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### The Characterization of Repurchase Agreements in the Context of the Federal Securities Laws

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## THE CHARACTERIZATION OF REPURCHASE AGREEMENTS IN THE CONTEXT OF THE FEDERAL SECURITIES LAWS

In an effort to regulate the securities market and to prevent fraudulent transactions, Congress enacted the Securities Act of 1933<sup>1</sup> and the Securities and Exchange Act of 1934<sup>2</sup> (the "Acts").

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<sup>1</sup> Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)) [hereinafter "Securities Act"]. The Securities Act governs primarily the distributorship of first time offered securities to the public and generally requires the registration of all public offerings of securities. See T. HAZEN, *THE LAW OF SECURITIES REGULATION* 1, 5-7 (1985). The scope of the Securities Act is limited, applying only to the distribution of securities and the protection of purchasers of securities. *Id.* at 7.

The legislative history of the Securities Act reveals that congressional entrance into the field of securities regulation was partially in response to the stock market crash of 1929. See Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 GEO. WASH. L. REV. 86, 86 (1959). Congress recognized that one of the major causes of the crash was the widespread practice of floating fraudulent securities. See T. HAZEN, *supra*, at 6; see also Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933) (purpose of Securities Act to prevent reoccurrence of the stock market crash by requiring truthful disclosures at time of securities issue); Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) (crash precipitated investigation into stock market).

"A fundamental purpose [of securities regulation] . . . was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

The registration requirements of the Securities Act were designed to insure the adequate disclosure of relevant information upon which rational investment decisions could be based. See T. HAZEN, *supra*, at 31; L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 92-93 (1983); see generally Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1344-55 (1966) (discussion of disclosure applicability, requirements, methods, and quality); Douglas & Bates, *supra*, at 187-90 (detailed review of Securities Act's purpose, scope, effect, and administration); Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1162-64 (1970) (discussing when securities must be registered).

<sup>2</sup> Securities and Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)) [hereinafter "Exchange Act"]. Congress enacted the Exchange Act as an additional response to the stock market crash of 1929. See Loomis, *The Securities Exchange Act of 1934 and The Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 216-17 (1959) (citing SENATE COMM. ON BANKING AND CURRENCY, *STOCK EXCHANGE PRACTICES*, S. REP. No. 1455, 73d Cong., 2d Sess. 1 (1934)).

The Exchange Act was designed to regulate "all aspects of public trading of securities." T. HAZEN, *supra* note 1, at 7. To adequately regulate the vast securities industry, Congress established the Securities and Exchange Commission ("SEC" or "Commission"). See 15

In construing the definition of a "security" set forth in these Acts, courts have encountered difficulty in determining whether a particular investment or instrument is, in essence, a security.<sup>3</sup> The principal issue underlying this determination traditionally has been whether the investment or instrument required the protection of the federal securities laws.<sup>4</sup> Despite the formulation of many different tests and approaches,<sup>5</sup> a satisfactory definition of a security has proven elusive.<sup>6</sup> The lack of a consistent and workable definition of a security has resulted in the failure of the courts to adequately characterize traditional repurchase agreements ("repos")

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U.S.C. § 78d (1982). The SEC, in administering its numerous and complex regulations, seeks to ensure adequate disclosure and due process in the securities field. See Orrick, *Organization, Procedures and Practices of the Securities and Exchange Commission*, 28 GEO. WASH. L. REV. 50, 50 (1959). The Exchange Act also prohibits fraud, material misrepresentations, and omissions of fact in connection with the purchase or sale of any security. See 15 U.S.C. § 78j(b) (1982); *infra* note 39.

<sup>3</sup> Compare *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982) (bank-issued certificate of deposit held not to be a security) and *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559 (1979) (interest in noncontributory, compulsory pension plan not a security) and *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 (1975) (shares of stock used to purchase subsidized co-op housing not securities) with *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 9 (1971) (treasury bonds held to be securities) and *Tcherepnin v. Knight*, 389 U.S. 332, 345-46 (1967) (withdrawable capital share in savings and loan association included as a security) and *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299-300 (1946) (offering of units in citrus grove development combined with agreement to transfer proceeds directly to investor held a securities transaction).

<sup>4</sup> See T. HAZEN, *supra* note 1, at 15. See also *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982) (bank-issued certificate of deposit held not a security for purposes of anti-fraud provisions of securities laws). The Court emphasized that the certificate was already federally insured and therefore did not require the protection of the securities laws. See *id.* at 558; see also Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311, 329 (1984) (discussing *Marine Bank* decision and concepts of securities); Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99, 137-38 (1982) (same).

<sup>5</sup> See, e.g., *Forman*, 421 U.S. at 851-53 (economic reality or *Howey-Forman* test); *Howey*, 328 U.S. at 298-301 (investment contract or *Howey* test); *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1065 (10th Cir. 1976) (risk capital analysis), *cert. denied*, 431 U.S. 965 (1977); *SEC v. Glenn W. Turner Enter.*, 474 F.2d 476, 481-83 (9th Cir.) (modified *Howey* test with "solely" not strictly construed), *cert. denied*, 414 U.S. 821 (1973). See also *infra* notes 8-15 and accompanying text (further discussion of courts' various tests and approaches). For a more detailed discussion of the struggle for a workable definition of security, see generally Carney, *supra* note 4, at 317-73 (satisfying *Howey* test may not be a sufficient condition; contextual approach may provide supplement); Carney & Fraser, *Defining a "Security": Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L.J. 73, 78-114 (1981) (risk capital analysis better alternative to inadequate *Howey* test).

<sup>6</sup> See *infra* notes 8-16 and accompanying text.

in the context of the federal securities laws.<sup>7</sup>

Early judicial attempts at developing a useful definition of a security focused primarily upon interpretation of the statutory phrase "investment contract."<sup>8</sup> In a landmark decision, *SEC v. W.J. Howey Co.*,<sup>9</sup> the Supreme Court held that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."<sup>10</sup> Relying heavily upon the manner in which the investment was marketed, the Court focused on the economic underpinnings of the investment package.<sup>11</sup> Although it has

<sup>7</sup> See, e.g., *United States v. Erickson*, 601 F.2d 296, 300 n.4 (7th Cir.) ("in substance a secured loan"), *cert. denied*, 444 U.S. 979 (1979); *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980) (essentially collateralized loans). *But see* *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 19 (2d Cir. 1986) (characterization no longer necessary as repos subject to securities laws), *cert. denied*, 107 S. Ct. 952 (1987).

<sup>8</sup> See, e.g., *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (assignments of oil leases held to involve investment contract); *SEC v. Crude Oil Corp. of America*, 93 F.2d 844, 848 (7th Cir. 1937) (bill of sale and delivery contracts to purchase oil royalties held to be investment contracts); *SEC v. Bourbon Sales Corp.*, 47 F. Supp. 70, 72-73 (W.D. Ky. 1942) ("An investment contract . . . means the entrusting of money or property to another with the expectation of profit or income therefrom through the efforts of other persons.") (citing *SEC v. Bailey*, 41 F. Supp. 647, 650 (S.D. Fla. 1941)).

<sup>9</sup> 328 U.S. 293 (1946).

<sup>10</sup> *Id.* at 298-99. The *Howey* Court held that an offering of units of a citrus grove development, coupled with a contract for remitting the profits to the investor, was an offering of an "investment contract" within the meaning of the Securities Act. *See id.* at 299-300. Consequently, the offering was subject to the registration requirements of the Securities Act. *See id.* at 301.

In recent years, the *Howey* test has not been construed as originally formulated. *See, e.g., Forman*, 421 U.S. at 852 (dictum) (Court modified *Howey* test to apply to entrepreneurial or managerial efforts of others); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479-80 (5th Cir. 1974) ("solely" requirement of *Howey* should be construed functionally, not literally). The fourth prong of the *Howey* test, requiring the efforts solely of a third party, has been altered to include profits received "substantially" from the efforts of others. *See SEC v. Glenn W. Turner Enter.*, 474 F.2d 476, 481-83 (9th Cir.) (self-improvement contracts held to be investment contracts even though the profits did not come "solely" from the efforts of others), *cert. denied*, 414 U.S. 821 (1973). *See also* T. HAZEN, *supra* note 1, at 16 (recent refinements "diluted" *Howey* test's "solely" prong).

