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Securities Exchange Act of 1934--CML Remedies Based Upon Illegal Extension of Credit in Violation of Regulation T

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COMMENTS

Securities Exchange Act of 1934—Civil Remedies Based Upon Illegal Extension of Credit in Violation of Regulation T—Following the stock market crash of 1929, there was considerable agitation for the regulation, and even the elimination, of the purchasing of securities on credit. Indeed, the extension of credit for the purchasing of securities became an issue in the 1932 presidential campaign and finally, in 1934, came under direct federal control. Although the federal regulations were intended to eliminate the hazards associated with the extension of credit for the purchasing of securities, all the available evidence indicates that the substantial amount of credit in the stock market was a significant factor in pushing up prices during the bull market, and in magnifying the drop in prices that took place in May and June of 1962.[1] The speculators seem to have had no difficulty in satisfying their demands for credit from a variety of lenders who were adept at circumventing both the federal and stock exchange regulations. To understand the problems involved in purchasing securities on credit, and in particular the civil remedies based upon the illegal extension of credit, it is essential to understand the various pertinent credit regulations. Indeed, the failure on the part of some courts to appreciate the complexities of these regulations has led to confusing statements in several opinions.[2]

I. Description of Regulations

The customer who purchases securities on credit is called a "margin trader," and the "margin" is the amount that he deposits, the balance being advanced by a "broker-dealer" or other lender. Section 7 of the Securities Exchange Act of 1934[3] grants to the Board of Governors of the Federal Reserve System[4] the power to control margins by regulating the maximum amount of credit which can be extended for the purpose of purchasing securities.

1 See Rossant, *Credit as a Catalyst*, N.Y. Times, July 30, 1962, p. 27, col. 2; *What Made the Market Go Wild?*, Bus. Week, June 9, 1962, p. 90.

2 See, *e.g.*, Goldenberg v. Bache & Co., 270 F.2d 675 (5th Cir. 1959) (court seems to treat an exchange violation as a federal violation); Weis & Co. v. Offenberger, 31 Misc. 2d 628, 220 N.Y.S.2d 1001 (N.Y. City Munic. Ct. 1961) (court seems to treat a federal violation as an exchange violation).

3 48 Stat. 886 (1934), as amended, 15 U.S.C. § 78g (1958). This statute is hereinafter referred to as the "act" or the "Exchange Act."

4 The Board of Governors of the Federal Reserve System is hereinafter referred to as the "Board" or the "Federal Reserve Board."

Pursuant to the act, the Board has issued its Regulation T,[5] regulating broker-dealers, and its Regulation U,[6] regulating banks, both of which control the extension of credit to margin traders. The Federal Reserve regulations establish minimum requirements only and do not prevent either stock exchanges or lenders from adopting additional and higher margin requirements.[7]

There are two distinct types of margin requirements, one applying only at the time of purchase and the other applying at all subsequent times. An initial margin is required to be deposited in connection with the purchase of a security on credit. The initial deposit reflects the margin trader's equity in the security on the date of purchase, the equity being equivalent to the market value of the security reduced by the amount of credit outstanding on the security. On the other hand, if the market value of the security subsequently declines, the margin trader may be required to deposit additional margin to maintain his equity in the security at a specified "maintenance" level, which is generally lower than the level required for his initial equity. For example, if, under the initial margin requirement he must deposit fifty percent in connection with the purchase of a security valued at 100 dollars, his initial equity would be fifty dollars. Should the value of the security decline to sixty dollars, his equity in the security will decline to ten dollars, and, assuming that the "maintenance" requirement is twenty-five percent of the current market value, he must deposit an additional five dollars.

A. *Federal Regulations*

Since a discussion of Regulation U is beyond the scope of this comment, the following description is limited to Regulation T, which "applies to every member of a national securities exchange and every broker or dealer who transacts a business in securities through the medium of any such member."[8] Only securities listed on a national exchange are subject to its provisions;[9] however, certain listed securities, notably securities of the federal government and state and local bonds, are exempted.[10] Under Regula-

[5] 12 C.F.R. § 220 (1959).

[6] *Id.* § 221.

[7] *Id.* §§ 220.7(e), 221.3(i).

[8] *Id.* § 220.1.

[9] *Id.* § 220.3(c)(2). "Listed securities," referred to in Regulation T as "registered securities," include securities having unlisted trading privileges on a national securities exchange and securities exempted by the SEC. *Id.* § 220.2(d).

