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THE INVESTMENT BANKER AND THE CREDIT REGULATIONS

ROBERTA S. KARMEL*

Pursuant to authority granted by the Securities Exchange Act of 1934, the Federal Reserve Board promulgated the margin regulations to prevent the excessive use of credit for the purchase or carrying of securities. Recent developments indicate that these regulations may be applied to various types of financings arranged by the investment banker for corporate and institutional clients. The author examines the possible applicability of the margin regulations to the investment banker, concluding that these requirements impose severe restrictions on investment banking which are anomalous from both a business and a policy standpoint.

I

INTRODUCTION

RECENT developments have made the investment banker and his attorneys acutely conscious of the possible applicability of the credit regulations, particularly Regulation T, to various types of financings arranged by the investment banker for corporate and institutional clients. During the past year, more than previously, the credit regulations[1] have been rigorously enforced by the government in both civil and criminal prosecutions.[2] Also in a lawsuit between private litigants, the Second Circuit held that a loan made in violation of the margin regulations was void and therefore unenforceable.[3] Most recently, in July 1969, the credit regulations were each amended so as to be made more nearly equal in their application to loans to purchase over-the-counter stocks,[4] but significant differences persist among them.

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1 FRB Reg. T, 12 C.F.R. § 220 (1969); FRB Reg. U, 12 C.F.R. § 221 (1969); FRB Reg. G, 12 C.F.R. § 207 (1969); all promulgated by the Federal Reserve Board, under Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g (Supp. IV, 1965-1968), amending 15 U.S.C. § 78g (1964).

2 United States v. Whorl, Docket No. 69 Crim. 486 (S.D.N.Y., June 5, 1969) (indictment returned), was the first criminal charge brought under Regulation U since its enactment in 1934. See United States v. Weisscredit Banca Commerciale e d'Investimenti, Docket No. 70 Crim. 29 (S.D.N.Y., Jan. 14, 1970) (indictment returned); United States v. Lerner, Docket No. 69 Crim. 577 (S.D.N.Y., June 23, 1969) (indictment returned), and United States v. Coggeshall & Hicks, Docket No. 69 Crim. 431 (S.D.N.Y., May 16, 1969) (indictment returned), were criminal prosecutions during the past year based on violations of Regulation T; SEC v. Madison Square Garden Corp., Docket No. 69 Civ. 4364 (S.D.N.Y. 1969), an action for an injunction, included allegations of Regulation T violations.

3 Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd, 409 F.2d 1360 (2d Cir.), cert. denied, 38 U.S.L.W. 3173 (U.S. Nov. 10, 1969).

4 Prior to July 29, 1968, broker-dealers subject to the margin requirements were permitted to extend credit only on securities registered on a national securities

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This article will explore a number of situations in which Regulation T would appear to invalidate financial arrangements effected by an investment banker, although a commercial banker or other lender could legally make such loans. Further, to the extent that such situations involve the financing of essentially private, rather than public ventures, the prohibitions placed upon the investment banker under present interpretations of Regulation T by the agencies responsible for its enforcement, would not appear to be within the statutory purposes of the Securities Exchange Act of 1934. This article also will discuss the differences between loans which lawfully may be obtained by an investment banking firm and by the individuals associated with such a firm, the restrictions on the borrowings by individuals being more severe.

In the opinion of this writer, the credit regulations were not designed to cover the activities of an investment banker, particularly in the area of financing new or private corporate ventures, and the extent to which Regulation T may restrict such activities is anomalous from both a business and a legal point of view.

II

The General Provisions of the Margin Regulations

A. Statutory Authority and Purpose

The statutory authority for the margin regulations is contained in Section 7 of the Exchange Act. Sections 7(a) and (b) authorize the Federal Reserve Board to prescribe regulations with respect to the amount of credit that may be initially extended and subsequently maintained on securities. Pursuant to this authority, the Federal Reserve Board has promulgated Regulations T, U and G. Section 7(c) prohibits any member of a national securities exchange or any broker or dealer from directly or indirectly extending or maintaining credit or arranging for the extension or maintenance of credit to or for any customer on securities or on collateral other than securities, except in accordance with the rules and regulations of the Federal Reserve Board. Section 7(d) makes it unlawful for other lenders to extend or maintain credit or arrange for the extension or maintenance of

exchange. However, on July 29, 1968, the Exchange Act was amended to permit regulation of the amount of credit that may be extended and maintained with respect to securities not registered on a national securities exchange. 15 U.S.C. § 78g (Supp. IV, 1965-1968), amending 15 U.S.C. § 78g (1964). The Federal Reserve Board revised the margin regulations to conform to the amendments to the statute on July 8, 1969. See Federal Reserve Bank of New York Circular No. 6347 (June 6, 1969); Federal Reserve Bank of New York Circular No. 6291 (Feb. 11, 1969); Fed. Reg. Doc. Nos. 69-1983-85 (filed Feb. 14, 1969).

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credit in contravention of the rules and regulations of the Federal Reserve Board.

The margin requirements were enacted for the purpose of preventing the excessive use of credit for the purchase or carrying of securities. Their major objective is to regulate and restrict the volume of credit devoted to financing transactions in securities, in order to protect the national economy.[5] Three separate philosophies have been found in the legislative history of the Exchange Act as a justification for the margin requirements:[6] (1) excessive credit should not be permitted to cause undue market fluctuations;[7] (2) credit should not be diverted from more desirable uses elsewhere in the economy into the stock market;[8] and (3) investors should be protected from buying on too thin a margin.[9]

In cases arising under the margin regulations, one or the other of these philosophies has been emphasized in order to justify a particular result.[10] However, the Exchange Act was based on the premise that stock market speculation was inherently evil and largely responsible for the Great Depression. Both the Senate and House Reports quote a message sent by President Roosevelt to Congress on February 9, 1934, which contains the following statement:

> [O]utside the field of legitimate investment, naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.
>
> Such speculation has run the scale from the individual who has risked his pay envelope or his meager savings on a margin transaction involving stocks with whose true value he was wholly unfamiliar, to the pool of individuals or corporations with large resources, often not their own, which sought by manipulation to raise or depress market quotations far out of line with reason, all of this resulting in loss to the average investor, who is of necessity personally uninformed.[11]

The Reports also contain a supplemental letter of March 26,

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[5] Sutro Bros. & Co., 41 S.E.C. 443, 445 (1963).

[6] II L. Loss, Securities Regulation 1242-43 (2d ed. 1961); Comment, 116 U. Pa. L. Rev. 103, 114-15 (1967).

[7] S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934).

[8] Id.; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

[9] S. Rep. No. 792, supra note 7, at 3; S. Rep. No. 1455, 73d Cong., 2d Sess. 11 (1934).

[10] Compare Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949), with Moscarelli v. Stamm, 288 F. Supp. 453, 458-60 (E.D.N.Y. 1968). See also Serzysko v. The Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd, 409 F.2d 1360 (2d Cir.), cert. denied, 38 U.S.L.W. 3173 (Nov. 10, 1969).

[11] S. Rep. No. 792, supra note 7, at 1-2; H.R. Rep. No. 1383, supra note 8, at 1-2.