A further modification of the *Howey* test required that there be a substantial capital investment with a corresponding expectation of return for the federal securities laws to be applicable. *See International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559-60 (1979) (compulsory, noncontributory employee benefit plan not investment contract because economic realities reveal lack of actual investment). *See also* Dillport, *supra* note 4, at 105-06 (modifications and clarifications of *Howey* test).

<sup>11</sup> *See Howey*, 328 U.S. at 298-99. The Court, finding that investors were attracted exclusively by the potential for high returns, concluded that this scheme was, in essence, a profit seeking venture subject to the federal securities laws. *See id.* at 299-300; T. HAZEN,

been termed the investment contract test,<sup>12</sup> the *Howey* test may more accurately be characterized as an economic reality test.<sup>13</sup> In addition to the *Howey* test, some state and federal courts developed a risk capital test.<sup>14</sup> Under this test, an investment is a security if there is capital at risk and success is dependent upon the efforts of others, even if there is no common enterprise nor any expectation of profit.<sup>15</sup>

It is submitted, however, that neither the *Howey* test nor the risk capital test provides adequate guidelines to determine whether repurchase agreements are securities within the meaning of the securities laws. These tests are plagued with ambiguities and generalities which make their practical application haphazard at best. Moreover, the complex nature of the securities field has made it extremely difficult for the courts to develop a reliable formula. Consequently, when a court has been called upon to make this determination, it has applied an essentially ad hoc subjective test,

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*supra* note 1, at 15.

<sup>12</sup> See *Howey*, 328 U.S. at 298. The Court, discussing the meaning given investment contracts by various state courts, defined an investment contract as a "contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.'" *Howey*, 328 U.S. at 298 (quoting *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)).

<sup>13</sup> See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332 (1967). The Court stated that "in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality." *Id.* at 336 (citing *Howey*, 328 U.S. at 298); see also *supra* note 11 (emphasis on economic reality in *Howey* resulted in classification as security).

<sup>14</sup> See *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). In *Sobieski*, the court noted:

Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.

*Id.* at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89. See also *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1475 (D. Or. 1985) (risk capital test used to determine whether necessary monetary investment exists to qualify transaction as security); Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 381-83 (1967) (courts should focus on investor's contribution in transaction and risk of losing that value). But see *Forman*, 421 U.S. at 852-53; see also *SEC v. Glenn W. Turner Enter.*, 474 F.2d 476, 482 (9th Cir.) (test is whether efforts made by others affect company's success), *cert. denied*, 414 U.S. 821 (1973).

<sup>15</sup> See *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1064 (10th Cir. 1976), *cert. denied*, 431 U.S. 965 (1977); see also *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 646-47 (D. Colo. 1970) (court limited application of federal securities laws to extremely high risk, speculative franchises), *modified on other grounds*, 460 F.2d 666 (10th Cir. 1972). See generally *Carney & Fraser*, *supra* note 5, at 96-114 (overview of risk capital test).

based largely upon the "economic realities" underlying the investment, as determined by that particular court.<sup>16</sup>

This Note will examine whether repos are securities within the meaning of the securities laws, and will address this issue in light of the anti-fraud provisions and registration requirements of such laws. This Note will also consider possible alternative characterizations of repos and implications of these characterizations on the repo market and its participants. It will be suggested that courts should characterize repos in a manner that will exempt them from the costly and time consuming securities law registration requirements, yet subject repo issuers to the anti-fraud provisions of the Acts.

#### TRADITIONAL REPURCHASE AGREEMENTS AND THE REPO MARKET

Commercial repurchase agreements are highly specialized negotiated contracts, entered into almost exclusively by United States government securities dealers in order to finance their highly leveraged operations.<sup>17</sup> The dealer typically will borrow cash from a corporation or other investor who is searching for a short-term investment with low risk and a high return.<sup>18</sup> In exchange for

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<sup>16</sup> Cf. *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979). In *Daniel*, the Supreme Court endorsed the idea that the economic realities of the investment scheme should be weighed at least equally with, and possibly more than, the structure or the characterization of the scheme adopted by the parties. See *id.* at 558-59. *Accord* *Howey*, 328 U.S. at 298; see also *Forman*, 421 U.S. at 851-53 (Court looked to underlying economic realities rather than form of transactions); *Coffey*, *supra* note 14, at 378-80 (scrutinizing all surrounding circumstances and events to determine true nature of transaction).

<sup>17</sup> See J. MARTIN, J. PETTY, A. KEOWN & D. SCOTT, *BASIC FINANCIAL MANAGEMENT* 167 (2d ed. 1982) [hereinafter J. MARTIN]. Although government securities dealers are the borrowers in the majority of repurchase transactions, commercial banks and thrift institutions occasionally will attempt to finance their holdings by borrowing in the repo market. See Snow, *Description of the Repo Market and the Positions of the Players*, in *PRACTISING LAW INSTITUTE, REPURCHASE AND REVERSE REPURCHASE AGREEMENTS* 17, 20 (Course Handbook Series No. 290, 1982) [hereinafter *PLI HANDBOOK*].

The typical borrowers in repurchase agreements run highly leveraged operations, taking positions sometimes several hundred times above their capital holdings. See M. STIGUM & R. BRANCH, *MANAGING BANK ASSETS AND LIABILITIES* 43-44 (1983). "They will, moreover, buy and hold substantial positions if they believe that interest rates are likely to fall and that the value of these securities is therefore likely to rise. Speculation and risk taking are an inherent and important part of being a dealer." *Id.* at 43. See also McCurdy, *The Dealer Market for United States Government Securities*, *FED. RESERVE BANK OF N.Y. Q. REV.* 35, 45-47 (Winter 1977-78) (discussion of dealer financing).

<sup>18</sup> See Snow, *supra* note 17, at 23-28; Note, *Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action*, 52 *FORDHAM L. REV.* 828, 831 (1984). Repurchase agreements are relatively safe investments since both the dealer and the issuer of the

the investor's cash, the dealer agrees to sell and the investor agrees to buy a specified portion of the dealer's securities at an agreed-upon price as security for the agreement.<sup>19</sup> Simultaneously, the dealer agrees to repurchase and the investor agrees to resell the same securities at a later date at a specified higher price.<sup>20</sup>

In the contract, the parties usually will stipulate that any interest accruing on the securities after the initial purchase, but before the repurchase, will remain the property of the dealer.<sup>21</sup> Because of the economic characteristics of the transaction, repos generally are perceived by the participants as short-term collateralized loans.<sup>22</sup> In fact, a repurchase agreement is not a transaction in which securities are being "sold";<sup>23</sup> rather, the principal economic result is the formation of secured loans and borrowings.<sup>24</sup> The un-

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security (the federal government) must default for the investor to suffer a loss. See R. MOYER, J. MCGUIGAN & W. KRETLOW, *CONTEMPORARY FINANCIAL MANAGEMENT* 605 (2d ed. 1984) [hereinafter R. MOYER]. Additionally, the existence of an agreement to repurchase removes any marketability risk, since the investor has received a commitment from the dealer to repay cash at a specified time. See L. GITMAN, M. JOEHNK & G. PINCHES, *MANAGERIAL FINANCE* 381 (1985).

<sup>19</sup> See *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980); J. MARTIN, *supra* note 17, at 167. See also B. GUP, *PRINCIPLES OF FINANCIAL MANAGEMENT* 462 (1983); B. ROSEFSKY, *MONEY TALKS: BOB ROSEFSKY'S COMPLETE PROGRAM FOR FINANCIAL SUCCESS* 392 (1982); Securities Trading Practices of Registered Investment Companies, Exchange Act Release No. IC-13005, reprinted in 5 Fed. Sec. L. Rep. (CCH) ¶ 48,528, at 37,553-23 (Feb. 2, 1983) [hereinafter *Exchange Act Release*]; Bowsher, *Repurchase Agreements*, 61 FED. RESERVE BANK OF ST. LOUIS REV. 17, 17-18 (Sept. 1979).

