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SOME RECENT INNOVATIONS TO AVOID THE MARGIN REGULATIONS

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The internationalization of the capital markets, increased corporate takeover activity and sustained interest in securities speculation have combined to give rise to some interesting new questions with respect to the applicability of the margin regulations. Mr. Lipton, discussing devices recently created to avoid these regulations, explains the manner in which the Congress and federal administrative agencies have expanded the coverage of the regulations to include foreign financings, "warehousing" arrangements, joint ventures and "deep-in-the-money" options. On the basis of this trend toward expanded coverage, Mr. Lipton considers the applicability of the regulations to other devices presently being employed.

I

INTRODUCTION

IN response to the excessive stock market credit and thin margins of the 1920's stock market, Congress introduced federal margin regulation with the Securities Exchange Act of 1934 (1934 Act).[1] This regulation had three goals: (1) to prevent diversion of credit from more desirable uses, (2) to protect investors from foolishly purchasing stock on thin margin and (3) to prevent excessive credit from causing unwarranted fluctuations in the stock markets.[2] To implement the 1934 Act the Federal Reserve Board (FRB) promulgated Regulation T covering securities brokers and dealers[3] and Regulation U covering banks.[4] Until the recent revival of speculative activity, there were few basic

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1 15 U.S.C. §§ 78a-78hh-1 (1964), as amended, (Supp. V, 1970). For the margin provisions of the 1934 Act see id. § 78g (Supp. V, 1970).

2 See S. Rep. No. 792, 73d Cong., 2d Sess. 3-4, 8 (1934). See also S. Rep. No. 1445, 73d Cong., 2d Sess. 11 (1934); Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 5, at 158 (1963).

3 12 C.F.R. § 220 (1970).

4 Id. § 221.

problems under these regulations. The principal concern was the FRB's periodic adjustment of the amount of the margin requirement in response to the current credit situation and stock market activity.[5]

When speculative activity returned to the stock market and as speculators fashioned innovative devices to avoid the limitations of the margin regulations, special problems did emerge but they caused few difficulties. Regulation G was adopted to control the credit supplied by the nonbroker, nonbank lender.[6] To meet the speculative activity in convertible bonds, the margin regulations were extended to cover this type of security;[7] at the same time, selected over-the-counter securities were made subject to the margin regulations.[8] In addition, the margin regulations were further extended to meet the growth of equity-funding plans involving the purchase of mutual fund shares and the use of such shares as collateral for payment of life insurance premiums.[9]

During the last few years, however, the emergence of a $40 billion Eurodollar market, sustained interest in speculation and the increase in corporate tender-offer takeovers have produced some interesting new questions with respect to the applicability of the margin regulations. The practical and policy questions created by the internationalization of the capital markets[10] re-

[5] See note 16 infra.

[6] 12 C.F.R. § 207 (1970).

[7] 34 Fed. Reg. 9196 (1969). For the amendment to § 7 of the 1934 Act permitting the application of the margin regulations to convertible securities see 15 U.S.C. § 78g (Supp. V, 1970).

[8] 34 Fed. Reg. 9196 (1969).

[9] 35 Fed. Reg. 6959 (1970).

[10] The internationalization of the capital and credit markets and the worldwide popularity of United States securities as investments have resulted in a number of securities regulation issues. To facilitate the sale by United States corporations of Eurodollar bonds the Securities and Exchange Commission (SEC), in response to the request of a presidential task force, which was seeking ways to alleviate the balance of payments deficit, took the position that the registration provisions of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1964), as amended, (Supp. V, 1970), did not apply. SEC Securities Act Release No. 4951 (July 9, 1964). Similar motives resulted in passage of the Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, tit. I, 80 Stat. 1539 (codified in scattered sections of the Int. Rev. Code of 1954), which in turn gave rise to the great growth in offshore investment funds. The abuses in this area have caused the SEC to become concerned with preserving the integrity of investment in American securities and it is reported to be considering regulation. See Speech by Chairman Hamer H. Budge, in BNA Sec. Reg. L. Rep. No. 76, at F-1 (Nov. 11, 1970). The SEC has adopted guidelines with respect to the registration, prospectus and selling requirements for domestic United States investment funds offering their shares to non-United States citizens in foreign countries. See SEC Securities Act Release No. 5068 (June 23, 1970). In Roth v. Fund of Funds, Ltd., 405 F.2d 421 (2d Cir. 1968), cert. denied, 394 U.S. 975 (1969), it was held that the short-swing profits recovery provisions of the 1934 Act apply to offshore investment funds.