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1934, from President Roosevelt to the Chairman of the Committee on Banking and Currency, which states:

> The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted "boom" which had so much to do with the terrible conditions of the years following 1929.[12]

To some extent the bill was a compromise between those who felt it was wise social policy to prohibit the average investor from purchasing securities on credit and those who felt that some borrowed money was necessary for a highly liquid market.[13]

The staff members of the Federal Reserve Board who testified at the Congressional Hearings on the Exchange Act were primarily concerned with curbing stock market speculation, as opposed to directing money into other channels or protecting investors.[14] Mr. E. A. Goldenweiser, Director of Research and Statistics of the Federal Reserve Board, in his testimony on the Exchange Act stated:

> It is often said that the stock exchange diverts funds from business to the stock market. As a general statement, that statement is not, strictly speaking, correct, because the credit does not stay in the stock market.
>
> It is, however, true that the stock exchange diverts credit from small industries throughout the country into the large corporations.[15]

Mr. Goldenweiser and Mr. Woodlief Thomas, who were on the Research Staff of the Federal Reserve Board, were in agreement that excessive stock market credit made securities rise too high and fast and fall too low and fast, and stimulated a rapid expansion and contraction of the total amount of credit in the economy.[16]

As the foregoing reflects, regardless of the differing points of view of persons responsible for framing the provisions of the Exchange Act, an important objective of the statute was to curtail credit extended to investors or traders to purchase securities listed on the national securities exchanges. To the extent that the

[12] S. Rep. No. 792, supra note 7, at 1-2; H.R. Rep. No. 1383, supra note 8, at 1-2. See also, Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 35-36, 827, 829 (1934).

[13] Hearings on H.R. 7852 and H.R. 8720, supra note 12, at 97.

[14] The House Report on the Exchange Act explicitly states that the main purpose of the bill is neither to increase the safety of security loans to lenders nor to protect the small speculator, even though "such a result will be achieved as a by-product of the main purpose." H.R. Rep. No. 1383, supra note 8, at 8.

[15] Hearings on H.R. 7852, supra note 12, at 67-68.

[16] Id. at 57, 67.

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margin regulations encompassed credit to purchase over-the-counter securities, the aim was to prevent evasions of the statute. Mr. Woodlief Thomas analyzed the types of stock market credit which should be regulated by statute as follows: (1) credit obtained by traders from banks (2) credit obtained by traders from brokers and (3) credit obtained by brokers from banks.[17]

B. Differences Between the Margin Regulations

Regulation T is applicable to any "creditor" as defined in the Regulation, namely, "any broker or dealer, including every member of a national securities exchange."[18] Regulation U applies to banks which includes, in addition to member banks of the Federal Reserve system, any banking institution organized under the laws of the United States or any other banking institution, whether incorporated or not, doing business under the laws of any state of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks.[19] Regulation G applies to any person who is not subject to Regulation T or Regulation U and who, in the ordinary course of business during any calendar quarter, extends or arranges for the extension of $50,000 or more, or has outstanding at any time during the quarter $100,000 or more in credit, secured directly or indirectly, in whole or in part, by collateral that includes any "margin" securities.[20]

In general, a broker or dealer subject to Regulation T is prohibited from extending credit to its customers for the purpose of purchasing or carrying securities, except on margin securities, and then the amount of the loan may not exceed a percentage of the market value of the securities, now twenty per cent, which is set by the Federal Reserve Board from time to time.[21] Similarly, a Regulation U lender may not loan more than twenty per cent of the current market value of any stocks which are directly or indirectly securing a credit to purchase or carry any margin stocks,[22] and a Regulation G lender may not loan more than twenty per cent of the current market value on any margin secu-

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[17] Id. at 51.

[18] 12 C.F.R. § 220.2(b) (1969).

[19] 15 U.S.C. § 78c (a)(6) (1964).

[20] 12 C.F.R. § 207.1(a), (c) (1969).

[21] 12 C.F.R. §§ 220.3(b), 220.8 (1969). The operation of the credit regulations is explained generally in Kelly & Webb, Credit and Securities: The Margin Requirements, 24 Bus. L. 1153 (1969).

[22] 12 C.F.R. §§ 221.1(a), 221.4(a) (1969).

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rities which are collateral for a loan to purchase or carry any such securities.[23]

Despite the apparent similarity between the three regulations, there are significant differences in their coverage of loans to purchase or carry securities other than "margin" securities, as defined in the regulations. Under Regulations U and G a "margin stock" or "margin security" is a stock or security registered on a national securities exchange, an "O-T-C margin stock," a debt security convertible into a margin stock or security, a warrant or right to purchase a margin stock or security, and, with certain exceptions, securities of an investment company registered pursuant to Section 8 of the Investment Company Act of 1940.[24] Under Regulation T a "margin security" is any security registered on a national securities exchange or any O-T-C margin stock.[25] Under all three regulations, an O-T-C margin stock is a stock not traded on a national securities exchange which the Board of Governors of the Federal Reserve System has determined to have the degree of national investor interest, the depth and breadth of market, the availability of information respecting the stock and its issuer and the character and permanence of the issuer to warrant subjecting such security to the provisions pertaining to O-T-C margin stocks. From time to time the Federal Reserve Board publishes a list of O-T-C margin stocks.[26]

The coverage of Regulation T is much broader than the coverage of Regulations U and G with respect to (1) loans to purchase or carry securities which do not fall within the definitions of margin stocks or securities, including the securities of closely held non-public corporations, and (2) loans to purchase or carry any securities where such loans are not collateralized by stocks or margin securities. Either of these two types of loans may be made without regard to the collateral restrictions of Regulations U or G. However, a Regulation T lender is prohibited from making a loan to purchase securities other than margin securities, whether such loan is secured or unsecured, and further, may not accept any collateral for a loan to purchase securities except margin securities. Such securities must be assigned whatever loan value is prescribed at the time by the Federal Reserve Board.

C. The Operation of Regulation T

Regulation T limits all financial relations between any "creditor" and any "customer." A customer is defined to include "any

[23] 12 C.F.R. §§ 207.1(c), 207.5(a) (1969).
[24] 12 C.F.R. §§ 207.2(d), 221.3(v) (1969).
[25] 12 C.F.R. § 220.2(f) (1969).
[26] 12 C.F.R. §§ 220.2(e), 221.3(d), 207.3(b) (1969).

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person, or any group of persons acting jointly, (1) to or for whom a creditor is extending or maintaining credit, or (2) who, in accordance with the ordinary usage of the trade, would be considered a customer of the creditor." This definition extends to principals and employees of a firm and any joint venture in which a creditor participates, if such persons would be considered customers, but for such relationship or participation.[27] All financial relations between a creditor and a customer are deemed part of the customer's "general" account with the creditor, except for certain types of "special" accounts which are governed by special rules.[28] A "general" account is what is commonly called a "margin" account, in which margin securities are purchased and sold according to whatever margin is permitted by the Federal Reserve Board at the time of the transaction.

The types of "special accounts" provided for in the regulation may be generally described as follows: (1) omnibus accounts, in which one broker-dealer may effect transactions for another broker-dealer on less than the normal margin on certain conditions; (2) cash accounts, in which securities which have no loan value (principally over-the-counter securities which do not qualify as O-T-C margin stocks) must be purchased because no credit can be extended in connection with such purchases; (3) arbitrage accounts; (4) commodity accounts; (5) miscellaneous accounts, in which various types of special brokerage transactions, as well as credit transactions for a purpose other than purchasing or carrying securities may be financed; (6) specialist's accounts; (7) subscription accounts, in which the acquisition of a margin security through rights may be financed; (8) bond accounts, in which transactions in exempted or registered non-equity securities may be financed; (9) convertible debt security accounts, in which margin debt securities convertible into margin stock may be carried; and (10) equity funding accounts.[29] Virtually all of these special account provisions are either for the purpose of segregating to ascribe a loan value different from that of a margin security to a particular type of non-margin security, or of permitting credit extensions to broker-dealers by other broker-dealers for the purpose of carrying out their brokerage functions. It is noteworthy that although Regulation T purports to cover all financial relations between a customer and a creditor, those portions of the business of a brokerage firm devoted to investment banking are generally ignored.

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[27] 12 C.F.R. § 220.2(c) (1969). Sutro Bros. & Co., 41 S.E.C. 443 (1963).

[28] 12 C.F.R. § 220.3(a) (1969).

[29] 12 C.F.R. § 220.4 (1969).