<sup>20</sup> See *Miller*, 495 F. Supp. at 467. The latter part of this transaction is known as a reverse repurchase agreement or "reverse repo." See M. STIGUM, *THE MONEY MARKET* 42 (rev. ed. 1983). Nevertheless, a repurchase agreement and a reverse repurchase agreement are identical transactions. See *id.* If an investor is seeking cash, he is involved in a repurchase agreement. *Id.* Conversely, if he is seeking securities in exchange for cash, it is a reverse transaction. *Id.*; Bowsher, *supra* note 19, at 18.

<sup>21</sup> *Miller*, 495 F. Supp. at 467. The dealer will continue to receive interest on the securities, but will have to pay the investor interest on the cash as determined by the repo market interest rate. See E. SHAPIRO, E. SOLOMON & W. WHITE, *MONEY AND BANKING* 323 (5th ed. 1968).

<sup>22</sup> See M. STIGUM, *supra* note 20, at 396; Exchange Act Release, *supra* note 19, at 37,553-23.

<sup>23</sup> M. STIGUM, *THE MONEY MARKET: MYTH, REALITY AND PRACTICE* 328 (1978).

<sup>24</sup> See *id.*; R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 687 (2d ed. 1984) [hereinafter R. BREALEY]. If a repurchase agreement is considered a secured loan to the borrower, the lender should obtain a perfected security interest in the collateral to protect himself against the claims of third-party creditors of the borrower. See Hirschberg, *Issues Which Frequently Arise in Structuring and Documenting Commercial Repurchase Transactions*, in *PLI HANDBOOK*, *supra* note 17, at 213, 220-21. Note, however, that if the seller has only an option to repurchase, and not an obligation, then the transaction should not be considered a secured loan. See *Chase Manhattan Bank, N.A. v. Mehlman*, 59 App. Div. 2d 694, 694, 398 N.Y.S.2d 686, 687 (1st Dep't 1977), *aff'd*, 46 N.Y.2d 802, 386 N.E.2d 833, 413

derlying securities exchanged in the transaction are treated simply as collateral in the financial markets; the risk of fluctuations in the value of the securities remains with the dealer even though theoretically the investor has title until the subsequent repurchase.<sup>25</sup>

Although these transactions may resemble ordinary loans, Federal Reserve Bank regulations treat repos differently from ordinary loans and require the transactions to be structured as sales and repurchases rather than as straight loans.<sup>26</sup> Repurchase agreements are of limited duration, usually for just one night. They involve enormous sums of money<sup>27</sup> and typically are closed by an oral agreement subject to written confirmation.<sup>28</sup> In addition, when government securities are used to secure the transaction, repos are exempt from Federal Reserve loan limits and reserve requirements.<sup>29</sup>

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N.Y.S.2d 922 (1978). For the guidelines used to determine whether a security interest may be perfected in securities which are the subject of repurchase agreements, see generally U.C.C. art. 8; U.C.C. §§ 9-305, 9-312 (1978).

<sup>25</sup> See *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980); *M. STIGUM*, *supra* note 23, at 399-400; see also *First Am. Nat'l Bank v. United States*, 467 F.2d 1098, 1101 (6th Cir. 1972) (the lender "is completely insulated from the risk of market fluctuations in this type of transaction [repo]—its investment is completely secured since it is assured of receiving the price it paid for the bonds."); *United Planters Nat'l Bank v. United States*, 426 F.2d 115, 118 (6th Cir.) (repo characterized as loan because investor/lender assumed no risk, whereas in a sale, risk of price fluctuations assumed by investor), *cert. denied*, 400 U.S. 827 (1970); *American Nat'l Bank v. United States*, 421 F.2d 442, 452 (5th Cir.) (court characterized repo as loan, due to lack of risk for investor), *cert. denied*, 400 U.S. 819 (1970).

<sup>26</sup> See 12 C.F.R. § 7.1130 (1980) (interpretative rulings on lending limits); *id.* § 204.123 (1987) (sale of Fed funds by investment companies or trust where entire interest held exclusively by depository institution); *id.* § 204.124 (1987) (repos involving only Treasury and Fed securities); see also *City of Harrisburg v. Bradford Trust Co.*, 621 F. Supp. 463, 469-70 (M.D. Pa. 1985); Lucas, Jones & Thurston, *Federal Funds and Repurchase Agreements*, FED. RESERVE OF N.Y. Q. REV. 33, 33-35 (Summer 1977) [hereinafter Lucas]. Federal funds transactions are closely related to the development of repos. Lucas, *supra*, at 34-36. Traditionally, Federal Reserve member banks have traded their reserve balances as a method of acquiring capital for investment. See *id.* at 34. The borrowing bank can thus meet its reserve requirements without having to sell its securities, and it can put these securities to use in other investments. See *id.*

Except for two minor differences, federal funds are basically identical to repos. See *Miller*, 495 F. Supp. at 469. One difference is that federal bonds can be traded only when the investor's unsecured loans are exempt from reserve requirements, while repos can be traded by any investor with sufficient capital. See *id.* The second difference lies in the economic consequences of the two transactions; a federal funds transaction results in an unsecured loan, while a repo results in a secured loan. See *id.*

<sup>27</sup> See R. BREALEY, *supra* note 24, at 687; see also Bowsher, *supra* note 19, at 18 (agreements usually for \$500,000 or more).

<sup>28</sup> See *SEC v. Miller*, 495 F. Supp. 465, 469 (S.D.N.Y. 1980).

<sup>29</sup> See Lucas, *supra* note 26, at 33-34.



The major advantages of participating in repo transactions flow directly from the use of government securities as collateral.<sup>30</sup> The investor encounters very little risk that the dealer will refuse to honor the securities at the time of the repurchase.<sup>31</sup> On the other hand, the dealer likes the ease with which the securities can be transferred.<sup>32</sup> Most securities are held merely as bookkeeping entries at the Federal Reserve Bank, enabling them to be exchanged over the federal wire without any physical delivery.<sup>33</sup> Consequently, repo transactions, which can be completed very quickly,<sup>34</sup> provide sophisticated investors with features they seek most: liquidity, security, and good returns on their investments.<sup>35</sup>

Despite the risk of fluctuating market conditions, repurchase agreements are still regarded as safe investments as long as their participants remain financially secure.<sup>36</sup> It is, therefore, not surprising that a government securities dealer may yield to temptation and make misrepresentations concerning its own financial well-being or make other fraudulent claims to induce investors to purchase or sell government securities pursuant to repurchase

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<sup>30</sup> See *infra* notes 31-35 and accompanying text.

<sup>31</sup> See R. MOYER, *supra* note 18, at 605. The securities typically utilized in repurchase transactions are United States government securities, backed by the full faith and credit of the United States government. See *id.* For the investor to incur a loss, the government would have to default on its obligations. See *id.*

<sup>32</sup> See Bowsher, *supra* note 19, at 18; see also *infra* text accompanying note 33 (describing the procedures of a repo transaction).

<sup>33</sup> See Bowsher, *supra* note 19, at 18.

Transactions are negotiated by telephone, either on a direct basis between parties supplying and acquiring funds or through a small group of market specialists (U.S. government securities dealers). Most large banks and business firms employ traders who maintain telephone contact with potential suppliers (or borrowers) of funds, making offers to borrow (or lend) at specific interest rates.