sulted first in court holdings that the margin regulations do not reach foreign financial institutions[11] and then recently in congressional action which extended the regulations to fill most of the gaps caused by these decisions.[12] The determination of federal administrative agencies not to countenance avoidance of the margin regulations in corporate takeover attempts or by devices which enable speculation on less than required margin is reflected in FRB rulings concerning "deep-in-the-money" options and joint venture arrangements[13] and the SEC attack on "warehousing" arrangements.[14] These recent responses indicate a legislative and administrative resolve to give the regulations their most extensive application.

II

Foreign Financing

In mid-1969 Kirk Kerkorian, through his private Tracy Investment Company, embarked on a takeover of Metro-Goldwyn-Mayer, Inc. (MGM). To finance the takeover Tracy arranged a loan from a subsidiary of Transamerica Corporation. MGM fought the takeover and seized on the ownership by Transamerica of MGM's competitor, United Artists, as a basis for attacking the Tracy financing arrangements on antitrust grounds. The attack was partially successful.[15] Rather than continue the battle on that front, Tracy sought other financing.

Tracy resorted to the Eurodollar market, arranging to borrow $50 million from a German bank and $12 million from an English bank. The collateral provisions of both loans required Tracy to pledge securities having a value of not less than 150% of the amount of the loan. MGM shares were specifically contemplated as part of the collateral. Still strenuously resisting the takeover attempt, MGM again sought to enjoin the tender offer. This time the foreign financing arrangements of Tracy were attacked as violations of the margin regulations. If the loans were subject to the margin regulations, the 150% coverage required by the foreign banks would have been proscribed because

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[11] See Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp., 303 F. Supp. 1354 (S.D.N.Y. 1969); Ferraioli v. Cantor, [1964-1966 Transfer Binder]CCH Fed. Sec. L. Rep. ¶ 91,615 (S.D.N.Y. 1965); Kook v. Crang, 182 F. Supp. 388 (S.D.N.Y. 1960).

[12] Act of Oct. 26, 1970, Pub. L. No. 91-508, § 301, 84 Stat. 1114. See text accompanying notes 35-42 infra.

[13] See text accompanying notes 50-56 infra.

[14] See Part III infra.

[15] Metro-Goldwyn-Mayer Inc. v. Transamerica Corp., 303 F. Supp. 1354 (S.D.N.Y. 1969).

the domestic requirement of 80% margin in effect at that time[16] would have required that the value of the securities pledged as collateral be not less than 500% of the principal of the loan.

In *Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp.*[17] the court held that the margin regulations did not reach these foreign lending institutions. Basing its analysis on the requirements in Regulation G that a Regulation G lender register by filing "with the Federal Reserve Bank of the district in which the principal office of such person is located,"[18] the court found Regulation G applicable *only* to those lenders who can register with a Federal Reserve Bank of the district in which the lender has a principal place of business.[19] Since no Federal Reserve districts exist in Germany or England, the court concluded that the Eurodollar loans were not subject to the limitations of Regulation G. To buttress its decision the court made reference to Section 30(b) of the 1934 Act[20] which exempts persons transacting business in securities outside of the United States from the coverage of the Act.[21] The court cited *Schoenbaum v. Firstbrook*[22] as authority for its reading of section 30(b) to exclude foreign banks.[23]

This formalistic approach taken in *MGM*[24] to the ques-

[16] See 12 C.F.R. § 207.5(a) (1970). The present margin requirement is set at 65% margin. See 34 Fed. Reg. 9984 (1969), made effective, 35 Fed. Reg. 7376 (1970).

[17] 303 F. Supp. 1354 (S.D.N.Y. 1969).

[18] 12 C.F.R. § 207.1(a) (1970).

[19] 303 F. Supp. at 1357-58.

[20] 15 U.S.C. § 78dd(b) (1964). See note 27 infra.

[21] 303 F. Supp. at 1358.

[22] 405 F.2d 200 (2d Cir.), rev'd on other grounds on rehearing, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969). See Comment, Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law, 55 Va. L. Rev. 1103 (1969).

[23] 303 F. Supp. at 1358.