[10] *Id.* § 220.3(c)(2). The term "exempted" securities is used with the same meaning

tion T unlisted securities have no collateral value and must be purchased strictly on a cash basis.[11] Finally, the extension of credit, with securities as collateral, for purposes other than purchasing or carrying securities is not subject to the Regulation.[12]

Although the Exchange Act grants to the Board power to prescribe both an initial and a maintenance requirement,[13] Regulation T sets only an initial margin requirement. The Board establishes the initial margin requirement by promulgating, from time to time, the "maximum loan value" for listed securities in terms of a percentage of their current market value.[14] For example, if the "maximum loan value" is set at thirty percent, the margin trader must deposit seventy dollars in connection with the purchase of a security valued at 100 dollars. Since all securities purchased on credit are included in the margin trader's general margin account,[15] the amount of margin which must be deposited in connection with a purchase of additional securities is reduced to the extent of the "available credit" in the account.[16] The "available credit" is the total of the current maximum loan values of all securities held in the particular account reduced by the credit outstanding in the account.[17] In other words, although the maximum loan value of a security is initially determined at the time it is purchased, the maximum loan value of the securities held in the account is continually recalculated on the basis of present margin requirements and current market values[18] to determine the account's "available credit."

Although the Board prescribes the "maximum loan value" from time to time, credit initially extended on a purchase may be retained regardless of a reduction of the margin trader's equity due to declines in market price, termination of the listed or exempt

as that given to it in § 3(a)(12) of the Exchange Act [48 Stat. 884 (1934), 15 U.S.C. § 78c(a)(12) (1958)]. 12 C.F.R. § 220.2(e) (1959).

11 *Id.* § 220.3(c)(2).

12 *Id.* § 220.4(f)(8).

13 48 Stat. 886 (1934), as amended, 15 U.S.C. § 78g (1958).

14 12 C.F.R. § 220.3(c)(2) (1959). The "maximum loan value" is prescribed in *id.* § 220.8 (Supp. 1962). The "current market value" of a security is its total cost or the net proceeds of its sale. *Id.* § 220.3(c)(4).

15 *Id.* § 220.3(a). For "special accounts," see *id.* § 220.4.

16 *Id.* § 220.3(b)(1).

17 *Ibid.* The credit outstanding, referred to in Regulation T as "adjusted debit balance," includes the current market value of the securities sold "short" in the account and other specified items that could make it differ from the net debit balance of the account. *Id.* § 220.3(c)(4).

18 The "current market value" of securities held in the account is the closing sales price of the security on the preceding business day. *Id.* § 220.3(c)(4).

status of securities in the account, or changes in initial margin requirements.[19] However, when more credit is outstanding on the securities in the account than would be permitted in the event of a new purchase of the same securities under current margin requirements, the account becomes "restricted," and Regulation T places limitations upon the withdrawal and substitution of securities in a "restricted" general account.[20] Listed or exempted securities can be withdrawn from a "restricted" account only if other listed or exempted securities (counted at their maximum loan value),[21] or cash, are deposited in the account in an amount equal to the specified retention requirement, which is a percentage of the current market values of the securities withdrawn.[22] However, the margin trader may sell one security and buy another of no greater value on the same day since the status of an account is determined only at the close of each day.[23] If there is "available credit" in the account, obviously there is no restriction on withdrawals.

Certain transactions are excluded from the requirements of the general margin account, for example, the exercise of subscription rights. To avoid hampering the acquisition of additional capital by industry and to facilitate the maintenance by existing shareholders of their proportionate ownership of a corporation, the Board prescribes a lower margin requirement for securities acquired through the exercise of subscription rights.[24] However, the special subscriptions account cannot be used as a means of avoiding the margin requirements of a general account.[25]

19 *Id.* § 220.7(b).

20 *Id.* § 220.3(b)(2) (Supp. 1962). "Restriction" may result, for example, from a decline in the market value of the securities in the account or an increase in margin requirements.

21 The maximum loan value of an exempted security is determined by the broker-dealer in good faith. *Id.* § 220.3(c)(2).

22 *Id.* § 220.3(b)(2) (Supp. 1962). The retention requirement is prescribed in *id.* § 220.8(c) (Supp. 1962).

23 *Id.* § 220.4(h)(1).

24 *Ibid.* The margin is set at 25% of the current market value of the securities acquired in cash.

25 *Id.* § 220.4(a)(3). "An example of a transaction for which the special subscriptions account *is not intended* would be as follows:

"A customer having a 'long' position of 100 shares of security 'A' in a 'restricted' general account receives rights to subscribe to additional shares of security 'A.' Using his rights, and possibly purchasing additional rights if necessary, he makes a subscription to 100 shares of security 'A' in the special subscriptions account on 25% margin. He then sells the 100 shares of security 'A' in his general account and withdraws 75% of the net proceeds of sale.