*Id.*

<sup>34</sup> See *id.*

<sup>35</sup> See *SEC v. Miller*, 495 F. Supp. 465, 470 (S.D.N.Y. 1980). Repos, however, do carry some risks inherent in the trading of all securities. See *id.* at 472. There is a risk that the dealer may prove uncreditworthy and default on his obligations to repurchase. See *id.*; M. STIGUM, *supra* note 23, at 399-400. However, repos involve little risk of default because they have as collateral securities guaranteed by the federal government. See S. KIM & H. GUTHUES, *FINANCE PRINCIPLES: AN INTRODUCTION* 250, 251 (1982).

There is also a liquidity risk when giving up cash for securities, *Miller*, 495 F. Supp. at 472. However, this risk is essentially non-existent because of the limited duration of the agreement—typically one night. See S. BOLTEN & R. CONN, *ESSENTIALS OF MANAGERIAL FINANCE* 423 (1982); R. BREALEY, *supra* note 24, at 687.

<sup>36</sup> See *supra* notes 31 and 35.

agreements.<sup>37</sup> In anticipation of possible fraud in the securities field, Congress enacted section 17(a) of the Securities Act of 1933<sup>38</sup> and section 10(b) of the Securities and Exchange Act of 1934.<sup>39</sup> The Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 10(b), promulgated Rule 10b-5<sup>40</sup> to protect investors in transactions in which fraud occurred in the offer, purchase or sale of the security.<sup>41</sup> The threat of liability under these anti-fraud provisions would encourage government securities dealers to make full and accurate disclosures in all their representations and provide repo participants with current information concerning their transactions.<sup>42</sup>

<sup>37</sup> See, e.g., *City of Harrisburg v. Bradford Trust Co.*, 621 F. Supp. 463 (M.D. Pa. 1985) (misrepresentation based on financial condition of government securities dealer); *SEC v. Drysdale Sec. Corp.*, 606 F. Supp. 295 (S.D.N.Y. 1985) (same), *rev'd*, 785 F.2d 38 (2d Cir.), *cert. denied*, 106 S. Ct. 2894 (1986); *SEC v. Gomez*, [1985] Fed. Sec. L. Rep. (CCH) ¶ 92,013, at 91,019 (S.D. Fla. Apr. 4, 1985) (same).

<sup>38</sup> 15 U.S.C. § 77q(a) (1982). Section 17(a) of the Securities Act states, in pertinent part, that:

It shall be unlawful for any person in the offer or sale of any securities . . . directly or indirectly—

- (1) to employ any device, scheme or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made . . . not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

*Id.*

<sup>39</sup> 15 U.S.C. § 78j(b) (1982). Section 10(b) of the Exchange Act states, in pertinent part, that:

It shall be unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

*Id.*

<sup>40</sup> 17 C.F.R. § 240.10b-5 (1986). The regulation states, in pertinent part:

It shall be unlawful for any person, directly or indirectly . . .

- (a) to employ any device, scheme, or artifice to defraud,
- (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or
- (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase and sale of any security.

*Id.*

<sup>41</sup> See *supra* notes 38-40.

<sup>42</sup> Cf. *The Issuance of "Retail Repurchase Agreements" by Banks and Savings and Loan Associations*, Securities Act Release No. 6351, Exchange Act Release No. 18122, Trust

## CHARACTERIZATION OF REPOS

For federal security anti-fraud provisions to apply, there must be a purchase or sale of a "security," and the misrepresentation or fraud must occur "in connection" with such purchase or sale.<sup>43</sup> Consequently, a debate has arisen as to whether to characterize a repurchase agreement as a loan, as a separate security, or as a purchase and sale of the securities underlying the agreement.<sup>44</sup> This Note will examine possible repo characterizations from the perspective of the SEC and will follow with a discussion of the judiciary's response to this position.

A. *Repos as Loans*

If repos were characterized as loans, the SEC would not have regulatory authority over them because the Commission's anti-fraud jurisdiction is limited to transactions in connection with the purchase or sale of a security, and loans generally do not involve the use of securities.<sup>45</sup> However, an SEC hands-off policy is not desirable in any government securities transaction fraught with the potential for widespread fraud. Consequently, the SEC has taken

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Indenture Act Release No. 658, Investment Co. Act Release No. 11958, *reprinted in* 1 Fed. Sec. L. Rep. (CCH) ¶ 2024, 2559-2, 2559-4 to 2559-6 (Sept. 25, 1981) [hereinafter Exchange Act Release, "*Retail Repurchase Agreements*"] (banks offering retail repos should accurately disclose all facts regarding repos). *See also* Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*, 37 VAND. L. REV. 401, 424-25 (1984) (potential liability should deter fraud).

<sup>43</sup> *See supra* notes 38-40.

<sup>44</sup> *See, e.g.*, SEC v. Drysdale Sec. Corp., 785 F.2d 38, 40 (2d Cir.) (fraud "in connection with" repos governed by anti-fraud provisions), *cert. denied*, 106 S. Ct. 2894 (1986); SEC v. Miller, 495 F. Supp. 465, 467 (S.D.N.Y. 1980) (repos characterized as loans); SEC v. Gomez, [1985] Fed. Sec. L. Rep. (CCH) ¶ 92,013, at 91,019 (repos characterized as securities and thus governed by anti-fraud provisions).

<sup>45</sup> *See* 15 U.S.C. §§ 77q, 78j(b) (1982); 17 C.F.R. § 240.10b-5 (1986); Note, *supra* note 42, at 416. The anti-fraud provisions apply to separate purchases and sales of underlying government securities and to securities transactions themselves. *See* 15 U.S.C. §§ 77q, 78j(b) (1982); 17 C.F.R. § 240.10b-5 (1986); *see also* Exchange Act Release, "*Retail Repurchase Agreements*", *supra* note 42, at 2559-4. The SEC declared in this Release that:

The economic realities of traditional repurchase agreements suggest that such agreements are not themselves separate securities. For purposes of the federal securities laws, however, they are deemed to involve the purchase and sale of the U.S. government securities to which they relate. As a result, the antifraud provisions of such laws would apply to the offer, sale and purchase of U.S. government securities occurring in connection with traditional repurchase government securities occurring in connection with traditional repurchase agreements.

*Id.* (footnote omitted).

the position that a repo should not be characterized as a loan.<sup>46</sup>

### B. Repos as Separate Securities

Traditionally, the SEC has wavered between categorizing repos either as separate securities or as a purchase and sale of securities underlying the agreement.<sup>47</sup> If classified as a separate security, repurchase agreements would be subject to the time consuming and expensive registration procedures required of separate securities under the Acts.<sup>48</sup> Consequently, the Commission has moved towards categorizing repos as a purchase and sale of the securities which underlie the repurchase agreement.<sup>49</sup> In an *amicus curiae* brief filed in *Manufacturers Hanover Trust Co. v. Drysdale Securities Corp.*,<sup>50</sup> the SEC examined the statutory definitions of "security" given in section 2(1) of the Securities Act<sup>51</sup> and section 3(a)(10) of the Securities and Exchange Act,<sup>52</sup> and concluded that

<sup>46</sup> See, e.g., Brief for the Securities and Exchange Commission, *Amicus Curiae*, *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13 (2d Cir. 1986) (Nos. 85-7827, 85-7865, 85-7929) [hereinafter *Amicus Curiae Brief*] (SEC argued that repos should be characterized as securities), *cert. denied*, 107 S. Ct. 952 (1987).

<sup>47</sup> Compare Brief for Appellant, *SEC v. Drysdale Sec. Corp.*, 785 F.2d 38 (2d Cir. 1986) (No. 85-6111) (SEC apparently argued that a repo should be characterized as a security) with *Amicus Curiae Brief*, *supra* note 46 (SEC maintained that repos should not be characterized as separate securities but as involving the purchase and sale of the securities underlying the agreement).

<sup>48</sup> See Exchange Act Release, "*Retail Repurchase Agreements*", *supra* note 42, at 2559-4 n.7; see also T. HAZEN, *supra* note 1, at 27-84 (discussion of registration requirements in federal securities laws).

<sup>49</sup> See *Amicus Curiae Brief*, *supra* note 46.