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The only types of transactions which relate to investment banking, as opposed to commission or trading activities, specifically dealt with are non-purpose loans and financial arrangements between members of an underwriting syndicate, which are exempted.

Most security credit is extended by member firms of the New York Stock Exchange,[30] which has its own margin rules over and above the requirements of Regulation T.[31] Many member firms have developed fairly complex procedures to insure compliance with the margin requirements, but such procedures and requirements are concerned primarily with the permissible debit balances in the accounts of a firm's brokerage customers.[32]

D. *Prohibitions Against Arranging for Credit*

Section 7(c) of the Exchange Act makes it unlawful for a broker-dealer to "arrange" for the extension or maintenance of credit in contravention of the credit regulations. Regulation T provides:

> A creditor may arrange for the extension or maintenance of credit to or for any customer of such creditor by any person upon the same terms and conditions as those upon which the creditor, under the provisions of this part, may himself extend or maintain such credit to such customer, *but only upon such terms and conditions*, except that this limitation shall not apply with respect to the arranging by a creditor for a bank subject to Part 221 of this chapter (Regulation U) to extend or maintain credit on registered securities or exempted securities.[33]

In *Sutro Brothers & Co.*,[34] the SEC Division of Trading and Exchanges urged that a broker unlawfully "arranges" for a credit extension if knowing or with reasonable grounds to know that a customer has secured credit in excess of that permitted by Regulation T, the broker performs any act for the purpose of assisting the customer in implementing the loan. Similarly, in *Russell L. Irish*,[35] the National Association of Securities Dealers, Inc.(NASD) took the position that mere knowledge on the part

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[30] Report of Special Study of Securities Markets, pt. 4, H.R. Doc. No. 95, 88th Cong., 1st Sess. 1 (1963) [hereinafter Special Study].

[31] Rule 421, NYSE Constitution and Rules ¶ 421, 3272 (1966); Rule 431, id. at ¶ 2431, 3751-57; Rule 432, id. at ¶ 2432, 3757-60. The National Association of Securities Dealers has adopted Regulation T as part of its Rules of Fair Practice. NASD Manual ¶¶ 4001-25, 5267.

[32] See Dept. of Member Firms of the New York Stock Exchange, Supervision and Management of Registered Representatives and Customer Accounts 3, 8, 13, 17, 22 (1967).

[33] 12 C.F.R. § 220.7(a) (1969) (emphasis added).

[34] 41 S.E.C. 443 (1963).

[35] SEC Securities Exchange Act Release No. 7718, at 3 (Oct. 5, 1965), aff'd, Irish v. SEC, 367 F.2d 637 (9th Cir. 1966), cert. denied, 386 U.S. 911 (1967).

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of a broker that a loan had been made to a customer by a bank secured by mutual fund shares bought from the broker, made the broker's participation in the transaction an unlawful arranging where all the broker did was advise the mutual fund to send the certificates to him for transmittal to the customer.

In both cases, the Commission rejected these contentions, stating that:

> In view of the language and history of Regulation T, we are not prepared to find an "arranging" by a broker-dealer where the customer on his own initiative and without recommendation, assistance or advice from the broker establishes credit and the terms thereof with another for accomplishing collateral loan transactions and the only function, activity or connection of the broker and its employees with the parties and the transactions is to execute the customer's orders and follow the customer's instructions as to delivery of securities and receipt of payment. In our view, Regulation T does not suggest such a result, and to hold otherwise would in effect make the broker an insurer that customers were employing credit, wherever secured, only to the extent that credit could be provided by the broker.[36]

However, if a broker permits himself to become an intermediary between his customer and another lender, by conveying the customer's communications or instructions to the lender or by responding to requests or directives of the lender concerning the customer's transactions, the broker becomes so involved in the extension or maintenance of credit that he is "arranging." Therefore, in the *Irish* case, the signing of a receipt for payment of mutual fund shares which stated that the broker would deliver the certificates to the bank as collateral for the loan, where the bank would not otherwise have made such payment, was held by the Ninth Circuit to constitute an unlawful "arranging."[37]

It is important to note that a broker can be liable for unlawful arranging with respect to a credit extension which a broker could not make under Regulation T, even if the lender is not acting in violation of the law. For example, the *Sutro* case involved loans by factors, who at that time were unregulated lenders. The respondent was in no way assisting its customers or the factors involved to perform any unlawful act, but rather was unlawfully arranging for loans which it could not have legally made. On the other hand, where a broker arranges for a credit extension by another lender, governed by Regulations U or G, and such

[36] Sutro Bros. & Co., 41 S.E.C. 443, quoted in SEC Securities Exchange Act Release No. 7718, at 3 (Oct. 5, 1965).

[37] Irish v. SEC, 367 F.2d 637 (9th Cir. 1966), cert. denied, 386 U.S. 911 (1967).

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other lender acts illegally, the broker can be held liable either on the theory that he is unlawfully arranging, or on the theory that he is aiding or abetting another's violation.[38]

III

NON-PURPOSE LOANS

A. Distinction Between Purpose and Non-Purpose Credits

In a special miscellaneous account, a broker-dealer may "[e]xtend and maintain credit to or for any customer without collateral or on any collateral whatever for any purpose other than purchasing or carrying or trading in securities."[39] Such a credit is a "non-purpose" as opposed to a "purpose" credit. However, every extension of credit made by a broker-dealer on a margin security is presumed "to be for the purpose of purchasing or carrying or trading in securities, unless the creditor has accepted in good faith a written statement" to the contrary, which specifically states that such credit is not for the purpose of purchasing or carrying or trading in securities.[40]

The restrictions of Regulations U and G are applicable only to "purpose" credits, that is credits directly or indirectly secured by certain types of collateral for the purpose of purchasing or carrying margin stocks or securities. The term "indirectly secured" includes any arrangement under which the customer's right to sell, pledge or otherwise dispose of the collateral is in any way restricted so long as the credit remains outstanding, or any arrangement which would accelerate the maturity of the credit.[41] In general, all purpose credits to the same person are considered a single credit, and the collateral therefore is similarly considered.[42] The purpose of a credit is determined by substance rather than form. "Credit which is for the purpose, whether immediate, incidental, or ultimate, of purchasing or carrying a margin stock is 'purpose credit,' despite any temporary application of funds otherwise."[43] Further, a credit to reduce or retire an indebtedness incurred to purchase a stock is for the purpose of carrying securities.[44]

The obvious objective of these provisions is to prevent eva-

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[38] Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949). 39 Fed. Res. Bull. 950 (1953), 12 C.F.R. § 220.111 (1969).

[39] 12 C.F.R. § 220.4(f)(8) (1969).

[40] 12 C.F.R. § 220.7(c) (1969).

[41] 12 C.F.R. §§ 207.2(i), 221.3(c) (1969).

[42] 12 C.F.R. §§ 207.2(g), 221.3(d) (1969).

[43] 12 C.F.R. §§ 207.2(c) (1969).

[44] 12 C.F.R. § 221.3(b) (1969).

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sions of the margin requirements, and they would interdict most arrangements which could be invented to avoid the regulations. At the same time, the complex credit needs of a going business, only one of which may be to purchase securities, frequently makes the application of these provisions difficult. In responding to inquiries about the distinction between purpose and non-purpose credits, the Federal Reserve Board sometimes has focused on the segregation of credits and of the collateral used to secure these credits. At other times the Board has concentrated on whether a particular transaction is a purchase or carrying under the regulations. While most of the Board's rulings in this area are under Regulation U, the same rationale probably would be applied to inquiries under Regulation T.