[24] The court paid scant attention to the underlying policy considerations with respect to the extraterritorial application of the margin regulations. In its trial memorandum Tracy made the argument that unregulated resort to foreign lenders for stock market credit was beneficial to the overall domestic credit situation since it freed domestic credit for more desirable purposes. See Memorandum for Tracy Investment Company in Opposition to Motion for Preliminary Injunction at 9-11, Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp., 303 F. Supp. 1354 (S.D.N.Y. 1969), on file at the New York University Law Review office. This argument misses the true nature of the Eurodollar market and the interchangeable demands made upon it for industrial and commercial loans and for stock market credit. Indeed, the vast majority of Eurodollar loans are for purposes other than speculation in the stock markets. While Tracy's argument was not well founded, there are significant policy considerations with respect to extension of domestic regulation to the Eurodollar market and the encouragement of the counterflow of funds to offset the United States balance of payments deficit. These considerations apply also to the broader areas of securities regulation, taxation and monetary policy. See note 10 supra. Cf. Finch v. Marathon Sec. Corp., 316 F. Supp. 1345 (S.D.N.Y. 1970).

tion of the applicability of the margin regulations to foreign lenders ignores the purpose-and-effects test followed in *Schoenbaum*, the leading case on the extraterritorial application of the federal securities laws. *Schoenbaum* was a derivative suit brought by American shareholders of a Canadian corporation, Banff Oil Ltd., to recover damages under rule 10b-5 from another Canadian corporation, Aquitaine Company of Canada Ltd., the controlling shareholder of Banff. The claim was based upon the alleged fraudulent sale in Canada of some of Banff's treasury stock to Aquitaine at a bargain price without disclosure of material information. The district court concluded there was no subject matter jurisdiction because the sales in question took place in Canada between foreign buyers and foreign sellers.[25] The Second Circuit disagreed, holding that two factors were determinative of the question of extraterritorial jurisdiction: (1) the plaintiff stockholders, although suing derivatively on behalf of a Canadian corporation, were American investors, and (2) the Banff stock, the value of which was adversely affected by the fraudulent transaction, was traded on an American exchange. The court stated:

> We believe that Congress intended the Exchange Act to have extraterritorial application in order *to protect domestic investors who have purchased foreign securities on American exchanges* and *to protect the domestic securities market from the effects of improper foreign transactions in American securities*. In our view, neither the usual presumption against extraterritorial application of legislation nor the specific language of Section 30(b) show Congressional intent to preclude application of the Exchange Act to transactions regarding stocks traded in the United States which are effected outside the United States, when extraterritorial application of the Act is necessary to protect American investors.[26]

Also at issue in *Schoenbaum* was the effect of section 30(b) on extraterritorial application of the 1934 Act.[27] The Second

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[25] Schoenbaum v. Firstbrook, 268 F. Supp. 385 (S.D.N.Y. 1967), rev'd, 405 F.2d 200 (2d Cir.), rev'd on other grounds on rehearing, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969).

[26] 405 F.2d at 206 (emphasis added). The *Schoenbaum* court quite carefully confined its holding to the particular situation before it:

> We hold that the district court has subject matter jurisdiction over violations of the Securities Exchange Act although the transactions which are alleged to violate the Act take place outside the United States, *at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors.*

Id. at 208 (emphasis added).

[27] U.S.C. § 78dd(b) 15 (1964). Section 30(b) reads as follows:

> The provisions of this chapter or of any rule or regulation thereunder shall not apply to any person *insofar as he transacts a business in securities with-*

Circuit rejected a broad application of this exemptive provision to any transaction in securities conducted wholly outside the United States,[28] stating: "The language and purpose of §30(b) show that it was not meant to exempt transactions that are conducted outside the jurisdiction of the United States *unless they are part of* a 'business in securities.' "[29] In other words, the exemption was not a broad one that applied to all extraterritorial transactions, but a specific and limited one for the benefit of broker-dealers and banks engaged in the securities business abroad with respect to transactions occurring abroad. Indeed, the court reasoned from this specific exemption that Congress intended a generally broad extraterritorial application:

> [S]ince Congress found it necessary to draft an exemptive provision for certain foreign transactions and gave the Commission power to make rules that would limit this exemption, the presumption must be that the Act was meant to apply to those foreign transactions not specifically exempted.[30]

Ironically, the district court in *MGM* cited *Schoenbaum* to buttress its conclusion that Regulation G did not apply to foreign bank lenders because the Second Circuit's opinion mentioned banks as well as broker-dealers as being the type of persons who "transact a business in securities without the jurisdiction of the United States."[31] It seems clear, however, that the reference to foreign banks as persons who transact a business in securities without the jurisdiction of the United States was not intended to refer to lending activities, but to the securities brokerage and underwriting functions commonly carried on by banks outside the United States.

