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 1933¹ and the Securities and Exchange Act of 1934² (the "Acts").


"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).


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. The principal issue underlying this determination traditionally has been whether the investment or instrument required the protection of the federal securities laws. Despite the formulation of many different tests and approaches, a satisfactory definition of a security has proven elusive. 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”).


* 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).

* See infra notes 8-16 and accompanying text.
in the context of the federal securities laws.  

Early judicial attempts at developing a useful definition of a security focused primarily upon interpretation of the statutory phrase "investment contract." In a landmark decision, SEC v. W.J. Howey Co., 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." Relying heavily upon the manner in which the investment was marketed, the Court focused on the economic underpinnings of the investment package. Although it has
been termed the investment contract test, the Howey test may more accurately be characterized as an economic reality test. In addition to the Howey test, some state and federal courts developed a risk capital test. 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.

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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12 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)).

13 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).

14 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. 962 (1973).

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

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.17 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.18 In exchange for

16 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 568-59. 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 376-80 (scrutinizing all surrounding circumstances and events to determine true nature of transaction).

17 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 McCurdey, 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).

18 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. Simultaneously, the dealer agrees to repurchase and the investor agrees to resell the same securities at a later date at a specified higher price.

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. Because of the economic characteristics of the transaction, repos generally are perceived by the participants as short-term collateralized loans. In fact, a repurchase agreement is not a transaction in which securities are being "sold"; rather, the principal economic result is the formation of secured loans and borrowings. The un-

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).


20 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.

21 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).

22 See M. Stigum, supra note 20, at 396; Exchange Act Release, supra note 19, at 37,553-23.


24 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.\textsuperscript{25}

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.\textsuperscript{26} Repurchase agreements are of limited duration, usually for just one night. They involve enormous sums of money\textsuperscript{27} and typically are closed by an oral agreement subject to written confirmation.\textsuperscript{28} In addition, when government securities are used to secure the transaction, repos are exempt from Federal Reserve loan limits and reserve requirements.\textsuperscript{29}

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).

\textsuperscript{25} 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).

\textsuperscript{26} 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 Harriaburg 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 indentical 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.

\textsuperscript{27} See R. BREALEY, supra note 24, at 687; see also Bowsher, supra note 19, at 18 (agreements usually for $500,000 or more).

\textsuperscript{28} See SEC v. Miller, 495 F. Supp. 465, 469 (S.D.N.Y. 1980).

\textsuperscript{29} 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. The investor encounters very little risk that the dealer will refuse to honor the securities at the time of the repurchase. On the other hand, the dealer likes the ease with which the securities can be transferred. 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. Consequently, repo transactions, which can be completed very quickly, provide sophisticated investors with features they seek most: liquidity, security, and good returns on their investments.

Despite the risk of fluctuating market conditions, repurchase agreements are still regarded as safe investments as long as their participants remain financially secure. 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 agreements. See infra notes 31-35 and accompanying text.

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.

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. Bolt and R. Conn, Essentials of Managerial Finance 423 (1982); R. Brealey, supra note 24, at 687.
agreements. In anticipation of possible fraud in the securities field, Congress enacted section 17(a) of the Securities Act of 1933\(^3\) and section 10(b) of the Securities and Exchange Act of 1934.\(^4\) The Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 10(b), promulgated Rule 10b-5\(^4\) to protect investors in transactions in which fraud occurred in the offer, purchase or sale of the security.\(^4\) 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.\(^5\)

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\(^4\) 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.\(^4\)

\(^5\) 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 . . . to 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.\(^4\)

\(^6\) 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.\(^4\)

\(^7\) See supra notes 38-40.

\(^8\) Cf. The Issuance of "Retail Repurchase Agreements" by Banks and Savings and Loan Associations, Securities Act Release No. 6961, 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. 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. 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. 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


See supra notes 38-40.


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.\textsuperscript{46}

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.\textsuperscript{47} 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.\textsuperscript{48} Consequently, the Commission has moved towards categorizing repos as a purchase and sale of the securities which underlie the repurchase agreement.\textsuperscript{49} In an \textit{amicus curiae} brief field in \textit{Manufacturers Hanover Trust Co. v. Drysdale Securities Corp.},\textsuperscript{50} the SEC examined the statutory definitions of “security” given in section 2(1) of the Securities Act\textsuperscript{51} and section 3(a)(10) of the Securities and Exchange Act,\textsuperscript{52} and concluded that


\textsuperscript{47} 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 \textit{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).