B. Segregation of Credits

The Federal Reserve Board has interpreted the term "purpose" very broadly, emphasizing that purpose cannot be determined upon a narrow analysis of the immediate use to which the proceeds of a loan are put. For example, if a borrower purchases exempt securities with the proceeds of a loan, but intends soon thereafter to sell the securities and replace them with registered stocks, the loan is a purpose loan.[45] Similarly, a multi-purpose loan, one purpose of which is to purchase registered securities, is a purpose credit under Regulation U.[46] Further, and more troubling, where a loan is made solely on a borrower's signature and becomes secured by registered stock shortly after the disbursement, a bank's good faith in making a non-purpose loan is subject to question. Good faith in making a non-purpose loan requires a "reasonable diligence to learn the truth." The proper exercise of such reasonable diligence demands that one possess the same searching mentality as the Federal Reserve Board.[47]

The extent to which the Board will search out a purpose to purchase securities is demonstrated by two of its rulings regarding loans to meet current expenses, secured by securities fully paid for, where the borrower is making additional securities purchases. One interpretation involved AT&T employees who wished to take advantage of a stock option plan to buy company shares through payroll deductions. Since the employees already owned shares purchased under previous offerings, a bank proposed

[45] 33 Fed. Res. Bull. 27 (1947), 12 C.F.R. § 221.101 (1969).

[46] 23 Fed. Res. Bull. 392-93 (1937). Cf. 31 Fed. Res. Bull. 1198 (1945) (loan as addition to outstanding purpose loan).

[47] 45 Fed. Res. Bull. 256 (1959), 12 C.F.R. § 221.110 (1969); 39 Fed. Res. Bull. 951 (1953), 12 C.F.R. § 221.106 (1969).

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to receive such shares as security for "living expenses" loans, which would be advanced in monthly installments in the amount of the employee's payroll deduction under the stock option plan. The Board concluded that such a loan would violate Regulation U if it exceeded the maximum loan value of the collateral, because "[a]lthough the proposed loan would purport to be for living expenses, it seems quite clear, in view of the relationship of the loan to the Employees' Stock Plan, that its actual purpose would be to enable the borrower to purchase AT&T stock, which is registered on a national securities exchange."[48]

The second interpretation involved a business concern which proposed to purchase mutual fund shares, from time to time, with proceeds from its accounts receivable, and then pledge the shares with a bank in order to secure working capital. The Board held that although the immediate purpose of the loan would be to replenish working capital, as time went on the business would be acquiring mutual fund shares at a cost that would exceed the net earnings it normally would have accumulated, and therefore the loans were subject to the purpose credit provisions of Regulation U. Further, the Board stated that the deposit of proceeds from accounts receivable in a time account for one year before using those funds to purchase mutual fund shares would not change the situation in any significant way.[49]

Of particular relevance to the investment banker is a Board interpretation that a stock secured loan is a purpose credit under Regulation U if it is made to enable the borrower to contribute capital to a stock brokerage firm. This interpretation applies whether the firm does only a commission business for customers or a dealer business and whether the capital is new money or the replacement of capital withdrawn from the firm.[50]

C. *Purchase or Carrying of Securities*

In grappling with the problem of what is a purchase or carrying of securities under the credit regulations, the Federal Reserve Board has attempted to distinguish between transactions which increase the volume of credit in the securities markets and those that do not. In taking this approach, the Board has adopted the rationale of certain court decisions dealing with insiders' profits under Section 16(b) of the Exchange Act, which reject the characterization of a transaction as a "purchase" where this accords with

[48] 48 Fed. Res. Bull. 690-91 (1962), 12 C.F.R. § 221.114(d) (1969).
[49] 53 Fed. Res. Bull. 964 (1967), 12 C.F.R. § 221.116 (1969).
[50] 32 Fed. Res. Bull. 995 (1946); See also 25 Fed. Res. Bull. 772 (1939).

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probable legislative intent, even though a literal reading of the statute would yield the opposite conclusion.[51]

Thus the Board has held that a "transfer" of a corporation's stock by a dealer to the corporation for the purpose of retiring the shares, where only ten per cent of the consideration was paid in cash, is not a "purchase" of the shares by the corporation under Regulation T, and thus is permitted. The Board reasoned that although from the dealer's viewpoint the transaction was a "sale" and ordinarily a sale by one party connotes a purchase by the other, the corporation did not become the owner of any securities acquired through the use of credit. When the transaction was completed, the equity interest of the dealer was transmuted into a dollar-obligation interest; in lieu of its status as a stockholder of the corporation, the dealer became a creditor of the corporation. The Board was convinced that an extension of credit to retire debt securities was not for the purpose of purchasing securities, whether the retirement was obligatory or voluntary, and it saw no valid basis for distinguishing between the retirement of debt and equity securities.[52] However, the Board has deemed the retirement of debt securities to be for the purpose of carrying securities, where the debentures were originally issued for the purpose of purchasing or carrying stocks.[53]

In a situation where the Board was required to consider both purpose and segregation of credits, it made the distinction between purchase and redemption even more tenuous. In response to a question regarding a loan by a bank to an open-end investment company that customarily purchases stocks registered on a national securities exchange, the Board held that in view of the general operations of such a company, any loan by a bank to such a company should be presumed to be subject to Regulation U as a loan for the purpose of purchasing or carrying registered stocks. Further, the fact that the company proposed to use the proceeds of the loan to redeem some of its own shares did not make the loan permissible, since application of the loan to some other use could

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[51] See Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied sub nom. Blau v. Petteys, 385 U.S. 1006 (1967); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).

[52] 48 Fed. Res. Bull. 1589-90 (1962), 12 C.F.R. § 220.119 (1969).

[53] 23 Fed. Res. Bull. 717 (1937). In an apparently contradictory, yet contemporaneous interpretation, the Board held that the purchase of debentures by a national bank, which were originally issued to purchase registered securities, was not prohibited by Regulation U. 23 Fed. Res. Bull. 716 (1937). However, this ruling is of little precedential value because Regulation U was then framed in terms of "loans" instead of "extensions of credit," which in the Board's view, was a broader concept.

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not foreclose the purchase or carrying of registered stocks as its ultimate purpose.[54]

IV

Exchange and Tender Offers

A. Extension of Credit

Almost anything other than a cash transaction probably involves credit under the margin requirements. The terms "credit" and "to extend" and "to maintain" credit are not defined in Regulations T, U or G. However, the terms "extension of credit" and "to extend credit" have been defined by the Federal Reserve Board in Regulation O, which relates to extension of credit by member banks to their executive officers. This definition includes any transaction as a result of which an executive officer becomes obligated to a bank, directly or indirectly, by any means whatsoever, by reason of an endorsement on an obligation or otherwise, to pay money or its equivalent, and it is so broad that there is a specific exemption permitting executive officers to cash checks at banks.[55]

The credit regulations were initially drafted in terms of loans rather than credit extensions. In a 1937 interpretation the Federal Reserve Board stated that "to extend credit" was a broader concept than "to loan."[56] More recently, the Board considered whether a corporation's guaranty of an "unsecured" bank loan to exercise an option to purchase stock of the corporation was an "extension of credit" for the purposes of Regulation G. Officers and employees of the corporation obtained bank loans for the purchase price of the stock from a bank by executing an unsecured note. The corporation guaranteed the loans, holding the purchased shares as collateral to secure it against loss on the guaranty. The corporation's stock was registered on a national securities exchange. The Board concluded that a person who guarantees a loan is lending his credit to the borrower, and that the guaranty described should be considered an "extension of credit" under Regulation G, "in order to prevent circumvention of the regulation's limitation on the amount of credit that can be extended on the security of registered stock."[57]

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[54] 44 Fed. Res. Bull. 1279 (1958), 12 C.F.R. § 221.109 (1969).

[55] 12 C.F.R. § 215.2(c) (1969).

[56] 23 Fed. Res. Bull. 717 (1937).

[57] 55 Fed. Res. Bull. 441 (1969), 12 C.F.R. § 207.104 (1969). The Board also concluded that the bank involved violated the "arranging" provisions of Regulation U.