<sup>50</sup> 801 F.2d 13 (2d Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1987).

<sup>51</sup> 15 U.S.C. § 77b(1) (1982 & Supp. 1987). Section 2(1) of the Securities Act states in part:

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights . . . or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

*Id.*

<sup>52</sup> 15 U.S.C. § 78c(a)(10) (1982 & Supp. 1987). Section 3(a)(10) of the Exchange Act states in part:

The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-

a repurchase agreement is not a "security" for purposes of the Acts.<sup>53</sup>

Although repos arguably may be considered notes because they involve a commitment on the part of one party to pay a fixed sum of money to repurchase the underlying securities, they still cannot be viewed as securities in the form of "notes."<sup>54</sup> In *Exchange National Bank of Chicago v. Touche Ross & Co.*,<sup>55</sup> the Second Circuit stated that a party claiming that a note is not within the 1933 Securities Act "has the burden of showing that 'the context otherwise requires.'"<sup>56</sup> The court's discussion implies that a note is presumed to be a security.<sup>57</sup> However, in *Exchange National Bank*, Judge Friendly stated that "note[s] which simply [formalize] an open-account debt incurred in the ordinary course of business (particularly if . . . it is collateralized)" should not be considered securities.<sup>58</sup> Such notes strongly resemble repurchase agreements, thus it is unlikely that any court would define a repo

trust certificate, certificate of deposit, for a security . . . or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing.

*Id.* The Supreme Court has stated that, despite the variations of the definitions of security given in the Acts, the definitions should be considered "virtually identical." See *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967).

<sup>53</sup> See *Amicus Curiae Brief*, *supra* note 46, at 8-18.

<sup>54</sup> See, e.g., *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976) (enumerating types of notes outside statutory definition); see generally Lipton & Katz, "Notes: Are (Are Not?) Always Securities—A Review," 29 *Bus. Law.* 861 (1974) (discussing when collateralized notes are not to be viewed as securities); Note, *The Economic Realities of Defining Notes as Securities Under the Securities Act of 1933 and the Securities and Exchange Act of 1934*, 34 *U. Fla. L. Rev.* 400 (1982) (outlining judicial definitions that cause notes to fall outside the purview of securities regulations).

<sup>55</sup> 544 F.2d 1126 (2d Cir. 1976).

<sup>56</sup> *Id.* at 1137-38 (emphasis in original).

<sup>57</sup> See *id.* at 1138. In this case, however, the Second Circuit gave various examples of notes which would not be securities:

[T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized). When a note does not bear a strong family resemblance to these example and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply.

*Id.*

<sup>58</sup> *Exchange Nat'l Bank*, 544 F.2d at 1138.

as a security in the form of a note.<sup>59</sup>

It is submitted that repurchase agreements also cannot be viewed as a "right to subscribe to or purchase a security" so as to allow a characterization of repos as separate securities. Parties to repurchase agreements do not have a right or option to sell or purchase securities.<sup>60</sup> On the contrary, the participants are contractually obligated either to sell to or purchase from each other securities of the same class and issuer on an agreed-upon later date.<sup>61</sup> In this context, repos resemble mandatory forward contracts in which the parties respectively agree to purchase or sell securities on an agreed-upon future date.<sup>62</sup> In cases involving forward contracts pertaining to Government National Mortgage Association certificates ("Ginnie Maes"), courts have viewed such for-

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<sup>59</sup> See *Amicus Curiae Brief*, *supra* note 46, at 13-14. Traditional repurchase agreements involve transactions which bind investors and dealers within the ordinary course of the securities business. See *id.* Additionally, the size of repurchase transactions, their short terms, bargained-for prices, and non-assignability warrant the conclusion that repos should not be held to be notes within the meaning of the securities laws. See *id.* at 14.

These same considerations warrant the conclusion that a traditional repurchase agreement should not be deemed a security in the form of an "evidence of indebtedness." Cf. *United States v. Austin*, 462 F.2d 724, 736 (10th Cir.), *cert. denied*, 409 U.S. 1048 (1972) (evidence of indebtedness defined as "contractual obligation to pay in the future for consideration presently received"); *United States v. Jones*, 182 F. Supp. 146, 149 (W.D. Mo. 1960) (evidence of indebtedness found to exist where instrument contained "on its face evidence of an obligation as to which some innocent person would act in relation to the terms thereof").

The SEC has maintained the position that retail repurchase agreements are securities in the form of notes, evidences of indebtedness, and debentures. See Exchange Act Release, "*Retail Repurchase Agreements*", *supra* note 42, at 2559-3. However, it is necessary to distinguish between retail repos and the traditional wholesale repos previously discussed. Retail repos are primarily offered to the general public for investments of less than \$100,000 for terms of not less than ninety days. *Id.* at 2559-2. The SEC compared the two forms of repos stating:

[T]raditional repos usually have a shorter duration (one day is not untypical, involve larger amounts (one million dollars is not uncommon), are privately negotiated rather than mass marketed, and involve entire government securities which often are delivered directly to the purchaser; an event which rarely, if ever, occurs in a retail repo transaction.

*Id.* at 2559-4. See generally Lowy, *Special Rules Applicable to Retail Repurchase Agreements*, in *PLI HANDBOOK*, *supra* note 17, at 251 (detailed discussion of retail repurchase agreements).

<sup>60</sup> See *In re Fin. Corp.*, 1 Bankr. 522, 524-26 (W.D. Mo. 1979), *aff'd sub nom.* *Financial Corp. v. Occidental Petroleum Corp.*, 634 F.2d 404 (8th Cir. 1980); *Miller v. Schweickart*, 413 F. Supp. 1062, 1067 (S.D.N.Y. 1976).

<sup>61</sup> See Novikoff & Julis, *Repurchase and Reverse Repurchase Agreements Under Articles 8 and 9 of the Uniform Commercial Code*, in *PLI HANDBOOK*, *supra* note 17, at 79, 81.

<sup>62</sup> See *Amicus Curiae Brief*, *supra* note 46, at 11; see also *SEC v. G. Weeks Sec., Inc.*, 678 F.2d 649, 652 (6th Cir. 1982) (definition of forward contract).

ward contracts as involving only a purchase or sale of the underlying government securities and not as separate securities themselves.<sup>63</sup> As Ginnie Maes are exempted from the Securities Act registration requirements,<sup>64</sup> so are the forward contracts involving them.<sup>65</sup> Ginnie Maes are, however, subject to the anti-fraud provisions of both Acts.<sup>66</sup> It is submitted that repos, which resemble forward contracts, should enjoy similar treatment from the SEC.

### C. *Repos as a Purchase and Sale of Securities Underlying the Agreement*

The SEC does not maintain that repurchase agreements qualify as securities under the Acts,<sup>67</sup> or that it is necessary to treat them as separate securities in order to protect investors.<sup>68</sup> The SEC would treat repos as transactions occurring "in connection with" the purchase and sale of the securities underlying the agreement, so that they would still be subject to anti-fraud regulation.<sup>69</sup>

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<sup>63</sup> See, e.g., *Abrams v. Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 588-89 (7th Cir. 1984) (purchase of Ginnie Maes is "in connection with" purchase of underlying securities but forward contracts not separate securities); *SEC v. G. Weeks Sec., Inc.*, 678 F.2d 649, 652 (6th Cir. 1982) (Ginnie Mae forward contract not a security); see generally *In re Legel, Braswell Gov't Sec. Corp.*, 648 F.2d 321, 323-24 n.3 (5th Cir. 1981) (description and uses of Ginnie Maes).

<sup>64</sup> See 15 U.S.C. § 77c(a)(2) (1982). Section 4(a)(2) of the Securities Act provides, in pertinent part, that "the provisions of this subchapter shall not apply to any . . . security issued or guaranteed by the United States." *Id.*

<sup>65</sup> See *id.*; see also *LTV Fed. Credit Union v. UMIC Gov't Sec., Inc.*, 523 F. Supp. 819, 832-33 (N.D. Tex. 1981) (standby commitment to purchase Ginnie Maes enjoys Ginnie Maes' exemption from registration). Cf. *Diamant Inv. Co.*, SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,447, 76,818, 76,819 (Sept. 11, 1980) (if underlying security exempted from registration by statute, then repo should be similarly exempted).