"This customer did not use his rights as a stockholder to retain his equity in the corporation. He merely used the rights as a device to carry the security position on

B. *Exchange Requirements*

Illustrative of the exchange margin requirements is New York Stock Exchange Rule 431, which provides both initial margin and maintenance requirements.[26] The required initial margin is an amount equivalent to the maintenance requirement, with a minimum equity of 1,000 dollars. The maintenance requirement, which is particularly significant because of the omission of a like requirement under Regulation T, depends upon the type of transaction. For example, the aggregate of all securities "long"[27] in the account must be constantly maintained at a twenty-five percent margin level.[28] This required margin expresses the relationship of the margin trader's equity in the securities to their current market value.[29] Although listed securities exempted under Regulation T are subject to Rule 431, they receive favorable treatment.[30]

C. *Private Requirements*

If the broker-dealer or other lender feels inadequately protected by the federal or exchange requirements, he may demand and obtain higher initial margin and maintenance requirements through separate agreements with individual traders. In any event, all margin accounts are watched daily at brokerage houses, particularly those in which the need for more margin is becoming apparent. When, in the broker's opinion, the margin gets too low, which may be as much as forty percent of the current market value of the security, he sends out a margin call for more cash or collateral. Normally a customer will be allowed three full business days to meet the margin call, although the period may be as short as one day.

II. LEGISLATIVE HISTORY

To determine the principal purpose underlying the federal credit regulations, attention should be focused on the legislative history of these provisions. As a result of the economic events fol-

25% margin instead of 75% margin by transferring it to the special subscriptions account." New York Stock Exchange M.F. Circular No. 79, at 2, July 12, 1951.

26 Rules 431(a), (b).

27 A "long" position signifies ownership of securities, whereas a "short" position signifies securities sold short and not covered as of a particular date.

28 Rule 431(b)(1). A customer may consolidate all transactions to support his position.

29 See Rule 431(d)(1) for determination of value for margin purposes.

30 Rule 431(c)(2).

lowing the stock market crash of 1929 some persons advocated the complete prohibition of purchasing securities on credit, while others adopted the thesis that, even though some margin should be required, a liquid market—made liquid with borrowed funds—is desirable.[31] Although the latter view prevailed, the voluminous hearings on the proposed legislation brought out a wide range of opinions concerning the purposes which margin regulations should serve.

Three primary objectives were advanced during the legislative hearings as being the basic purposes for the enactment of legislation governing margin requirements. First, it was advocated that the principal objective should be the protection of the margin trader, sometimes referred to as the "innocent lamb," in contradistinction to the protection of the broker-dealer afforded by the exchange and private margin requirements.[32] The Senate report asserted that the main objective of the margin regulations was to protect the margin trader by making it impossible for him to buy on too thin a margin,[33] since in the event of unfavorable developments in the financial world such loans are promptly called and may result in the forced sale of the margin trader's securities.[34] Indeed, margin traders are frequently sold out near the bottom of a market decline, thereby maximizing their losses. Secondly, the opinion was expressed that margin regulations should be instruments of credit policy designed to stabilize stock market fluctuations and thus contribute to business stability.[35] In theory, when security prices rise the margin trader has more available credit to buy more securities on margin, and, in addition, more investors may be induced to buy on margin. Such purchases, in turn, tend to raise prices further and so increase again the ability of the margin trader to borrow, whereas a decline in security prices frequently results in forced selling to meet margin calls which, in turn, increases the volume of sell orders and intensifies the decline in prices.[36] Finally, the House committee took the position that

31 See generally BOGEN & KROOSS, SECURITY CREDIT ch. 8 (1960), for a general discussion of the background of the regulations.

32 On protection of Exchange members, see *id.* at 80.

33 Senate Committee on Banking and Currency, *Report on Stock Exchange Practices*, S. REP. No. 1955, 73d Cong., 2d Sess. 11 (1934).

34 "[N]o evidence has ever been gathered on the volume of 'distress selling' and the number of persons forced out by the slim margins and great depreciations in price of the early 1930's." VERNON, THE REGULATION OF STOCK EXCHANGE MEMBERS 55 (1941).

35 *Hearings on Stock Exchange Practices Before Senate Committee on Banking and Currency*, 73d Cong., 2d Sess. pt. 15 (1934).