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B. Exempted Exchanges

Regulation T specifically exempts exchanges of any margin or exempted security in a general account, special bond account or special convertible security account, for the purpose of participating in a reorganization or recapitalization in which the security is involved.[58] This provision relates to the substitution provisions of Regulation T, and is therefore an exemption as to the permissible loan value of securities involved in a reorganization and recapitalization, as opposed to an exemption as to a purpose credit.[59] The terms "reorganization" and "recapitalization" are not defined in Regulation T, and it can be assumed, therefore, that the above described exemption covers reorganization under the Internal Revenue Code as well as under the Bankruptcy Act.[60]

Reorganizations and recapitalizations have been deemed purchase and sale transactions under the anti-fraud provisions of the federal securities acts,[61] even though they sometimes have been regarded as exempt transactions under the registration and other provisions of the acts.[62] Whether the Federal Reserve Board would regard a reorganization or recapitalization as a purchase of securities subject to the credit regulations probably would depend upon the particular facts involved.

It would appear that in an exchange of equity securities not involving cash, the securities initially held would have the same market value as the securities subsequently received. Therefore, even assuming an exchange offer is a "purchase" of securities, no extension of credit would be involved in such a transaction and the credit regulations would not apply to it. The various types of temporary advances of credit by a broker-dealer which could be required in order to consummate exchange offers would also appear to be exempted from the credit regulations.[63]

Under a liberal construction of the credit regulations, an exchange of debt securities for equity securities, where the debt se-

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[58] 12 C.F.R. § 220.6(e) (1969). Cf. 12 C.F.R. § 221.3(g) (1969); 12 C.F.R. § 207.4(d) (1969).

[59] Cf. 24 Fed. Res. Bull. 834 (1938).

[60] Cf. I L. Loss, supra note 6, at 518-28.

[61] SEC v. National Sec., Inc., 393 U.S. 453 (1969); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

[62] I L. Loss, supra note 6, at 518-42; SEC Securities Exchange Act Release No. 8177 (Oct. 10, 1967).

[63] See 12 C.F.R. § 220.3(h) (1969) (loan value of unissued securities in a general account); 12 C.F.R. § 220.4(c)(3) (1969) (loan value of unissued securities in a cash account); 12 C.F.R. § 220.4(d) (1969) (arbitrage account provisions).

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curities are issued for the purpose of acquiring the equity securities which are the subject of the exchange, could be construed as an extension of credit for the purpose of purchasing securities. In this situation, the lender is the equity stockholder, and the purchaser is the corporation making the exchange offer. Therefore absent special facts, a regulated loan is not involved. The question arises, however, as to whether a broker-dealer which offers and sells such debt securities is unlawfully "arranging" an extension of credit. Where the equity securities involved in such an exchange are securities of the same corporation which is issuing the debt securities, and the equity securities are then retired, the Federal Reserve Board, in the ruling discussed above,[64] regarded the exchange as exempt from the credit regulations. However, the Board specifically left open the questions of whether an extention of credit to purchase securities would be involved if the securities of two different corporations were being exchanged or if equity securities acquired in exchange for debt securities were not immediately retired.

In point of fact, exchange offers of debt for equity securities are not uncommon. Many such offers have been registered with the SEC, and the agency has never objected to any such exchange offer on the ground that it violated Regulation T. In theory, there is no reason to distinguish between a registered exchange offer and the private placement, by an investment banker, of debentures in exchange for equity securities. On the other hand, there is no reason to distinguish, as far as practical effect is concerned, between such an exchange and a debt offering to raise funds to purchase equity securities.

Although the Federal Reserve Board has not published any formal rulings covering the foregoing problems, the agency's staff has informally been taking the position that a debenture offering registered with the SEC pursuant to Section 5 of the Securities Act of 1933 is not an extension of credit, whereas a private placement of debt securities to purchase securities is an extension of credit. The justification given for such a position is that a holding that registered debenture offerings are extensions of credit for purposes of the margin requirements would fly in the face of custom and seriously damage the bond markets.

Nevertheless, where a long term debenture is issued in exchange for equity securities, the amount of credit available to the ordinary investor to purchase or trade in the public securities markets is not increased whether the debenture offering is registered

[64] See text accompanying note 52 supra.

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or not. Additionally, such a transaction usually would have the effect of taking securities off the market.

It is suggested that a distinction between sales of securities and extensions of credit, based on the nature and quality of the debentures, would be sounder, both theoretically and practically, than the distinctions between registered and unregistered offerings. An analogous distinction has been made under the reorganization provisions of the Internal Revenue Code, where short-term notes (generally notes with a term of five years or less) are deemed instruments of deferred sale rather than securities.[65] Similarly, short term commercial paper (with a maturity of nine months or less) is exempt from the definition of a security in the security acts.[66]

C. Cash Tender Offers

The Federal Reserve Board has stated that a stock secured loan made for the business purpose of purchasing a controlling interest in a corporation is subject to Regulation U. In reaching this conclusion, the Board rejected the argument that such a loan should be exempt on the ground that the Regulation is directed solely toward purchases of stock for speculative or investment purposes.[67] Since Regulation T is even more restrictive than Regulation U, there is no reason to suppose the Board would interpret Regulation T any differently. Therefore, a broker-dealer could not finance the purchase of a controlling equity interest of a corporation for a customer, and could not arrange for such financing, except on the terms and conditions permitted by Regulation T.

This would appear to make participation by a broker-dealer in the financing arrangements for a large number of cash tender offers illegal. In the case of a tender offer for over-the-counter securities which do not qualify as "O-T-C margin stock," this interpretation of the credit regulations would be especially harsh and illogical, because a broker-dealer may not extend or maintain any credit on such securities, while a bank or other lender may do so. Therefore, the manager of a tender for such securities could do nothing to assist the tenderor to obtain lawful financing for the tender offer, or participate in the negotiations for such financing.[68]

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[65] See Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933).

[66] Section 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c (a)(3); § 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c (10) (1964).

[67] 45 Fed. Res. Bull. 256 (1959), 12 C.F.R. § 221.110(b)(2) (1969).

[68] In Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp., 303 F. Supp. 1354 (S.D.N.Y. 1969), an action was instituted for a preliminary injunction to enjoin a tender offer because the financing of the offer by two European lending institutions allegedly violated Regulations T and G. Since the action was dismissed on the ground that the foreign lenders were not subject to the credit regulations,

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V

Investments in Non-Public Ventures

A. Closed Corporations and Investment Partnerships

The prohibitions contained in Regulation T against extending credit to a customer for the purpose of purchasing, carrying or trading in securities, except where such loans are properly secured by margin securities, apply to the securities of closed as well as public corporations. Further, such prohibitions presumably would apply to the financing of the organization of a closed corporation, as well as to the purchase of control of the corporation.

A more troublesome question is whether such prohibitions and/or the prohibitions of Regulations U and G apply to loans obtained by the limited partners of a private investment partnership in order to finance the purchase of their respective interests in the partnership. For purposes of Section 5 of the Securities Act, limited partnership interests probably would be deemed "securities,"[69] and the definition of the term "security" in the Exchange Act includes, among other things, a "participation in any profit-sharing agreement."[70] Nevertheless, to hold generally that a limited partnership interest in a private business venture is a security under the credit regulations would appear to defeat one of the purposes for which such regulations were enacted, namely to channel credit away from the stock market to other parts of the economy. Since a limited partnership interest would not be a "margin stock" or "margin security" under Regulations U and G, respectively, this is a problem which ordinarily would arise only under Regulation T. However, there is one type of limited partnership interest which poses a problem under all three of the credit regulations, namely an interest in an investment partnership.