On the basis of the *Schoenbaum* rationale, *MGM* could have held that the margin regulations apply in the case of a domestic borrower obtaining credit to purchase shares traded in the domestic market. There is no question that Regulation G did not apply literally to foreign banks.[32] Moreover, there is no ques-

out the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this chapter. (emphasis added).

[28] Such a broad application has been discussed in other decisions. See Ferraioli v. Cantor, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,615 (S.D.N.Y. 1965). Cf. Roth v. Fund of Funds Ltd., 405 F.2d 421 (2d Cir. 1968), cert. denied, 394 U.S. 975 (1969); Kook v. Crang, 182 F. Supp. 388 (S.D.N.Y. 1960).

[29] 405 F.2d at 208 (emphasis added).

[30] Id.

[31] 303 F. Supp. at 1358.

[32] The FRB has vacillated on the issue of application of the margin regulations to foreign lenders and an argument can be made that such coverage was omitted deliberately from Regulation G. See Karmel, The Applicability of the

tion that the underlying purposes of section 30(b) are to avoid both difficulties of administration of the 1934 Act, such as providing offices for the local registration of foreign lenders, and involvement with foreign nations in the sensitive area of securities and credit regulation. The basic question of the applicability of the margin rules, therefore, requires weighing the administrative convenience and noninvolvement considerations against purpose-and-effects considerations. A decision in favor of extraterritorial application is justified if the determination is that the regulation of the domestic economy or the protection of the resident is more important than ease of administration or noninvolvement.

The court in *MGM* could have determined that the technical problems facing it did not frustrate the congressional purposes of protecting the domestic market from the effects of speculative borrowing and protecting the borrower from his own folly. With the internationalization of the money and credit markets, the purpose of the margin regulations to properly allocate credit also applies to foreign borrowings since they are largely interchangeable with domestic borrowings for many credit purposes.[33] Except for the policy questions inherent in an extension of application of domestic laws to foreign transactions,[34] the market fluctuation and credit allocation policies underlying the margin regulations would support their extension to any loan to purchase domestic securities, without regard to the domicile of the borrower. Such policy considerations are present in the recent extension of the margin regulations by the Foreign Bank Accounts Act.[35] The Act, however, by focusing on the borrower rather than on the lender, has avoided the jurisdiction policy question and the administrative technicalities of registration and reporting.

Title III of the Foreign Bank Accounts Act adds section 7(f) to the 1934 Act[36] and provides essentially that the margin regulations are applicable to United States borrowers as well as United States lenders. To be subject to the regulations, the borrower must be either a "United States person" or a "foreign person controlled by a United States person or acting on behalf

Margin Regulations to Foreign Financial Institutions, 4 Int'l Law. 496, 509-11 (1969); Weiner, Regulations U, T & G and the Application Thereof to Foreign Entities and Transactions, 86 Banking L.J. 507 (1969).

[33] See note 24 supra.

[34] The jurisdiction policy questions involved in extraterritorial application of the 1934 Act include: (1) whether the economic activity is one that requires regulation of foreign persons, (2) whether the diplomatic risk of possible offense to foreign nations from regulation of their citizens should be taken and (3) whether, as a practical matter, such regulation can be enforced.

[35] Act of Oct. 26, 1970, Pub. L. No. 91-508, § 301, 84 Stat. 1114.