36 BOGEN & KROOSS, *op. cit. supra* note 31, at 42-43.

the margin regulations were to be designed as selective credit controls to regulate the aggregate amount of credit which could be directed into the stock market and out of the more productive uses of commerce and industry.[37] There was a desire to prevent a recurrence of the pre-crash situation where capital which would have otherwise been available to supply the needs of commerce, industry and agriculture was attracted by the high interest rates in the stock market.[38]

The Exchange Act clearly states that credit regulations are designed primarily to regulate the use of credit; section 7 granted the Board authority to regulate the extension of credit "for the purpose of preventing the excessive use of credit for the purpose of purchasing and carrying securities."[39] Moreover, Congress apparently intended that the Board's power would be used to prevent undue market fluctuations and to help stabilize the economy in general, because it directed the Board to adopt, as its initial method of regulation, a formula based upon past price movements of each security used as collateral.[40] In addition, both of these objectives are expressions of national credit policy, and after extended debate the administration of the margin provisions was assigned to the Federal Reserve Board, an agency designed to stabilize the nation's economic progress, rather than to the Securities and Exchange Commission. It is also of interest to note that the original bill was rewritten along the lines suggested by the Federal Reserve Board and the Treasury Department.[41] In practice, the Board itself has followed the philosophy that the regulations were intended to be instruments of monetary policy. The Board chairman has stated:

> "Regulation of stock market credit is a supplemental instrument of credit policy . . . , one of the means of making a broad credit and monetary policy effective. . . . [E]ach instrument of credit policy . . . should be used in such a manner as to blend all the instruments into a harmonious whole for the maximum contribution to stabilize economic progress for the whole community."[42]

37 House Report on Stock Exchange Practices, H.R. REP. No. 1383, 73d Cong., 2d Sess. 8 (1934).

38 For other proposed objectives, see BOGEN & KROOSS, *op. cit. supra* note 31, ch. 8.

39 48 Stat. 886 (1934), as amended, 15 U.S.C. § 78g(a) (1958). See also § 2(3)(a), 48 Stat. 882 (1934), as amended, 15 U.S.C. § 78b(3)(a) (1958).

40 48 Stat. 886 (1934), as amended, 15 U.S.C. § 78g(a) (1958).

41 BOGEN & KROOSS, *op. cit. supra* note 31, at 94.

42 1 Joint Committee on the Economic Report, *Monetary Policy and the Management of the Public Debt*, S. DOC. No. 123, 82d Cong., 2d Sess. 409-10 (1952).

This policy is reflected in the Board's justifications for the seventeen basic changes in margin requirements which it has ordered from 1934 through 1962,[43] and in the Board's establishment of a lower margin requirement for the exercise of subscription rights. Thus, regulation of the use of credit and stabilization of the stock market would seem to constitute the primary objectives underlying the federal credit regulations, with the protection of the "innocent lamb" as only a possible by-product.

III. JUSTIFICATION OF CIVIL REMEDIES BASED UPON THE ILLEGAL EXTENSION OF CREDIT

The Exchange Act contains no express civil remedy for the illegal extension of credit.[44] The act does, however, contain three specific civil liability sections: 9(e), for manipulation;[45] 16(b), for insiders' profits from short-swing trading;[46] and 18, for misleading statements in documents filed with the SEC.[47] Also, courts have afforded implied civil remedies under certain provisions of the act; for example, private litigants have frequently recovered damages for violations of section 10(b),[48] an anti-fraud provision, and the Commission's Rule 10b-5 issued thereunder.[49] For the most part, the civil remedies, both express and implied, have been based upon provisions designed to protect the investor from certain unfair practices such as misrepresentation and inadequate disclosure.[50] Most of the implied remedies can be justified on the ground that they effectuate the underlying policy of the provisions, and that, in addition, they are statutory alternatives for the common-law action for deceit. However, substantially different considerations are involved with regard to implied civil remedies under the credit regulations. Not only were the regulations designed primarily as instruments of national fiscal policy, rather than to provide protection to the investor, but also no public policy against the extension of credit for the purchase of securities existed at common law.

43 See BOGEN & KROOSS, *op. cit. supra* note 31, app. III, at 169-77 (listing the stated reasons for changes in margin requirements).

44 See 48 Stat. 886 (1934), as amended, 15 U.S.C. § 78g (1958).

45 48 Stat. 890 (1934), as amended, 15 U.S.C. § 78i(e) (1958).

46 48 Stat. 896 (1934), as amended, 15 U.S.C. § 78p(b) (1958).

47 48 Stat. 897 (1934), as amended, 15 U.S.C. § 78r (1958).

48 48 Stat. 891 (1934), as amended, 15 U.S.C. § 78j(b) (1958).

49 17 C.F.R. § 240.10b-5 (1949).