Where an investment partnership customarily purchases margin securities, a loan to purchase an interest in such a partnership would appear to be a "purpose credit."[71] In its informal guidelines pertaining to private investment partnerships, the New York Stock Exchange has required that such a partnership conform to Regulation T if its general or managing partners are connected

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the court's opinion did not discuss the extent to which the financing of cash tender offers by domestic lenders may be subject to the credit regulations.

[69] I L. Loss, supra note 6, at 502-06.

[70] 15 U.S.C. § 78c (10) (1964).

[71] 44 Fed. Res. Bull. 1279 (1958); 32 Fed. Res. Bull. 995 (1946), 12 C.F.R. § 221.109 (1969).

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with a member firm.[72] However, this requirement would appear to relate to borrowings for the investment activities of the partnership rather than any loans obtained by the partners in order to make their initial capital contributions.

Where an investment partnership is formed to invest in the securities of non-public companies—venture capital situations[73] —rather than in margin securities, the problem of the application of the margin regulations to financing participations in such a partnership becomes particularly acute. This type of investment activity is almost diametrically opposed to the type of stock market speculation which the margin requirements were designed to limit. Nevertheless, under a liberal construction of the margin regulations, a loan to finance a participation in a venture capital fund could be deemed a "purpose credit" under Regulation T and, if secured by stocks or by margin securities, under Regulations U and G, respectively, as well.

B. Broker-Dealer Firms

In a special miscellaneous account, where the ordinary margin rules are not applicable, a broker-dealer may:

> [e]xtend and maintain credit, (a) to or for any partner of a firm which is a member of a national securities exchange to enable such partner to make a contribution of capital to such firm, or to purchase stock in an affiliated corporation of such firm, or (b) to or for any person who is or will become the holder of stock of a corporation which is a member of a national securities exchange to enable such a person to purchase stock in such corporation, or to purchase stock in an affiliated corporation of such corporation; provided the lender as well as the borrower is a partner in such member firm or a stockholder in such member corporation, or the lender is a firm or a stockholder in such member corporation, or the lender is a firm or corporation which is a member of a national securities exchange and the borrower is a partner in such firm or a stockholder in such corporation . . . .[74]

It should be noted that a bank or Regulation G lender could not finance such an investment, if secured by stocks or margin securities, because such a loan would be deemed a "purpose credit."[75] Further, the above quoted exemption applies only to

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[72] PLI Corporate Law and Practice Transcript Series No. 2, Investment Partnerships and "Offshore" Investment Funds 295 (1969) (Remarks of James F. Swartz, Jr.).

[73] See generally Venture Capital for Small Business—A Symposium, 24 Bus. L. 935 (1969).

[74] 12 C.F.R. § 220.4(f)(2) (1969).

[75] See text accompanying note 50 supra.

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the financing of investments in member firms of a national securities exchange, and would not apply to investments in over-the-counter brokerage firms. Since the exemption covers capital contributions to partnerships, as well as purchases of stock of corporations, it would appear that capital contributions to private investment funds other than broker-dealers, whether doing business in corporate or partnership form, are at least presumptively subject to the general provisions of Regulation T.

VI

Borrowing by Broker-Dealers and Associated Persons

A. Broker-Dealers

The usual prohibitions of Regulation T do not apply to borrowings by an investment banking firm because a broker-dealer ordinarily is not its own "customer" for purposes of the regulation, even though principals of the broker-dealer may be customers.[76] Rather, borrowings by a broker-dealer are governed by Regulation T which provides in pertinent part:

> It is unlawful for any creditor, directly or indirectly, to borrow in the ordinary course of business as a broker or dealer on any registered security (other than an exempted security) except:
>
> (1) from or through a member bank of the Federal Reserve System; or
>
> (2) from any nonmember bank which shall have filed with the Board an agreement which is still in force and which is in the form prescribed by this part; or
>
> (3) to the extent to which, under the provisions of this part, loans are permitted between members of a national securities exchange and/or brokers and/or dealers, or loans are permitted to meet emergency needs.[77]

The statutory authority for this section of Regulation T is Section 8 of the Exchange Act,[78] rather than section 7, which is the basis for most of the provisions of Regulation T. Section 8 also covers the financial responsibility or net capital requirements of broker-dealers and prohibitions concerning the hypothecation of customers' securities. It would appear therefore that the provisions restricting borrowing by broker-dealers are aimed primarily at subjecting the rehypothecation of customers' securities to the general margin limitations.

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[76] 12 C.F.R. § 220.2(c) (1969).

[77] 12 C.F.R. § 220.5(a) (1969).

[78] 15 U.S.C. § 78h (1964).

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This conclusion is bolstered by the legislative history of the Exchange Act. In the Senate Report accompanying the Act it was explained that the ordinary procedure for the extension of a margin loan was:

> [f]or a broker to extend credit to his customer in order to finance the purchase of a security, the broker in turn borrowing from a banking institution or another broker. The ease and celerity with which such a transaction is arranged, and the absence of any scrutiny by the broker of the personal credit of the borrower, encourage the purchase of securities by persons with insufficient resources to protect their accounts in the event of a decline in value of the securities purchased.[79]

This was the evil which the margin regulations were designed to eliminate without completely abolishing margin trading.

The restrictions against borrowing by broker-dealers in Regulation T are complemented by certain provisions of Regulations U and G. Regulation G provides in pertinent part:

> No lender shall extend or maintain any credit for the purpose of purchasing or carrying any margin security to any customer who is subject to Part 220 of this Chapter (Regulation T) without collateral or on collateral consisting of margin securities (other than exempted securities). Where the credit is to be used in the ordinary course of business of such customer, such credit is presumed to be for the purpose of purchasing or carrying margin securities unless the lender has in his records a statement to the contrary . . . .[80]

Regulation U exempts from its general provisions certain types of credit extended to broker-dealers, specifically (1) credit to aid in the financing of distributions of securities over-the-counter; (2) credit to meet emergency needs; (3) credit secured by properly hypothecated customers' securities; (4) credit to finance deliveries against payment; (5) credit extended against securities in transit; (6) same day credits; (7) credit to finance arbitrage transactions; (8) credit to finance the transactions of an odd-lot dealer; and (9) credit to exchange specialists and O-T-C market makers.[81]

It should be noted that Section 220.5(a) of Regulation T, set forth above, makes it unlawful for a creditor *"to borrow"* rather than *"to obtain credit,"* except under the conditions specified. Almost all other provisions of the credit regulations speak in terms of credit extensions rather than loans, and there is some authority for the proposition that "to extend credit" is a broader

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79 S. Rep. No. 792, supra note 7, at 6-7.
80 12 C.F.R. § 207.1(f)(1969).
81 12 C.F.R. §§ 221.2, 221.3(o), 221.3(w) (1969).

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concept than "to loan." In two 1937 Federal Reserve Board interpretations, the Board distinguished between a loan by a bank to a corporation for the purpose of retiring debentures, and a purchase by a bank of debentures issued to raise funds to purchase stocks, ruling that the former loan was prohibited and the latter purchase was permitted.[82] The Board felt that the term "to loan" was not as broad as the term "to extend credit," and at the time Regulation U was expressed in terms of "loans."

B. Associated Persons

In *Sutro Brothers & Co.*, the Securities and Exchange Commission held that the prohibitions of Section 7(c) of Regulation T against arranging for credit in excess of that permitted under the Regulation applies to arrangements for such credit made by salesmen of a broker-dealer for their own accounts as well as for the accounts of their customers. The Commission stated that:

> A salesman who effects transactions in his own account occupies a dual role: in this capacity he clearly is a customer, although in acting in other capacities he is a representative of the broker-dealer . . . . A salesman effecting transactions in his own account is a customer to whom the broker-dealer may advance credit for the purchase of securities only as permitted for all other customers, and it follows that the broker-dealer may arrange for the extension of credit by another to the salesman-customer only to the same extent as for other customers. It is immaterial that the salesman himself is the instrument through whom the broker-dealer arranges for the extension of credit; neither he nor the broker-dealer can close his eyes to the fact that he is a representative of the broker-dealer whose acts may be attributed to the broker-dealer.[83]

In *Kidder Peabody & Co.*,[84] the Commission held that a registered representative violated Regulation T when he arranged with a bank for an extension of credit to himself for the purpose of purchasing and carrying unlisted and non-exempt securities through his account where such loans were on terms and conditions which the registrant could not lawfully maintain. The Commission stated that "the provisions of Regulation T must be complied with when a registered representative of a broker-dealer finances personal stock transactions by obtaining 'purpose loans' at a bank." It should be noted that in the *Sutro* and *Kidder Peabody* cases the lenders were not acting in violation of law.