\textsuperscript{48} See Exchange Act Release, “Retail Repurchase Agreements”, supra note 42, at 2559-4 n.7; see also T. HAZEN, supra note 1, at 27-34 (discussion of registration requirements in federal securities laws).

\textsuperscript{49} See \textit{Amicus Curiae Brief}, supra note 46.

\textsuperscript{50} 801 F.2d 13 (2d Cir. 1986), cert. denied, 107 S. Ct. 952 (1987).


(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.

\textit{Id.}


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.\textsuperscript{53}

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."\textsuperscript{54} In Exchange National Bank of Chicago v. Touche Ross & Co.,\textsuperscript{55} 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.'"\textsuperscript{56} The court's discussion implies that a note is presumed to be a security.\textsuperscript{57} 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.\textsuperscript{58} Such notes strongly resemble repurchase agreements, thus it is unlikely that any court would define a repo
as a security in the form of a note. 69

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. 60 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. 61 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. 62 In cases involving forward contracts pertaining to Government National Mortgage Association certificates ("Ginnie Maes"), courts have viewed such for-

69 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).


61 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.

62 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. As Ginnie Maes are exempted from the Securities Act registration requirements, so are the forward contracts involving them. Ginnie Maes are, however, subject to the anti-fraud provisions of both Acts. 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, or that it is necessary to treat them as separate securities in order to protect investors. 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.

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63 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).

64 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.


67 See supra notes 47-66; infra notes 68-70 and accompanying texts.

68 See Amicus Curiae Brief, supra note 46, at 18; Note, supra note 42, at 423.

69 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.\(^7\) 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.\(^7\)

**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.\(^2\) The first two cases directly to address this issue were *SEC v. Gomez*\(^7\) and *City of*...

\(^7\) See supra notes 48-49.

\(^7\) 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 (1988). 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 case of transaction. See supra notes 30-35 and accompanying text.

\(^7\) See infra notes 73-76 and accompanying text.

Harrisburg v. Bradford Trust Co.,74 in which both courts considered repurchase agreements to be "securities" entitled to anti-fraud protection.75 Both courts further found that the alleged acts satisfied the "in connection with" requirement of the anti-fraud provisions.76 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.77 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 loans78 and that the SEC does
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. Specifically, Rule 10b-5 requires the alleged fraud to be "in connection with the purchase or sale of any security." If a transaction fails to meet this requirement, the anti-fraud provisions of the securities laws cannot be invoked. In Chemical Bank v. Arthur Andersen & Co., 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. 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. Yet,
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.85

The Chemical Bank interpretation of the “in connection with” requirement was followed and extended to repos in SEC v. Drysdale Securities Corp.,86 in which misrepresentations concerning the financial condition of a government securities dealer were made to induce investors to enter into repurchase agreements.87 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;88 therefore, repos were “indistinguishable from collateralized loans.”89

On appeal, however, the Second Circuit reversed the district court’s judgment and reinstated the complaint based upon the federal securities laws.90 The court held that the alleged misrepresentations...
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. 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. In a standard collateralized loan, the lender holds the collateral as security and can sell it only if the borrower defaults. Repo "lenders," on the other hand, acquire immediate ownership rights in the securities received and can dispose of them as they wish. In fact, until

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91 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 Rule10b-5 Private Claims for Damages, 56 Tax. L. Rev. 62, 67 (1977) (any deceptive practice imposes liability).


93 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 replunge the collateral upon terms which do not impair the debtor's right to redeem it").

94 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. Consequently, the court determined that repos should not be characterized as collateralized loans. Such a classification would have prevented enforcement of the anti-fraud provisions of the federal securities laws against repo issuers. For this reason, characterization of repos as loans, for purposes of the federal securities laws, has not been judicially upheld.

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

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).

86 See M. Srigus, supra note 20, at 41; supra note 94 and accompanying text.
87 Drysdale, 785 F.2d at 41-42.

87 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).

88 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.)

ities laws, did not directly address the issue of whether repos should be subject to the registration requirements of the securities laws. 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. 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.

Howard R. Schatz

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100 See Amicus Curiae Brief, supra note 46, at 19.