[36] Id.

of or in conjunction with such person" and the security involved must be either a "United States security" or any other security purchased or carried within the United States. Section 7(f)(1) provides that loans may not be obtained by the specified persons for the purpose of purchasing or carrying the specified securities (without regard to whether the lender's office or place of business is in a State or the transaction occurred in whole or in part within a State) if under the other provisions of section 7 and the rules prescribed thereunder, the transaction would be prohibited "if it had been made or the transaction had otherwise occurred in a lender's office or other place of business in a State."[37]

Section 7(f)(2) defines "United States person," "United States security" and "foreign person controlled by a United States person" as follows:

> (A) The term "United States person" *includes* a person which is organized or exists under the laws of any State or, in the case of a natural person, a citizen or resident of the United States; a domestic estate; or a trust in which one or more of the foregoing persons has a cumulative direct or indirect beneficial interest in excess of 50 per centum of the value of the trust.
>
> (B) The term "United States security" *means* a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State.
>
> (C) The term "foreign person controlled by a United States person" *includes* any non-corporate entity in which United States persons directly or indirectly have more than a 50 per centum beneficial interest, and any corporation in which one or more United States persons, directly or indirectly, own stock possessing more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock.[38]

The definitions raise a problem. In defining "United States person" and "foreign person controlled by a United States person" the term "includes" is used, while in defining "United States security" the term "means" is used. The definitions in clauses (A) and (C) may, and perhaps should, be read to set forth only some of the persons included within the scope of the section. Thus a foreign entity with little or no ownership interest in the United States may be subject to the margin rules.

An inclusion of this sort is of much more than academic interest. In recent years there has been tremendous growth in the number and size of offshore investment funds—funds sold

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[37] Id.

[38] Id. (emphasis added).

to entities which are not "United States persons" but which invest all or substantially all of their assets in United States securities.[39] Many of these funds are managed by United States investment managers. If section 7(f) were interpreted to include foreign entities with no American ownership, but whose investment decisions are made by United States persons, a substantial additional area will be brought within the ambit of the margin rules. The effects test would seem to presage such an interpretation since the effect on the domestic market from speculative borrowing by these funds is substantial.

Title III of the Act represents the Senate version of the bill which differed from the House bill[40] in two basic respects. First, the House version would have amended Section 7(a) of the 1934 Act to provide that the FRB could adopt rules and regulations with respect to (1) the amount of credit which any person could obtain and retain on any security (other than an exempted security) regardless of the identity and location of the lender and (2) the amount of credit which any person could extend and maintain on any security (other than an exempted security) regardless of the identity and location of the borrower. Second, the amendment would have made it unlawful for any person to obtain or retain credit in willful and knowing violation of any rules so adopted by the FRB or in violation, whether or not willful or knowing, of any rule so adopted by the FRB either (1) on the basis of a material misrepresentation of the purpose for which the credit is to be used or (2) in an aggregate amount exceeding $1 million at any one time.

The House version was designed to solve the problem of the small investor who unknowingly is a party to a margin violation by his creditor. Thus, unless a borrower of less than $1 million obtained credit by materially misrepresenting the purpose of the loan or acted with actual knowledge that the credit was in violation of the margin rules, no criminal liability would attach. Perhaps, when the FRB adopts rules under section 7(f) with respect to borrowers, exceptions similar to the provisions of the House bill will be made for the small borrower.

Section 7(f) as enacted provides that the specified credit may not be received "if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is

[39] Approximately 100 such funds exist. While no precise figures as to their assets are available, it is reasonable to estimate from published information with respect to such funds that they hold in excess of $2 billion of United States securities.

[40] H.R. No. 15073, 91st Cong., 2d Sess. (1970).

prohibited or would be prohibited if it had been made or the transaction had otherwise occurred in a lender's office or other place of business in a State."[41] Thus, the section adopts all of the present margin regulation law and FRB regulations and extends them extraterritorially and to the borrower. Section 7(f) also provides that it is immaterial whether the lender has an office in the United States or the transaction occurred in the United States. The obvious intent of the draftsmen is to make an act of the specified borrower a violation of the margin regulations if it is of a type that would involve a United States lender in a violation of the margin rules. However, the manner in which the statute is drafted leaves room for the interpretation that while the lender does not have to have an office in the United States, the lender still must be a "United States person." This ambiguity could have been avoided by using the language of the House version, "without regard to who or where the lender may be."[42]

The section 7(f) shift to apply the margin regulations directly to the borrower as well as to the lender raises several questions respecting the continuing validity of the judicially fashioned civil remedies under section 7. For instance, it has been held that a customer-borrower may recover damages from a regulated lender for injuries which he incurs from the lender's unlawful extension of credit to him.[43] Also, in an action against a customer for failure to pay for securities, a broker-dealer who violated the margin regulations by not liquidating the customer's account within the prescribed time has been limited in his recovery to an amount he would have recovered absent the violation.[44] The foregoing decisions illustrate the policy of the margin regulations to protect the investor-borrower from his own folly. The section 7(f) shift to apply the regulations directly to the borrower is probably not intended to undermine this policy, even though the intent to emphasize the other two goals of the 1934 Act is clear.[45]

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[41] Act of Oct. 26, 1970, Pub. L. No. 91-508, § 301, 84 Stat. 1114.