The interpretation commonly given to these cases by the reg-

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[82] 23 Fed. Res. Bull. 716, 717 (1937).
[83] Sutro Bros. & Co., 41 S.E.C. 443, 451 (1963).
[84] SEC Investment Advisor Act Release No. 232 (Oct. 16, 1968).

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ulatory agencies is that for the purposes of Regulation T a person associated with a broker-dealer, whether as a principal or as an employee, is both a customer and a creditor. Accordingly, the borrowings of such an associated person for the purpose of purchasing or carrying or trading in securities must be made on the same terms and conditions as would prevail in loans by a broker-dealer to a customer. This is the case even where the associated person could obtain a bank loan or a loan from an unregulated lender which would be in compliance with the law but which could not be made by a broker-dealer.

C. Joint Ventures

Participation in a joint venture by a broker-dealer is not exempt from the operation of Regulation T. On the contrary, any joint venture in which a creditor participates is a customer for the purposes of the regulation.[85] Additionally, there is a specific provision stating that in an account which is otherwise covered by the margin regulations which is a joint account in which the broker-dealer participates, the adjusted debit balance of the account shall include contributions by the creditor in excess of his right to participate in the profits of the venture.[86] This provision implies that a disproportionate contribution to a joint venture is an extension of credit under the margin requirements. Further, the formation of a joint venture by a broker-dealer for the purpose of purchasing securities in which the broker does not participate, but where certain joint venturers will be making contributions in excess of their participation rights, therefore could be construed as violative of those provisions which generally prohibit a broker from arranging credit which he could not himself extend. In the event that a broker-dealer contributes less than his proportionate interest in the profits of a venture, the applicability of the margin regulations is less clear, because this would appear to fall within the provisions relating to borrowing by broker-dealers, and probably should be analyzed pursuant to such provisions.

The foregoing conclusions are bolstered by a recent Federal Reserve Board interpretation of Regulation G which stated that a contribution to a joint venture involved an extention of credit, where a corporation contributed eighty per cent of the capital for a joint venture to buy and sell securities with an individual who contributed twenty per cent but was entitled to eighty per cent of the profits or losses. Each participant received interest of eight per

[85] 12 C.F.R. § 220.2(c) (1969).
[86] 12 C.F.R. § 220.6(b) (1969).

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cent on his respective capital contribution, and the corporation had the right to liquidate the joint portfolio if the individual's share of the losses equaled or exceeded his twenty per cent contribution to the venture. The Board felt that the incidents of the joint venture closely paralled those of an extension of margin credit, with the corporation as the lender and the individual as the borrower.[87]

VII

Arguments for Exempting Investment Banking Transactions from Regulation T

A. The "No Customer" Theory

The margin requirements always have allowed a greater latitude to banks than to brokers in various respects, notably the loan value may be ascribed to securities other than margin securities. The historical reason for this distinction was Congress' feeling that since over-the-counter securities had an indefinite market value, brokers could evade the margin requirements by extending credit on a package of registered and unregistered securities and undervaluing the latter. However, it was felt that banks would be less likely to so evade the law because they would handle loans on unregistered securities as a purely commercial proposition. Further, some draftsman thought brokers should be out of the lending business altogether because of the temptation to extend credit so as to increase their brokerage commissions.[88] These considerations tie in with the objective of the margin regulations to protect the average public investor against buying securities on too thin a margin.

However, the corporate client which goes to an investment banker for advice and service in connection with a tender offer or a private placement of debt securities for general corporate purposes (which may include the purchase of securities), is not an average investor or ordinary brokerage customer. The relationship of such a corporation to its investment banker is far more similar to the relationship of such a client to its commercial banker, than the relationship of a public investor to a broker-dealer.[89] Although compensation may motivate the investment banker to arrange the financing of a tender offer or the private

[87] 55 Fed. Res. Bull. 441-2 (1969), 12 C.F.R. § 207.104 (1969).

[88] II L. Loss, supra note 6, at 1259 n.59. The premises upon which these ideas were based were dubious, see Special Study, supra note 30, at 35-38, and the distinctions between banks and brokers have recently been lessened, although by no means eliminated. See note 4 supra.

[89] See United States v. Morgan, 118 F. Supp. 621, 650-55 (S.D.N.Y. 1953).

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placement of securities these transactions are far removed from lending money to a public investor in order to generate commission business. The corporate client does not need the protection of Regulation T to guard against foolish speculation in securities. In order to obtain financing for a tender offer, the corporation will have to rely on the commercial soundness of the tender as well as the company's general credit. Similarly, in a private placement of debt securities, the purchasers frequently are more knowledgeable and sophisticated, and the disclosures and representations more elaborate than in a public offering pursuant to a registration statement filed with the SEC. Particularly where a corporation can legally obtain such financing from a bank or other lender, there is no valid reason why its investment banker should not be able to assist in such credit arrangements. It is precisely this type of expertise which is within the peculiar province of an investment banker.[90]

It therefore can be argued that a corporate client which seeks out the services of an investment banker in connection with a tender offer or the placement of debentures is not a "customer" within the purview of Regulation T, even if this client may be a customer with respect to ordinary brokerage transactions in a margin or cash account, at least where the broker-dealer is not extending credit to the client in connection with the tender, or purchasing the debentures, but merely arranging for financing from another source. In a tender offer, it is really the tenderees rather than the tenderor who are "customers" in the ordinary sense. Similarly, the purchasers of the debentures rather than the issuer would ordinarily be brokerage customers.

A "customer" is defined in Regulation T as a person or group "to or for whom a creditor is extending or maintaining credit" or who, "in accordance with the ordinary usage of the trade, would be considered a customer of the creditor."[91] The dictionary definition of a "customer" is "one who regularly, customarily, or repeatedly makes purchases of, or has business dealings with, a tradesman or business establishment; a buyer or purchaser; a patron." By contrast, a "client" is defined as "one who employs the services of any professional or business man, as a customer."[92] While the two words are synonymous if used loosely, "customer" connotes a person who buys goods, whereas "client" connotes a person who buys services. This

90 Comment, 116 U. Pa. L. Rev. 103 (1967).
91 12 C.F.R. § 220.2(c) (1969).
92 Webster's Third New International Dictionary (1968).

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difference is recognized in the ordinary usage of the trade in that a broker usually will refer to a person who buys and sells securities through him as a "customer" (and hence a registered representative who executes such orders commonly is referred to as a "customer's man"), whereas an investment banker usually will refer to a person who has come to him for financial advice as a "client."

The margin rules of the New York Stock Exchange do not define customer except to state that the term includes "members, member organizations, partners and stockholders therein, as well as non-members."[93] However, other rules of the Exchange relating to customers and customers' accounts connote the idea that a customer is a person who effects transactions in securities through a member.[94] The overall provisions of Regulation T similarly view the customer-creditor relationship in the context of commission business.