50 See, *e.g.*, Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961); Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

As the Senate report indicates, there was some opinion to the effect that the principal objective of the credit regulations should be the protection of the margin trader from the risk of trading on too thin a margin. Indeed, this may be an intended by-product of the regulations; but this hardly seems to be a sufficient justification for implying civil remedies for the illegal extension of credit. Furthermore, most of the credit cases suggest that all margin traders are to be protected.[51] However, not all margin traders are "innocent lambs"; in fact, many are sophisticated investors and have the facilities and sources of information needed for determining the suitability of purchasing securities on credit. The margin trader, not the broker-dealer, is a speculator, and he knowingly assumes the risk of purchasing securities on an inadequate margin. It seems doubtful that Congress intended that all margin traders be treated as a special class of persons requiring protection from their own lack of judgment.[52] Moreover, even the inexperienced trader is allowed complete discretion within the limits of the margin requirements as to the amount of credit he can obtain; whereas, in certain transactions not covered by Regulation T, the broker-dealer is required to determine the suitability of the loan arrangement in accordance with the individual's financial situation.[53]

On the other hand, implied remedies based on violations of the credit regulations may be justified to the extent that they contribute to the enforcement of those regulations. Although the power to establish the regulations was assigned to the Federal Reserve Board, enforcement was delegated to the SEC. In turn, the SEC has allowed the stock exchanges to be more or less self-regulating in this regard. In light of the recent exposure of the apparent inadequacy of self-regulation,[54] and the lack of manpower in the SEC to police the individual broker-dealers adequately, additional instruments of enforcement are apparently necessary. Suits to enforce an implied civil liability may provide one such

[51] See, *e.g.*, Reader v. Hirsch & Co., 197 F. Supp. 111 (S.D.N.Y. 1961); Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949).

[52] For an interesting example of special treatment to a particular class, *cf.* Glover v. Callahan, 299 Mass. 55, 12 N.E.2d 194 (1937); Bishop v. Liston, 112 Neb. 559, 199 N.W. 825 (1924) (both involving suits for damages for rape in which minors were treated as a special class requiring protection).

[53] See SEC Rule § 240.15c2-5, 27 Fed. Reg. 7091 (1962).

[54] SEC, REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE (1962). See also *SEC Plans Increased Securities Industry Control; Stricter Self-Regulation Urged*, Wall St. J., Nov. 29, 1962, p. 2 (warning by William L. Cary, SEC Chairman).

instrument. The risk of private litigation might deter a potential violator, and, in addition, private actions would expose past violations that might otherwise go undiscovered. However, because of the expense involved, it seems likely that only violations resulting in substantial losses to the margin trader will be the subject of litigation, and these violations would probably be reported to the Commission regardless of whether a private remedy existed. Moreover, the broker-dealers' great fear is of publicity of alleged violations, and this results as much from complaints registered with the SEC or exchanges as from private litigation. Their primary concern is the loss of good will and the accompanying loss of business, rather than potential civil liability. Thus, whether the implied civil remedies actually aid the enforcement of the regulations appears to be dubious.

IV. CIVIL REMEDIES

Federal courts[55] have thus far not been hesitant in implying civil remedies for violations of the federal credit regulations. In the typical case, the broker-dealer illegally extends credit, and when the price of the security declines, the margin trader is sold out. Liability to the margin trader is based upon a general tort theory or, alternatively, on the ground that the contract is void.[56] Although both are traditional rationales for implied liabilities under the Exchange Act,[57] neither the tort nor the void contract theory is easily adapted to cases involving the illegal extension of credit. Moreover, since the credit violation cases have all been decided on a motion to dismiss for failure to state a claim, the decisions fail to resolve many problems peculiar to a cause of action founded upon an illegal extension of credit.

The void contract theory is based upon section 29(b) of the Exchange Act, which provides in part:

> "Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract . . . heretofore or hereafter made the performance of which involves the violation of, or the continuance of any

[55] The federal courts have exclusive jurisdiction in suits to enforce a liability or duty created by the Exchange Act. Securities Exchange Act of 1934, § 27, 48 Stat. 902, as amended, 15 U.S.C. § 78aa (1958).

[56] See, *e.g.*, Goldenberg v. Bache & Co., 270 F.2d 675 (5th Cir. 1959); Warshow v. Hentz & Co., 199 F. Supp. 581 (S.D.N.Y. 1961).

[57] For an excellent discussion of the alternative theories underlying the implied liabilities, see 3 LOSS, SECURITIES REGULATIONS 1757-63 (1961).