[42] H.R. No. 15073, 91st Cong., 2d Sess. (1970).

[43] E.g., Pearlstein v. Scudder & German, [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,710 (2d Cir. July 2, 1970); Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969).

[44] Billings Associates, Inc. v. Edwin Bashaw, 27 App. Div. 2d 124, 276 N.Y.S.2d 446 (4th Dep't 1967).

[45] The judicially fashioned § 7 civil remedies in favor of the borrower have not precluded criminal indictment of borrowers for inducing violation of the margin regulations by covered lenders. See United States v. Whorl, 69 Cr. 486 (June 5, 1969).

III

CORPORATE TAKEOVERS

During the height of the tender offer takeover activity of the late 1960's it was often alleged or suspected that acquiring companies were aided in obtaining shares of the target companies by brokerage firms and institutional investors. It seems that these firms and investors would accumulate shares pursuant to agreements with the acquiring companies whereby the acquiring companies would later purchase the shares at a profit. Such an arrangement came to light in the battle between G & W Land and Development Corporation and Madison Square Garden Corporation for control of Roosevelt Raceway, Inc.

In September 1969 Roosevelt Raceway had approximately 1.3 million shares of common stock outstanding. The shares were traded on the American Stock Exchange (Amex). Madison owned 348,200 shares and G & W owned 87,973 shares. On Friday, September 19, 1969 Roosevelt closed on the Amex at $37.50. On September 22, 1969 G & W announced its intention to make a tender offer to purchase 400,000 Roosevelt shares at $46.50 a share. Madison undertook to defeat the G & W tender offer. Arrangements were made with Goldman, Sachs & Co. to form a group to purchase Roosevelt stock in the open market with the agreement of Madison that within a year Madison would purchase the shares acquired by the Goldman, Sachs group at 120% of the cost.

The arrangement had the desired effect of creating demand for Roosevelt stock which raised the market price to or above the G & W tender offer price of $46.50. On September 25 the price went to $47 and remained above $46.50 for the next five days.

On October 6 the SEC commenced an action to enjoin the arrangement between Madison and Goldman, Sachs and the group formed by Goldman, Sachs on the ground, among others, that the arrangement constituted a violation of Regulation T since, in substance, it provided 100% financing to Madison for the purpose of purchasing and carrying Roosevelt stock.[46] The defendants subsequently entered into a consent decree which terminated the litigation and thereby avoided a decision on the issue.[47]

[46] Complaint, SEC v. Madison Square Garden Corp., 69 Civ. 4364 (S.D.N.Y., filed Oct. 6, 1969).

[47] See [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,649 (S.D.N.Y. Apr. 29, 1970).

The SEC attack was probably justified. The arrangement between Madison and Goldman, Sachs to purchase and "warehouse" the Roosevelt stock with the agreement of Madison to purchase the stock at the end of a year was essentially no different than a loan by Goldman, Sachs to Madison of the purchase price of the stock with the stock being pledged as collateral. Goldman, Sachs and the members of its group owned the stock and therefore they had the same protection that an arrangement in the form of a loan collateralized by the stock would have afforded. Goldman, Sachs was looking to the credit of Madison with respect to Madison's repurchase agreement just as it would have looked to Madison's credit in the case of a direct loan. The effect of the arrangement, therefore, was to permit Madison to obtain 100% financing on the market value of the Roosevelt stock at a time when the margin regulations permitted financing only to the extent of 20%.