<sup>66</sup> See 15 U.S.C. § 77q(a), (c) (1982). Exemptions in section 4 of the Securities Act do not apply to statutes regarding fraudulent interstate transactions. *Id.*; see also 15 U.S.C. § 78j (1982) (no provision in Exchange Act making anti-fraud provision inapplicable for registration-exempt security); *infra* note 71 (discussion of registration requirements as applied to repo market).

<sup>67</sup> See *supra* notes 47-66; *infra* notes 68-70 and accompanying texts.

<sup>68</sup> See *Amicus Curiae Brief*, *supra* note 46, at 18; Note, *supra* note 42, at 423.

<sup>69</sup> See *Amicus Curiae Brief*, *supra* note 46, at 18-19. The SEC does want to ensure repurchase agreements are within the anti-fraud protections of the federal securities laws. *Id.* The SEC believes that courts can achieve this goal without characterizing traditional repos as separate securities, by treating fraud in repo transactions as occurring "in connection with" the purchase and sale of the underlying securities. *Id.*; see also Exchange Act Release, "Retail Repurchase Agreements", *supra* note 42, at 2559-2 (anti-fraud provisions apply to repos "in connection with" government securities) (codified at 17 C.F.R. § 231.6351 (1986)).

The SEC thus would not subject repurchase agreements to the burdensome registration procedures required of separate securities under the Acts.<sup>70</sup> It is submitted that the SEC approach is superior in that it would have the dual benefit of protecting investors by subjecting repos to the anti-fraud provisions of the Acts without having the deleterious effects of invoking the registration provisions of the 1933 Act.<sup>71</sup>

#### JUDICIAL CHARACTERIZATION OF REPOS

The federal courts have not consistently followed the Commission's determination that traditional repurchase agreements are not securities within the meaning of the Acts.<sup>72</sup> The first two cases directly to address this issue were *SEC v. Gomez*<sup>73</sup> and *City of*

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<sup>70</sup> See *supra* notes 48-49.

<sup>71</sup> See Note, *supra* note 42, at 419; see also *Amicus Curiae Brief, supra* note 46, at 19 (requiring registration can have serious effects on "timing and costs of transactions"). Alternatively, repos might be characterized as separate securities but simultaneously declared exempt from registration requirements on the basis of the government securities exemption of the Securities Act. See 15 U.S.C. § 77c(a)(2) (1982). The SEC has not issued consistent opinions as to whether repos are exempt from registration. Compare *Exchange Act Release, "Retail Repurchase Agreements"*, *supra* note 42, at 2559-4 n.7 (SEC statement that registration provisions of securities laws inapplicable to repos) with *Amicus Curiae Brief, supra* note 46, at 19 n.37 ("The Commission expresses no views on whether traditional repos generally would be exempt from registration").

Repurchase agreements also may be exempt from registration by the private placement exemption of the Securities Act, which exempts "transactions not involving any public offering." 15 U.S.C. § 77d(2) (1982). The exemption primarily was enacted because Congress wanted to avoid time-consuming and expensive registration requirements if the Securities Act's application would not serve any practical need for either the participants or the general public. See T. HAZEN, *supra* note 1, at 128-29 (citing H.R. REP. NO. 85, 73rd Cong., 1st Sess. 1-29 (1933)). The exemption applies only to specific transactions involving the very few sophisticated investors whose bargaining positions are so strong that they do not need federal registration protection. See *id.* at 128.

Traditional repurchase transactions could fall within the private placement exemption if they satisfy the requirements of the SEC's safe harbor rule. SEC Rule 506, 17 C.F.R. § 230.506 (1986). Rule 506 exempts offers and sales of securities from registration when there are no more than thirty-five purchasers. *Id.* § 230.506(b)(2). When traditional repurchase agreements are offered to or entered into with more than thirty-five investors, which is not atypical, the private placement exemption would not apply. See *id.* Therefore, if a repo was deemed to be a security and if the offer or sale was made to more than thirty-five purchasers, the repo would have to comply with the registration provisions of the securities laws. See *id.* Registration would, in effect, cripple the repo market, as repos are attractive investments because of their liquidity and ease of transaction. See *supra* notes 30-35 and accompanying text.

<sup>72</sup> See *infra* notes 73-76 and accompanying text.

<sup>73</sup> [1985] Fed. Sec. L. Rep. (CCH) ¶ 92,013, at 91,018 (S.D. Fla. Apr. 4, 1985).



*Harrisburg v. Bradford Trust Co.*,<sup>74</sup> in which both courts considered repurchase agreements to be "securities" entitled to anti-fraud protection.<sup>75</sup> Both courts further found that the alleged acts satisfied the "in connection with" requirement of the anti-fraud provisions.<sup>76</sup> However, these two cases only examined whether repos were subject to the anti-fraud provisions, and not whether they were subject to the registration requirements.<sup>77</sup> It is submitted that these courts characterized repurchase agreements as "securities" without any conscious appreciation of the registration implications. Neither opinion recognized that classification, either as a separate security or as a purchase and sale of the underlying security, would bring about the same desired result in the anti-fraud context, but would bring about entirely undesired and different results in the registration context. It is therefore suggested that these opinions have value only insofar as they make it clear that repos are not to be characterized as collateralized loans<sup>78</sup> and that the SEC does

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<sup>74</sup> 621 F. Supp. 463 (M.D. Pa. 1985).

<sup>75</sup> See *Gomez*, [1985] Fed. Sec. L. Rep. at 91,019 (repos that "formed the basis . . . [for the] transactions are securities"); *City of Harrisburg*, 621 F. Supp. at 470 (repo agreements considered to be securities).

<sup>76</sup> See *City of Harrisburg*, 621 F. Supp. at 470-72; *Gomez*, [1985] Fed. Sec. L. Rep. at 91,019; In *Gomez*, the complaint alleged that Gomez, a certified public accountant and partner of an accounting firm, "knowingly and with the intent to defraud purchasers of securities," made either false statements or omitted material facts relevant to the financial condition of a holding company that dealt exclusively in U.S. government securities. See *Gomez*, [1985] Fed. Sec. L. Rep. at 91,018. The SEC claimed that Gomez violated sections 17(a)(1), (2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(1),(2), (3) (1982); section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1982); and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5 (1986) (the anti-fraud provisions) See *Gomez*, [1985] Fed. Sec. L. Rep. at 91,018. These alleged acts satisfied the "in connection with" requirements of the securities laws. *Id.*

In *City of Harrisburg*, the court followed the reasoning of *Gomez* and considered repos to be securities. *City of Harrisburg*, 621 F. Supp. at 469-70. The "in connection with" requirement was met as the brokers allegedly misrepresented or omitted certain facts concerning the repo transaction. See *id.* at 471. See also *United States v. Naftalin*, 441 U.S. 768, 773 (1979) (broker held subject to anti-fraud provisions for placing sell orders for shares he did not own, seeking to profit by purchasing below sale price; fraud held to be "in the offer and sale" of securities). Cf. *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971) (fraud "in connection with" purchase and sale of U.S. Treasury bonds subject to anti-fraud provisions); *Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975) (fraud "in connection with" purchase and sale of securities by publicly held mutual fund subject to anti-fraud provisions). See generally *infra* notes 78-100 and accompanying text (further discussion of "in connection with" requirement).

<sup>77</sup> See *City of Harrisburg*, 621 F. Supp. 469-72; *Gomez*, [1985] Fed. Sec. L. Rep. at 91,018-19.

<sup>78</sup> See *City of Harrisburg*, 621 F. Supp. at 470-72; *Gomez*, [1985] Fed. Sec. L. Rep. at 91,019; The *Gomez* court found repos to be securities for the purpose of denying a motion to

have the authority to supervise repo transactions.