> relationship or practice in violation of any provision of this title or any rule or regulation thereunder shall be void . . . as regards the rights of any person who, in violation of any such provision, rule or regulation shall have made or engaged in the performance of any such contract. . . ."[58]

Although this statutory provision does not specifically provide for a civil remedy, one court, in implying a remedy, has observed: "[A] statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it. The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it. . . ."[59] Relying on the 1938 amendment to section 29(b), which deals in part with actions maintained in reliance upon the subsection,[60] another court inferred that Congress, in passing the amendment, manifested the intention that the original statute be interpreted as providing for civil suits.[61] Furthermore, this court indicated, in dictum, that the plaintiff not only had an action for rescission but also one for damages. The inclusion of a damage remedy is dubious since the Senate report, in referring to the amendment, expressed an intent favoring private litigation only for rescission.[62]

However, since section 29(b) voids only the rights of a party to an illegal contract, it is not particularly suited to contracts involving the illegal extension of credit because of the three-fold relationship between the broker-dealer and the margin trader. In any particular transaction involving securities, a broker-dealer acts either as the agent (broker) for the margin trader in purchasing from a third person, or as a principal (dealer), being the actual vendor of the security; in advancing money for the purchase, the broker-dealer becomes the margin trader's creditor; and, finally, in holding the security to secure payment of his advances, the broker-dealer becomes the pledgee of the security.[63] Since the broker, in contradistinction to the dealer, is not a party to a valid purchase contract, should a margin trader be able to recover his

[58] 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78cc(b) (1958).

[59] Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). *Cf.* Goldstein v. Groesbeck, 142 F.2d 422, 427 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

[60] 52 Stat. 1076 (1938), 15 U.S.C. § 78cc(b) (1958).

[61] Geismar v. Bond & Goodwin, Inc., 40 F. Supp. 876, 878 (S.D.N.Y. 1941).

[62] S. REP. No. 1455, 75th Cong., 3d Sess. 10 (1938).

[63] Eddy v. Schiebel, 112 Conn. 248, 152 Atl. 66 (1930). For the technical aspects of the relationship, see generally BLACK, THE LAW OF STOCK EXCHANGES, STOCK BROKERS AND CUSTOMERS (1940); MEYER, THE LAW OF STOCK BROKERS AND STOCK EXCHANGES (1931).

margin in an action for rescission against the broker, since the margin only passed through the broker as a conduit to the innocent seller? Admittedly, a court may extend the illegality of the loan arrangement to the purchase transaction, since the loan is illegal under the regulations only to the extent that credit is extended for the purchase of securities.[64] The broker may be treated as the vendor of the securities rather than as an agent who served simply as a conduit between the margin trader and the innocent vendor, and thus the margin trader may be allowed to rescind the purchase agreement and recover his margin from the broker. Although this requires strained reasoning, such a result may be justified because most margin traders actually regard the broker, rather than the unknown third party, as the vendor. But if the credit is extended subsequent to the purchase, the connection between the illegality of the loan arrangement and the purchase transaction may be substantially weakened.[65] On the other hand, since the rights of the broker-dealer are void on the loan arrangement, should the margin trader be able to receive a windfall by retaining title to the stock[66] and ignoring the illegal loan? Surely with a little effort a court would be able to prevent a forfeiture of the broker-dealer's interest which might otherwise result from the margin trader's election to retain the securities and ignore the void loan contract. For instance, one court equated the voiding language of section 29(b) with a total breach of contract and allowed the seller, who had violated section 16 of the Exchange Act, to recover the market value of the securities delivered.[67]

Assuming that a court overcomes the aforementioned obstacles, it still must determine whether the rights of the margin trader are subject to the voiding provisions. One court has held that a margin trader, allegedly entering into a contract in good faith and without knowledge of Regulation T, is subject to section 29(b), and that the good faith defense of the Exchange Act[68] does not apply to parties to the contract.[69] The decision is justifiable if a literal construction is given to the language of section 29(b)(1),

[64] See 6A CORBIN, CONTRACTS § 1518 (rev. ed. 1962), and cases cited therein.

[65] See *id.* § 1529, and cases cited therein.

[66] Title to stock is in the margin trader although the stock is immediately pledged to the broker and held in "street name." Hobart v. Vanden Bosch, 256 Mich. 686, 240 N.W. 1 (1932).

[67] Banker's Life & Cas. Co. v. Ballanca Corp., 288 F.2d 784 (7th Cir.), *cert. denied*, 368 U.S. 827 (1961).

[68] Willful violation is a condition of criminal liability. Securities Exchange Act of 1934, § 32, 48 Stat. 904, as amended, 15 U.S.C. 78ff(a) (1958).