Another practice that developed with the increase in corporate takeover activity involves understandings with banks concerning loans to support tender offers. The acquiring company makes a "nonpurpose loan" on the strength of its general credit[48] and uses some or all of the proceeds of the loan to purchase control of another corporation. The acquiring company will then either effect an understanding with the bank that the target company will be merged into it with the assets of the target company becoming collateral for the original extension of credit, or it will enter into a loan agreement, which contains restrictions on its borrowing and pledging of assets. The latter type agreement, as a practical matter, constitutes the shares of the target company as collateral for the loan, and thereby raises the question whether they are collateral for a "purpose" loan.[49]

In another type of tender offer situation, the acquiring company will, prior or subsequent to the tender offer, sell debentures or refinance short-term loans to finance the tender offer. The question may be raised whether underwriters and other dealers participating in the distribution are arranging for the extension of credit, or (to stretch the question to an extreme) the ultimate purchasers of the debentures are extending credit, for the purpose of acquiring securities in violation of the margin rules.

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[48] See 12 C.F.R. § 207.102 (1970) in regard to the FRB interpretation that a "nonpurpose" loan is a question of fact.

[49] A purpose loan is one which is directly or indirectly secured by certain types of collateral for the purpose of purchasing margin stocks or securities. Id. § 207.2(c). See Karmel, The Investment Banker and the Credit Regulations, 45 N.Y.U.L. Rev. 59, 68-72 (1970).

Looking to the purposes of the margin provisions of the 1934 Act, it is possible to make cogent policy arguments for the application of the margin regulations to many of these corporate tender offer and takeover financing arrangements. Recent events have shown that a substantial number of our large and (previously assumed) sophisticated corporations have overextended themselves. Like the individual speculator who is tempted to trade on thin margin when available, they may need protection from their own folly. Since tender offers often create an inflated price for the stock of the target company, and even companies who are only rumored to be targets, the prevention of sharp market fluctuations becomes a consideration. Finally, the corporate takeover involves a diversion of credit to the stock markets of far greater magnitude than the financing of individual speculation.

IV

Joint Venture and Option Arrangements

The corporate takeover supported by warehousing, nonpurpose bank loans or some other financing arrangement is primarily a speculative activity of the more aggressive corporations. The desire of individuals and performance-oriented investment managers to speculate on thin margins has resulted in the creation of several equally interesting devices. In 1969 and 1970 the FRB had occasion to rule that two such arrangements—joint ventures[50] and deep-in-the-money options[51]—are proscribed by the margin regulations. The proscription of these arrangements is illustrative of the broad sweep that the FRB and the SEC can give to the margin regulations, if they so desire. This administrative action also raises the spectre of inadvertent violation by business arrangements not intended for speculative purposes.

A possibly unlawful joint venture arrangement may be illustrated by the following example. A and B establish a joint venture to invest in securities. A contributes 20% of the capital; B contributes 80%. A and B each receives interest on his capital contribution. A receives 80% of the profits; B receives 20% of the profits. Portfolio selections are mutually agreed upon, but B reserves the right to liquidate the portfolio if A's share of the losses equals or exceeds A's 20% capital contribution. B has possession of the portfolio. On liquidation the capital contributions are to be repaid first.

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[50] 34 Fed. Reg. 9121 (1969).
[51] 35 Fed. Reg. 3280 (1970).

The FRB ruled that such a joint venture violated the margin regulations. The Board analogized the arrangement to B lending 80% of the purchase price of the portfolio to A:

> Like a lender of securities credit, [B] is insulated against loss by retaining the right to liquidate the collateral before the securities decline in price below the amount of [his] contribution. Conversely, [A]—like a customer who borrows to purchase securities—puts up only 20 percent of their cost, is entitled to the principal portion of any appreciation in their value, bears the principal risk of loss should that value decline, and does not stand to gain or lose except through a change in value of the securities purchased.[52]

A more complicated arrangement is involved in deep-in-the-money options. For example, a thirty-day call (purchase) option is written on 100 shares of a stock then selling in the market at $100 per share. The exercise price of the call is $70 per share. The selling price (premium) of the call is $3250. The premium consists of two factors—$3000 represents the difference between the market price of $100 and the deep-in-the-money call price of $70 (100 shares times the $30 difference in the price equals $3000) and $250 represents the return to the writer of the option. The call is renewable at the election of the buyer for additional thirty-day periods at a premium of $150 for each thirty-day period.[53]

The deep-in-the-money option resembles closely purchase of the stock on 30% margin.[54] The writer of the call option in the above example purchases the stock in the market at $100 per share, a total expenditure of $10,000 plus commission. The writer supplies $7000 and the buyer of the call supplies $3000 through the payment of the $3250 premium. The $250 balance of the premium paid by the buyer compensates the writer for his commission expense on purchase of the shares and provides a

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[52] 34 Fed. Reg. 9121 (1969).