### THE "IN CONNECTION WITH" REQUIREMENT OF RULE 10b-5

As previously noted, the SEC relies on the "in connection with" language of the anti-fraud statutes to bring repurchase agreements within the ambit of those provisions.<sup>79</sup> Specifically, Rule 10b-5 requires the alleged fraud to be "in connection with the purchase or sale of any security."<sup>80</sup> If a transaction fails to meet this requirement, the anti-fraud provisions of the securities laws cannot be invoked.<sup>81</sup> In *Chemical Bank v. Arthur Andersen & Co.*,<sup>82</sup> the Second Circuit restrictively interpreted the "in connection with" requirement, holding that it would not be satisfied unless the plaintiff demonstrated that the defendant misrepresented the value of the securities in question.<sup>83</sup> Generally, any fraud or misrepresentation likely to be perpetrated in a repurchase transaction would relate to the financial condition of the government securities dealer, and not to a misrepresentation of value.<sup>84</sup> Yet,

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quash. *Gomez*, [1985] Fed. Sec. L. Rep. at 91,019. Thus ruling might be more useful as an explicit rejection of repos as collateralized loans, a characterization that is widespread. *See, e.g.*, *United States v. Erickson*, 601 F.2d 296, 300 n.4 (7th Cir.) ("in substance a secured loan"), *cert. denied*, 444 U.S. 979 (1979); *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980) (repo a "short-term" collateralized loan); *Ehrlich-Bober & Co. v. University of Houston*, 49 N.Y.2d 574, 577, 404 N.E.2d 726, 728, 427 N.Y.S.2d 604, 606 (1980) ("in essence, a loan transaction"). While such a classification may accurately describe the transaction from an economic perspective, *see Miller*, 495 F. Supp. at 467; *Dunning, Diagrams Outlining Repurchase Transactions*, in *PLI HANDBOOK*, *supra* note 17, at 13, 14, this designation can insulate repos from the reach of the Securities Act's anti-fraud provisions. *See Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1114 (5th Cir. 1974).

<sup>79</sup> *See Amicus Curiae Brief*, *supra* note 46, at 18-19.

<sup>80</sup> 17 C.F.R. § 240.10b-5 (1986). *See supra* note 40 (text of Rule 10b-5).

<sup>81</sup> *See* 15 U.S.C. §§ 77q(a), 78j(b) (1982); 17 C.F.R. § 240.10b-5 (1986).

<sup>82</sup> 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984).

<sup>83</sup> *See id.* at 943. The court held that the "in connection with" requirement could not be satisfied by a mere allegation that the defendant committed a prohibited act in a transaction of which a pledge of securities was a part. *Id.*

In an earlier case, the Supreme Court had stated "we need not decide whether misrepresentations or omissions involved in a securities transaction, but not pertaining to the securities themselves, can form the basis of a violation of [15 U.S.C. § 77q(a)]." *Rubin v. United States*, 449 U.S. 424, 429 n.6 (1981). *But cf.* *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971) (injury resulting from "deceptive practice touching" sale of securities actionable). However, the Second Circuit believed *Bankers Life* "pushed the perimeters rather far," and thus did not feel constrained by it. *See Chemical Bank*, 726 F.2d at 943 (quoting *ITT v. Vencap, Ltd.*, 519 F.2d 1001, 1014 n.26 (2d Cir. 1975)).

<sup>84</sup> *See City of Harrisburg v. Bradford Trust Co.*, 621 F. Supp. 463, 466 (M.D. Pa. 1985) (dealer allegedly promised to deposit repos in a segregated account but did not); *SEC v.*

under the restrictive interpretation advanced by the *Chemical Bank* court, such schemes involving repos would not be subject to the anti-fraud provisions because the fraud would not relate to the value of the securities in question.<sup>85</sup>

The *Chemical Bank* interpretation of the "in connection with" requirement was followed and extended to repos in *SEC v. Drysdale Securities Corp.*,<sup>86</sup> in which misrepresentations concerning the financial condition of a government securities dealer were made to induce investors to enter into repurchase agreements.<sup>87</sup> In *Drysdale*, the district court held that such misrepresentations were not "in connection with" the purchase and sale of securities since they did not concern the securities' value;<sup>88</sup> therefore, repos were "indistinguishable from collateralized loans."<sup>89</sup>

On appeal, however, the Second Circuit reversed the district court's judgment and reinstated the complaint based upon the federal securities laws.<sup>90</sup> The court held that the alleged misrepresen-

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Gomez, [1985] Fed. Sec. L. Rep. (CCH) ¶ 92,013, at 91,018 (S.D. Fla. Apr. 4, 1985) (false statements or omissions regarding financial well-being of dealer); *SEC v. Drysdale Sec. Corp.*, 606 F. Supp. 295, 298 (S.D.N.Y. 1985) (misrepresentations related to capitalization of dealer), *rev'd*, 785 F.2d 38 (2d Cir.), *cert. denied*, 106 S. Ct. 2894 (1986).

*Cf. Hadsell v. Hoover*, 484 F.2d 123 (10th Cir. 1973). In *Hadsell*, the plaintiff purchased corporate securities in a repurchase agreement from another corporation, not a government securities dealer, which later turned out to be insolvent. *Id.* at 124. The plaintiff relied on a fraudulently filed financial statement that indicated that the seller was in good financial standing and thus capable of repurchasing the corporate securities. *Id.* at 124-25. The court rejected the seller's argument that there was no fraud "in connection with" the purchase of securities. *Id.* at 127.

<sup>85</sup> See *SEC v. Drysdale Sec. Corp.*, 606 F. Supp. 295, 298-99 (S.D.N.Y. 1985), *rev'd*, 785 F.2d 38 (2d Cir.), *cert. denied*, 106 S. Ct. 2894 (1986); *Saxe v. E.F. Hutton & Co.*, 789 F.2d 105, 108 (2d Cir. 1986); *Chemical Bank*, 726 F.2d at 943; see also *Head v. Head*, 759 F.2d 1172, 1175-76 (4th Cir. 1985) (no misrepresentation as to value; thus no cause of action under Rule 10b-5). *But cf. A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967) ("a 10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value'").

<sup>86</sup> 606 F. Supp. 295 (S.D.N.Y. 1985), *rev'd*, 785 F.2d 38 (2d Cir.), *cert. denied*, 106 S. Ct. 2894 (1986).

<sup>87</sup> See *id.* at 297. The SEC brought this action against the dealer, three of its officers, and Warren Essner, a partner at the accounting firm responsible for the preparation of the allegedly false and misleading financial statements for Drysdale. *SEC v. Drysdale Sec. Corp.*, 785 F.2d 38, 39 (2d Cir. 1986). Essner's reports failed to disclose Drysdale's enormous capital deficit and that much of Drysdale's capital was held subject to outstanding loans. *Id.* at 40. Essner knew that the reports he prepared would be used to encourage investors to do business with Drysdale. *Id.* Losses to investors stemming from this fraudulent scheme were approximately \$300 million. *Id.* at 39.

<sup>88</sup> *Drysdale*, 606 F. Supp. at 299.

<sup>89</sup> See *Drysdale*, 785 F.2d at 40.

<sup>90</sup> *Id.* at 39.

tations concerning the government securities dealer's financial condition were sufficiently "in connection with" the purchase and sale of the underlying government securities and were therefore subject to the anti-fraud provisions of the federal securities laws.<sup>91</sup> The court distinguished the *Chemical Bank* decision by discussing the significant differences between repos and the traditional, short-term collateralized loans at issue in *Chemical Bank*.<sup>92</sup> In a standard collateralized loan, the lender holds the collateral as security and can sell it only if the borrower defaults.<sup>93</sup> Repo "lenders," on the other hand, acquire immediate ownership rights in the securities received and can dispose of them as they wish.<sup>94</sup> In fact, until

<sup>91</sup> *Id.* at 41-42. The *Drysdale* court analogized to *United States v. Naftalin*, 441 U.S. 768 (1979), and *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), when it held that misrepresentations concerning repurchase agreements, although not involving the value of the securities themselves, were nevertheless "in connection with" the purchase and sale of the underlying government securities and therefore subject to the anti-fraud provisions of the securities laws. *See id.* at 42.