In the case of investments by a broker-dealer for its own account or investments by persons associated with broker-dealers, the argument can also be made that such persons should not be considered "customers" where such investments are in non-public ventures. As explained above, a broker-dealer ordinarily is not considered its own customer for the purposes of Regulation T, but a person associated with a broker-dealer is regarded as a customer. However, the provisions of Regulation T covering the borrowings of a broker-dealer relate to borrowings "in the ordinary course of business as a broker or dealer."[95] This phrase probably covers transactions for the investment account of a broker-dealer. In any event, neither the text of the regulation nor the legislative history of the Exchange Act would justify the application of Regulation T to transactions by a broker-dealer for its own account involving securities other than margin securities.

Where an individual who is associated with a broker-dealer engages in transactions in securities which are publicly traded, there is some basis for the prevailing regulatory view that loans to finance such transactions should be only on the terms and conditions permitted by Regulation T. However, where such an individual proposes to invest in a closed corporation or a limited partnership, the justification for holding that Regulation T requires that such an investment be made only on a cash basis is tenuous. Indeed, since the definition of "customer" includes

[93] Rule 432, New York Stock Exchange Constitution and Rules, ¶ 2432, 3757-60 (1966).

[94] E.g., Rule 405, id. at ¶ 2405, 3700-01.

[95] See text accompanying notes 27-32 supra.

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"any partner in the firm who would be considered a customer of the firm if he were not a partner," transactions by a partner or employee which are not effected by or through a broker-dealer ought to be deemed outside of the ambit of Regulation T.

It should be noted that neither the Federal Reserve Board nor the SEC have shown any inclination to exclude any group of persons from the definition of the term "customer" in Regulation T. On the contrary, the SEC has held that transactions by a broker-dealer cannot be exempted from Regulation T or similar rules on the ground that they are "personal,"[96] and it therefore has been argued that any credit transaction in which a broker-dealer engages is subject to Regulation T.[97] One commentator has stated that the definition of "customer" is so broad that it is practically synonymous with "person," and therefore the investment banking clients of brokerage firms are clearly "customers."[98] Similarly, the Federal Reserve Board has stated that Regulation U applies to the activities of a bank when it is acting in its capacity as trustee.[99]

B. The "No Purchase" Theory

The only interpretations of the Federal Reserve Board which indicate any sort of an exemption from the credit regulations in the investment banking area are its rulings that retirements or redemptions of securities, which were originally issued for a purpose other than to purchase or carry securities, are not "purchases" under the regulations. In addition, the agency has informally taken the view that debentures sold pursuant to a registration statement under Section 5 of the Securities Act do not constitute an extension of credit; the SEC similarly has never announced or taken any action against registered exchange offers of debt for equity securities.

Nevertheless, the Federal Reserve Board has specifically left open its options in two crucial areas. In ruling that the acquisition by a corporation of its own securities for the purpose of retiring such securities was not a "purchase" under Regulation T, the Board stated that this interpretation should not be regarded as governing any other situations, for example, "cases where securities are being transferred to someone other than the issuer,

[96] 12 C.F.R. § 220.2(c) (1969).

[97] Archer v. SEC, 133 F.2d 795, 802-03 (8th Cir.), cert. denied, 319 U.S. 767 (1943); F. R. Gentry & Co., 41 S.E.C. 314 (1963).

[98] Weiss, Registration and Regulation of Brokers and Dealers 74 nn.12-13 (1965).

[99] Comment, supra note 90, at 103, 113 n.60.

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or to the issuer for a purpose other than immediate retirement. Whether the margin requirements are inapplicable to any such situations would depend upon the relevant facts of actual cases presented."[100]

Since the Board's theory in ruling that retirements are exempt from Regulation T was that when the transaction was completed "the equity interest of the dealer was transmitted into a dollar-obligation interest" and the securities involved were taken off the market, it is submitted that there should be no difference in result where a corporation other than the issuer purchases securities for the purpose of retirement. In certain types of takeovers and acquisitions, this is precisely the ultimate result of an exchange or tender offer. It is difficult, however, to distinguish between tender offers of this type and purchases of control, which, as pointed out above, the Federal Reserve Board has stated are covered by the credit regulations.[101] As suggested above, a more meaningful distinction between "purchases" and exempt transfers probably could be based on the type of financing involved.[102]

In situations involving the formation of a new business entity, it is probably as logical to argue that no purchase is involved because new securities are being created, as it is to state that a retirement or redemption does not involve a purchase because security interests are extinguished. Further, in the case of capital contributions to a newly formed closed corporation or limited partnership, the use of such a theory could be justified on the ground that no additional credit is being injected into the public securities markets.

C. *The "No Speculation" Theory*

It can be persuasively argued that the reasons for the passage of the credit regulations have no relevance to many of the investment banking transactions discussed herein. First, neither the investment banking client nor the investment banker needs to be protected from buying on too thin a margin. Second, the formation of a new business entity does not, in and of itself, result in a diversion of credit into the stock market from another sector of the economy. Although a cash tender offer may temporarily have such an effect, such a diversion is not for the purpose of speculating in securities, but for long term legitimate business

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100 58 Fed. Res. Bull. 1589 (1962), 12 C.F.R. § 220.119 (1969).
101 See text accompanying note 67 supra.
102 See text accompanying note 65 supra.

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purposes. In terms of the theoretical basis of the credit requirements, there is no reason to discriminate between the use of investment capital for a takeover or acquisition and any new business enterprise. Third, although takeovers and other corporate acquisitions may have an effect on stock prices, the evil of a downside snowballing effect due to an excessive credit extension is not a threat because once control of a corporation is acquired, it cannot be disposed of quickly or easily, and frequently would require registration under the Securities Act. Similarly, where a loan is obtained to invest in a new business enterprise, the the securities of which have no public market, the foreclosure of such a loan would have no impact on the stock market.[103]

The test as to whether securities transactions are subject to the margin regulations should be whether these transactions result in new credit being injected into the stock market for speculative purposes. In this connection, it is submitted that the Federal Reserve Board interpretation[104] that the purchase of control of a corporation is a transaction covered by the credit regulations is too broad. In situations involving a continuity of credit, such as exchanges of securities having an equivalent market value, the margin regulations do not apply. Where Corporation *A* makes a tender offer for the equity securities of Corporation *B* preliminary to a recapitalization or reorganization, so that Corporation *B*'s equity securities are either retired or exchanged for shares of Corporation *A*, the credit regulations should permit Corporation *A* to obtain what is really temporary financing to acquire Corporation *B*'s securities. Similarly, where Corporation *A* makes a tender offer for the equity securities of Corporation *B*, in order to acquire working control, the credit regulations should not apply because such an acquisition has a long range investment purpose, as opposed to a short term speculative purpose.

Transactions involving the securities of closed corporations or limited partnerships have no impact on the public security markets and the financing of such transactions should not be restricted by the credit regulations. Where such private business entities trade in the publicly traded securities of other companies, then it is appropriate for the credit regulations to apply to such transactions.[105]

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[103] See PLI Corporate Law Transcript Series No. 1, Texas Gulf Sulphur Insider Disclosure Problems 451-57, 564-68 (1968); Comment, supra note 90, at 103, 120.

[104] See note 67 supra.

[105] See text accompanying notes 71-72 supra.

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VIII

CONCLUSION

This article has indicated a number of areas in which the credit regulations, and particularly Regulation T, could prohibit the financing of investment banking transactions. To the extent that such transactions involve investments in securities which are not publicly traded, the public interest as expressed in the Exchange Act is not served by the regulation of such transactions. In addition, prevailing guidelines as to when and how the credit regulations apply to various types of exchange and tender offers are unclear and in certain respects are arbitrary.

This is not to argue that the investment banker should be completely exempt from the restrictions of the credit regulations. Rather, the foregoing problems arise in large part because the provisions of Regulations U and G applicable to banks and other lenders probably are better suited to the business of the investment banker than Regulation T which is primarily concerned with the execution of brokerage transactions in listed securities and publicly traded O-T-C securities.

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