[53] Where the buyer desires a put (sale) option rather than a call, the only difference in the above example would be the put exercise price, which would be $130 per share.

[54] The purpose of the deep-in-the-money option is best described by Gordon & Co., Inc., the Boston brokerage firm which originated the device:

> As margin requirements keep rising leverage of available funds become increasingly difficult.
>
> Gordon has devised a new concept which enables hedge funds, large investors, traders and similarly oriented groups to aggressively and effectively take *an immediate, in depth, long or short position in securities with considerable leverage of funds at a reasonable cost.*
>
> ....
>
> *For less than $33,000.00 one can control approximately $1,000,000.00 of securities.*

Gordon & Co., Inc., Memorandum 1-2, on file at the New York University Law Review office.

return on his $7000 investment. If the commission expense was the usual 1% or $100, the $150 balance of the premium would be an interest return of slightly more than 2% a month or 25% per annum. On this analysis the $150 premiums for additional thirty-day renewals may be viewed as monthly payments of interest on the $7000 supplied by the writer. Since the writer owns and has possession of the stock he is in a position comparable to that of a pledgee-lender. If the market price of the stock declines by 30%, the buyer will not exercise the option and the writer can protect himself by selling the stock.[55] When deep-in-the-money options are renewed, adjustment in price or premium is made so that the writer starts each thirty-day period with a full 30% margin.

From the standpoint of the buyer of the deep-in-the-money option, he has achieved control over 100 shares of a $100 stock with only $3000 plus the $250 for the commission expense and compensation to the writer. Thus, the device is one which channels credit to the stock market and enables speculation on thin margin and which, as a result, causes fluctuations in prices of securities and risk to the speculator of loss of his entire investment. In view of the previous ruling on the joint venture arrangement, the FRB not surprisingly followed similar reasoning in ruling that the deep-in-the-money option violated the margin requirements.[56]

Another technique sometimes employed to achieve a stock position by investing less than the required margin involves the practice of converting options. Instead of purchasing a stock, a speculator writes a put option on the stock and exchanges it for a call through an option broker. In the conversion process the broker takes the put option to a member firm of the New York Stock Exchange, and the firm "converts" it into a call option by purchasing the stock and issuing a call on the stock. (The converter, being protected against a decline in market price by the put and running no risk on the call because of ownership of the underlying stock, is essentially engaging in a money-lending transaction.) The call is then "sold" (interest on the price of the stock, floor brokerage and taxes) by the member firm to the option broker who "resells" it to the speculator for the broker's cost, plus an additional negotiated amount which is the broker's profit. The speculator is then in the position of having written

[55] A 30% decline in a 30-day period is abnormal and the writer of the deep-in-the-money option runs no more real risk than any thin margin lender.

[56] 35 Fed. Reg. 3280 (1970). The ruling has been attacked in a suit by Gordon & Co. which is presently pending. Cf. Gordon & Co. v. FRB, 317 F. Supp. 1045 (D. Mass. 1970).

a put option and purchased a call option on the same stock. If the stock declines in value, the converter will exercise the put option and the speculator will have to purchase the stock and suffer a loss. If the price of the stock rises, the speculator will exercise the call option issued by the converter and realize a profit.

The arrangement places the speculator in the same position in which he would have been if he had directly purchased the stock. However, in order to write a put option only 25% of the value of the optioned stock must be deposited with the member firm endorsing the option. If the speculator had purchased the stock, he would have had to deposit 65% of the value of the stock.[57] Thus, the technique gives the speculator the ability to profit from a rise in the value of the stock on thin margin. In light of the FRB ruling on deep-in-the-money options, it is likely that option conversion may also be violative of the margin rules.

V

Conclusion

The recent activity in the area of federal margin regulation indicates a definite trend towards expansion of the coverage of the margin rules. The congressional willingness to fill any gaps discovered through litigation is clearly demonstrated by the enactment of Title III of the Foreign Bank Accounts Act. Moreover, it is clear from the recent action in the field by the FRB and the SEC that these agencies intend to fully implement the purposes and policies underlying the margin provisions of the 1934 Act.

[57] See note 16 supra.