[69] Cohen v. G. F. Rothchild & Co., Civil No. 108-397, S.D.N.Y., March 31, 1958.

which provides, in part, that "every contract shall be void . . . as regards the rights of any person who, in violation of such provision . . . shall have made any such contract or engaged in the performance of any such contract."[70] Congress could have expressly voided only the rights of a violator rather than ambiguously voiding the rights of "any person" who makes a contract in violation of the act. Even assuming that section 29(b) voids only the rights of a violator, a court may be justified in regarding a margin trader, who is aware of the regulations, as a violator, because he aided and abetted the broker-dealer in his violation.[71] On the other hand, one court stated, in dictum, that the remedy is not affected by the margin trader's participation in the violation since Congress regards him as incapable of protecting himself.[72] However, the credit regulations were not designed to insure the margin trader who knowingly assumes the risk of too thin a margin against a loss from his own speculation, but rather were designed as instruments of credit policy. In a related area, New York courts have twice denied relief to a margin trader whose claim was based upon violations of exchange margin requirements, since a margin trader presumably has the facilities to determine the suitability of a loan arrangement.[73] There may, however, be some justification for protecting a margin trader who is inexperienced in purchasing securities on credit. Since the margin regulations are indeed complex, it does not seem unreasonable for an inexperienced trader to rely upon the superior knowledge of the broker-dealer, who holds himself out as an expert in the securities business.[74] Perhaps the law should protect the inexperienced trader from his own incapability. In fact, courts will probably continue to protect at least the inexperienced trader, assuming that the prior decisions which have merely denied motions to dismiss are actually indicative of the current judicial attitude toward questions of substance.

As an alternative ground for affording a civil remedy for vio-

70 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78cc(c) (1958).

71 The United States Criminal Code provides that whoever aids and abets in the commission of an offense is a principal. 18 U.S.C. § 2 (1958). Where a broker arranged for an illegal extension of credit by a private money lender, the latter was held to have aided and abetted the broker, and was thus subject to § 29(b)'s voiding provisions. Bonner v. Goldman, Civil No. 61-374-c, D. Mass., March 21, 1962.

72 Remar v. Clayton Sec. Corp., 81 F. Supp. 1014, 1017 (D. Mass. 1949).

73 Nichols & Co. v. Columbus Credit Corp., 204 Misc. 848, 126 N.Y.S.2d 715 (Sup. Ct. 1953), *aff'd*, 284 App. Div. 870, 134 N.Y.S.2d 591 (1954) (violation of a cotton exchange margin requirement); Weis & Co. v. Offenberger, 31 Misc. 2d 628, 220 N.Y.S.2d 1001 (N.Y. City Munic. Ct. 1961) (violation of New York Stock Exchange margin requirement).

74 *Cf.* Gardine v. Cottey, 360 Mo. 681, 230 S.W.2d 731 (1950) (expert participating in an illegal transaction).

lation of credit regulations courts have turned to the law of torts, in particular to the theory that if defendant's violation of a prohibitive statute[75] results in a particular danger causing injury to the plaintiff, the latter has a right of action if one of the purposes of the enactment was to protect individual interests such as the plaintiff's from that danger.[76] Even assuming that the credit regulations were designed to protect the inexperienced trader, there are additional obstacles to applying this tort doctrine to credit extension cases. Possibly the greatest of these obstacles is finding the causal connection between the inadequate margin and the injury. Initially, the margin trader should be required to demonstrate that the inadequacy of the initial margin was a substantial factor in causing the injury.[77] If he could have met the additional margin call, then the initial inadequacy was not a significant cause. Even if the margin trader was unable to meet the call, he should be required to demonstrate that the extension of excessive credit was the inducement for making the purchase.[78] Assuming the inducement, the broker-dealer should be allowed to demonstrate that an intervening event caused the injury. For example, the broker-dealer may have lawfully repledged the securities with a third party who became insolvent[79] or who converted the securities.[80] A court may even have difficulty in finding causation when the loss results from the failure of the issuer of the securities,[81] as compared with a loss caused by a general decline in securities prices. For the most part judicial decisions have expressly left open the question of causal connection.[82]

Perhaps the tort remedy should be available to an inexperienced trader in certain cases, but not to a sophisticated trader who knowingly assumes the risk of an inadequate margin. Although the amount of recovery allowed in a tort action would probably be limited to out-of-pocket loss, and thus would be identical to the

75 The tort theory does not apply to violations of exchange margin requirements. Nichols & Co. v. Columbus Credit Corp., 204 Misc. 848, 126 N.Y.S.2d 715 (Sup. Ct. 1953), *aff'd*, 284 App. Div. 870, 134 N.Y.S.2d 591 (1954); Weis & Co. v. Offenberger, 31 Misc. 2d 628, 220 N.Y.S.2d 1001 (N.Y. City Munic. Ct. 1961).

76 2 RESTATEMENT, TORTS § 286 (1934). See also Reader v. Hirsch & Co., 197 F. Supp. 111, 114 (S.D.N.Y. 1961) (citing § 286); Remar v. Clayton Sec. Corp., 81 F. Supp. 1014, 1017 (D. Mass. 1949) (leading case).

