukee, WI)
84. Unocal Corporation (Los Angeles, CA)
85. Vorys, Sater, Seymour and Pease (Washington, DC)
86. Yourshaw, Myron (Falls Church, VA)
87. Zenith Insurance Company (Encino, CA)

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Type of Commenter

	TYPE	NUMBER
1.	Securities Firm	7
2.	Law Firm	10
3.	Banking Institution	2
4.	Investor	3
5.	Member of Public	28
6.	Government Agency/Official	8
7.	Nonfinancial Corporation	13
8.	Trade Association/Special Interest Group	6
9.	Academic	4
10.	Insurance Industry	2
11.	Money Manager/Investment Advisor	2
12.	Arbitrageurs	1
13.	Labor Union	1

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