In *Perlow*, the scheme involved placing orders for the purchase of corporate stock with the intent to pay for them only if their market value increased by the payment date. *Perlow*, 375 F.2d at 396. The scheme was held to be "in connection with" the purchase and sale of securities, despite the fact that the misrepresentation involved did not relate to the value of the securities. *Id.* In *Naftalin*, a broker placed sell orders for shares he fraudulently claimed he owned, with the hope of profiting by actually purchasing the shares later in anticipation of a decline in prices. *Naftalin*, 441 U.S. at 770-71. The fraud was held to occur "in" the offer and sale of securities. *Id.* at 773.

In *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), the Supreme Court construed the "in connection with" requirement broadly when it stated:

Section 10(b) must be read flexibly, not technically and restrictively. Since there was a "sale" of a security and since fraud was used "in connection with" it, there is redress under § 10(b) . . . .

. . . .

The crux of the present case is that [the plaintiff] suffered an injury as a result of deceptive practices touching its sale of securities as an investor.

*Id.* at 12-13. Essentially, *Bankers Life* interpreted "in connection with" as requiring only a loose connection, as opposed to a direct relationship, between the allegedly fraudulent conduct and the sale of securities. *See id.*; *see also United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981) (phrase construed "flexibly" so as to include any deceptive practice "touching" securities' sale); Note, *The Pendulum Swings Further: The "In Connection With" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages*, 56 *TEX. L. REV.* 62, 67 (1977) (any deceptive practice imposes liability).

<sup>92</sup> *SEC v. Drysdale Sec. Cop.*, 785 F.2d 38, 41 (2d Cir.), *cert. denied*, 106 S. Ct. 2894 (1986).

<sup>93</sup> *See id.*; *see also U.C.C. § 9-207(1)* (1978) ("secured party must use reasonable care in the custody and preservation of collateral"); *U.C.C. § 9-207(2)(e)* (1978) ("the secured party may repledge the collateral upon terms which do not impair the debtor's right to redeem it").

<sup>94</sup> *Drysdale*, 785 F.2d at 41. In *SEC v. Miller*, 495 F. Supp. 465 (S.D.N.Y. 1980), the

the repo buyer is obliged to deliver the securities for repurchase, he may freely deal the collateral.<sup>95</sup> Consequently, the court determined that repos should not be characterized as collateralized loans.<sup>96</sup> Such a classification would have prevented enforcement of the anti-fraud provisions of the federal securities laws against repo issuers.<sup>97</sup> For this reason, characterization of repos as loans, for purposes of the federal securities laws, has not been judicially upheld.<sup>98</sup>

The *Drysdale* court, like other courts that have examined the status of repos in relation to the anti-fraud provisions of the secur-

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court stated:

Repos customarily provide for a right of substitution, which means that the lender need not resell the identical securities purchased, but may substitute different securities of the same issues. Thus, the lender is not required to safekeep the collateral, but may sell, pledge, use or dispose of it in any manner for any purpose, so long as he resells acceptable securities on the repurchase date.

*Id.* at 469 (footnote omitted).

<sup>95</sup> See M. STIGUM, *supra* note 20, at 41; *supra* note 94 and accompanying text.

<sup>96</sup> *Drysdale*, 785 F.2d at 41-42.

<sup>97</sup> See 15 U.S.C. §§ 77q(a), 78j(b) (1982); 17 C.F.R. § 240.10b-5 (1986). These laws apply only to securities or transactions "in connection with" securities. See 15 U.S.C. §§ 77q(a), 78j(b). However, commercial loans are not securities and therefore are not governed by these provisions. See *Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1114 (5th Cir. 1974).

<sup>98</sup> See *Drysdale*, 785 F.2d at 41-42. Whether a repurchase agreement would be characterized as a loan appears to depend on the context in which the characterization is made. See Hirschberg, *Issues Which Frequently Arise in Structuring and Documenting Commercial Repurchase Transactions*, in PLI HANDBOOK, *supra* note 17, at 213, 217-20.

In the context of the tax laws, repurchase agreements have been held to be secured loans, with the effect that the lender is not treated as the owner of the underlying securities for tax purposes. See, e.g., *First Am. Nat'l Bank v. United States*, 467 F.2d 1098, 1101 (6th Cir. 1972) (bank not entitled to tax exemption on interest earned on municipal bonds used in repos); *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 118 (6th Cir.) (as repo considered secured loan bank not entitled to tax exemption for interest earned), *cert. denied*, 400 U.S. 827 (1970); *American Nat'l Bank v. United States*, 421 F.2d 442, 452-53 (5th Cir.) (same), *cert. denied*, 400 U.S. 819 (1970). *But see* *Citizens Nat'l Bank v. United States*, 551 F.2d 832, 843 (Ct. Cl. 1977) (mere option to repurchase characterized as sale-repurchase agreement and not secured loan.)

In the context of the bankruptcy laws, there is not definitive characterization of repurchase transactions. Compare *Financial Corp. v. Occidental Petroleum Corp.*, 634 F.2d 404, 404-05 (8th Cir. 1980) (one week repurchase transaction involving U.S. Treasury bills held a sale and agreement to repurchase) and *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980) (repos treated as purchase and sale in bond transaction) with *In re Lombard-Wall, Inc.*, No. 82-B-11556 (S.D.N.Y. Sept. 16, 1982) (bench decision) (repo a secured loan and the securities merely collateral) (cited in A. Levin & J. Donovan, *Repurchase Agreements After the 1984 Amendments to the Bankruptcy Code*, in PRACTISING LAW INSTITUTE, REPURCHASE AND REVERSE REPURCHASE AGREEMENTS 143, 146 (Course Handbook Series No. 368, 1985). See generally Note, *Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action*, 52 FORDHAM L. REV. 828 (1984) (detailed discussion of repurchase agreements in the context of bankruptcy laws).

ities laws, did not directly address the issue of whether repos should be subject to the registration requirements of the securities laws.<sup>99</sup> The cumbersome registration requirements would, if applied to repos, result in an increase in transaction costs and a loss of liquidity which would most likely cause the destruction of the repo market.<sup>100</sup> Consequently, it is suggested that repos be characterized as transactions "in connection with" the purchase and sale of the securities underlying the agreement, thereby exempting them from the extensive registration requirements.

#### CONCLUSION

A traditional repurchase agreement may be characterized as a loan, as a separate security, or as a purchase and sale of the securities underlying the agreement. Characterization as a loan, however, would have the undesirable effect of leaving investors unprotected, by exempting repos from the anti-fraud provisions of the securities laws. Classification as separate security would also be unattractive because it would subject repos to the delay and expense of complying with the Securities Act's registration requirements. Recently, as an alternative approach, the SEC and the courts have characterized repos as a separate purchase and sale "in connection with" the securities underlying the agreement. Characterization of repurchase agreements as separate purchases and sales of the underlying government securities is the most logical approach. Such a characterization will help maintain the vitality of the repo market by protecting investors from fraud, while not requiring repo issuers to register their transactions with the SEC.

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<sup>99</sup> See *SEC v. Drysdale Sec. Corp.*, 785 F.2d 38 (2d Cir.), *cert. denied*, 106 S. Ct. 2894 (1986); *City of Harrisburg v. Bradford Trust Co.*, 621 F. Supp. 463 (M.D. Pa. 1985); *SEC v. Gomez*, [1985] Fed. Sec. L. Rep. (CCH) ¶ 92,013 (S.D. Fla. Apr. 4, 1985).

<sup>100</sup> See *Amicus Curiae Brief*, *supra* note 46, at 19.