77 See PROSSER, TORTS § 44, at 218-19 (2d ed. 1955).

78 Smith v. Bear, 237 F.2d 79, 87-88 (2d Cir. 1956) (dictum).

79 See, *e.g.*, Warshow v. Hentz & Co., 199 F. Supp. 581 (S.D.N.Y. 1961).

80 See, *e.g.*, Appel v. Levine, 85 F. Supp. 240 (S.D.N.Y. 1948).

81 See, *e.g.*, Nichols & Co. v. Columbus Credit Corp., 204 Misc. 848, 126 N.Y.S.2d 715 (Sup. Ct. 1953), *aff'd*, 248 App. Div. 870, 134 N.Y.S.2d 591 (1954).

82 See, *e.g.*, Warshow v. Hentz & Co., 199 F. Supp. 581 (S.D.N.Y. 1961).

amount of recovery allowed under the void contract theory, the former basis for liability may afford additional coverage. If the broker-dealer is acting only in the capacity of creditor-pledgee, not having participated in the purchase, the margin trader could still rely upon the tort doctrine, even though the margin did not pass through the broker-dealer.[83] Moreover, the broker-dealer may have arranged for a third party to extend the credit and therefore may be acting solely in the capacity of an agent. Although the availability of a claim against the broker-dealer on the void contract theory seems dubious, the trader might rely upon the tort doctrine since the broker-dealer has violated Regulation T by arranging for an extension of credit in violation of the margin requirements.

V. CONCLUSION

It seems likely that courts will continue to imply civil remedies for violations of credit regulations, at least for the protection of inexperienced margin traders. However, recovery should be denied to the sophisticated trader on the ground that he is an accomplice in the violation. Denying him a remedy would serve as a greater deterrent to future violations of Regulation T than an allowance of relief. Surely the sophisticated trader would be hesitant to enter into an unenforceable contract and be branded as a violator of a federal statute. Of course, a standard for deciding who is an inexperienced trader must be determined, but, more importantly, the courts must clarify the rights of the margin trader generally if section 29(b) is to act as a significant deterrent to the illegal extension of credit to the sophisticated trader.

Clarification of the implied civil remedies under the credit regulations may provide a possible solution to the problem of unregulated sources of credit for the purchase of securities. The Federal Reserve Board has authority[84] to prescribe rules and regulations governing the extension of credit to purchase securities by persons other than exchange members and broker-dealers transacting a business in securities through such members.[85] Pursuant to that authority the Board has thus far issued Regulation U, which is applicable only to banks.[86] Credit provided by unregulated

[83] Assuming the implied remedy based upon § 29(b) does not include an action for damages.

[84] 48 Stat. 887 (1934), as amended, 15 U.S.C. § 78g(d) (1958).

[85] If a broker-dealer transacts a business in securities through the medium of a member, he is subject to the regulations even as to a particular transaction which is not effected through a member. Federal Reserve Bull., Nov. 1938, p. 951.

[86] 12 C.F.R. § 221 (1959).

lenders such as factors and foreign banks is not presently affected by margin regulations.[87] There is evidence that these unregulated sources of credit have been employed frequently to circumvent credit regulations, especially at times when high margin requirements were in effect.[88] The Board recognized the importance of unregulated lending when it amended Regulation U in 1959 to provide that reports may be required not only from banks, but also from any person engaged substantially in the business of making loans for the purpose of purchasing and carrying listed securities.[89] Lack of adequate enforcement facilities presents the major obstacle to the effective application of margin requirements to unregulated lenders. Some hope has been expressed that this obstacle can be overcome through the judicial development of implied remedies.[90] Regrettably, there is no way to assess accurately the deterrent effect on the illegal extension of credit resulting from the existence of implied civil remedies.

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[87] *But cf.* Bronner v. Goldman, Civil No. 61-374-c, D. Mass., March 21, 1962 (private money lenders held to have aided and abetted a broker-dealer in violating Regulation T). Section 8(a) does make it unlawful for broker-dealers to borrow on listed securities except from member banks, non-member banks who have agreed to abide by the Board's requirements, or other broker-dealers who are subject to the Board's rules. 48 Stat. 888 (1934), as amended, 15 U.S.C. § 78h(a) (1958). Regulation U subjects to the margin requirements any loan by a bank to a person engaged substantially in the business of making loans for the purpose of purchasing or carrying registered securities. 12 C.F.R. § 221.3q (Supp. 1962).

[88] See Rossant, *Credit as a Catalyst*, N.Y. Times, July 30, 1962, p. 27, col. 2; *What Made the Market Go Wild?*, Bus. Week, June 9, 1962, p. 90.

[89] 12 C.F.R. § 221.3j (Supp. 1962).

[90] See Kook v. Crang, 182 F. Supp. 388 (S.D.N.Y. 1960) (discussing jurisdiction over foreign lenders).