Recent Ruling: Securities Regulation - Margin Requirements - Installment Purchase of Tax-Sheltered Programs [37 Fed. Reg. 6568(1972)]

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Recent Ruling: Securities Regulation - Margin Requirements - Installment Purchase of Tax-Sheltered Programs [37 Fed. Reg. 6568(1972)]

Erratum
Page 400, line 9. For "5" read "15". Page 400, footnote 53. For "78e" read "78o". Page 403, line 10. For "where" read "whether".

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Credit regulation in the securities market was generated primarily by the excessive credit extensions of the 1920's.¹ In the hope of protecting potential investors,² and, at the same time, creating a mechanism that would have a stabilizing effect on the stock market and thus the economy as a whole,³ Congress granted to the Board of Governors of the Federal Reserve System (the Board) the power to regulate the extension of credit by brokers and dealers "[f]or the purpose of preventing excessive use of credit for the purchase or carrying of Securities . . . ."⁴ In accordance with that statutory grant of power, the Board promulgated Regulation T to regulate extensions of credit by all brokers and dealers in securities.⁵ That regulation both fixes the margin requirements on all securities for which

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¹ See S. REP. NO. 792, 73d Cong., 2d Sess. 3-4, 8 (1934).
² Credit restrictions prevent the investor from buying securities on such thin collateral that market fluctuations force him into financial ruin. S. REP. NO. 1455, 73d Cong., 2d Sess. 11 (1934). See also note 3 infra.
³ See L. Loss, SECURITIES REGULATION 1242-43 (2d ed. 1961); S. Doc. No. 123, 82d Cong., 2d Sess. 409-10 (1952). The potential effect of unrestricted credit on both the investor and the market is readily apparent. In simplified form, when the lender has extended as much credit as the investor's collateral will support, any slight drop in price would cause him to call for additional collateral. If the investor has nothing more to pledge for his loan, he will be forced to sell a portion of his stock in order to reduce his debt to a level acceptable to his creditor. This sale will further depress the price of the stock, leading to further calls for additional collateral and the entire process could result in an unending downward spiral. By placing restrictions on the extension of credit, Congress hoped that collateral calls would not become necessary unless there was a drastic drop in prices on the stock market. Solomon & Hart, Recent Developments in the Regulation of Securities Credit, 20 J. PUB. L. 167, 169 (1971).
⁴ Securities Exchange Act of 1934 § 7(a), 15 U.S.C. § 78g(a) (1970) [hereinafter cited as Exchange Act]. In addition to protecting investors and stabilizing the market, credit restrictions also serve to allocate the nation's credit resources. By restricting credit in the stock market, credit resources may be channeled toward potentially more desirable commercial, industrial, and agricultural uses. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 8 (1934). Credit restrictions can also serve to implement general monetary policy aimed at controlling inflationary pressures. 2 Loss, supra note 3, at 1245. But see Moore, Stock Market Margin Requirements, 74 J. POL. ECON. 158 (1966).
credit may be extended, and determines which securities are eligible for credit sales.

In a recent ruling, the Board concluded that the sale by brokers or dealers of tax-shelter programs which contain provisions for payment in installments constituted "arranging for credit" in violation of Regulation T. The Board determined that the programs were securities within the meaning of Regulation T and that, since the securities were neither margin securities nor exempt from regulation, their sale on credit terms violated Regulation T. However, the Board limited the application of its ruling in a manner that has generated considerable confusion as to the scope of Regulation T.

While a detailed analysis of the statutory and regulatory framework of margin regulation is not within the scope of this discussion, an outline of the basic provisions is necessary to an examination of the ruling. As previously indicated, the statutory authority for the Board's power is in section 7 of the Securities Exchange Act of 1934 (Exchange Act). Section 7(a) of that Act originally established a flexible formula for determining margin requirements, but the Board soon replaced this procedure with a specific loan value for all securities subject to margin requirements. Section 7(b) grants to the Board the power to raise or lower margin require-

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7 Id.
8 15 U.S.C. § 78g (1970). It should be noted that there is an additional statutory restriction on extensions of credit by broker-dealers in § 11(d) (1) of the Exchange Act. In an attempt to further protect potential investors, Congress included a 30-day prohibition, enforceable by the Securities Exchange Commission (SEC) on credit extensions by individuals who are both brokers and dealers and who are participants in the distribution of a new issue of non-exempt securities. 15 U.S.C. § 78k(d)(1) (1970); E. Weiss, REGISTRATION AND REGULATION OF BROKERS AND DEALERS 84-88 (1965); see text accompanying notes 71-73 infra.
9 15 U.S.C. § 78g(a) (1970). This formula was inserted in § 7 as a temporary measure primarily to protect the Board from undue speculative pressure while it was formulating more extensive and effective methods of regulating credit. H.R. REP. No. 1383, 73d Cong., 2d Sess. 7-8 (1934). Additional reasons for the inclusion of a specific formula can be found in 2 Loss, supra note 3, at 1243.
10 The "margin" or "margin requirement" is the minimum amount a customer must deposit in his account in addition to the securities he has purchased. The customer may deposit additional funds or he may utilize the unused loan value of other securities in the account. Weiss, supra note 8, at 73 n.5; Solomon & Hart, supra note 3, at 170 n.17. For example, if the Board establishes a 45 percent maximum loan value, the margin requirement is 55 percent of the current market value. Thus, a customer purchasing a security for 100 dollars must pay 55 dollars in cash or securities whose value is 55 dollars determined at 45 percent of their market value. 2 Loss, supra note 3, at 1244. Thus, by varying the maximum loan value and therefore the margin requirement, the Board is able to contract or expand the amount of credit which may be extended for the purchase or carrying of securities. See note 4 supra & accompanying text.
ments as the needs of commerce and industry and the general credit situation in the country may require. And, section 7(c) makes it unlawful for a broker or dealer to extend, maintain, or arrange credit for a customer (1) on any non-exempt security in contravention of the Board's rules, or (2) without collateral or on any collateral other than securities. Section 7 does not apply to securities specifically exempted from the Exchange Act or securities which have been exempted from the credit provisions of the Act by the Securities and Exchange Commission (SEC).

Regulation T, developed by the Board pursuant to section 7 of the Exchange Act, establishes the rules by which brokers and dealers may extend credit to their customers. The Regulation performs essentially two functions: first, it defines the maximum loan value, and therefore the margin requirements, of securities on which credit may be extended by brokers and dealers; second, it specifies the securities on which a broker or dealer may not extend credit under any conditions.

Section 3(c) of Regulation T requires brokers and dealers to carry all credit transactions in a "general account" which is subject to the margin requirements established by the Board. If the customer does not deposit the required margin within four business days after the transaction, the creditor (broker or dealer) has only two alternatives. He may apply for an extension of time to allow his customer to meet the margin requirements or he must cancel

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13 Section 3(a)(12) of the Exchange Act, 15 U.S.C. § 78c(a)(12) (1970), in addition to exempting specific securities, allows the SEC, by rules and regulations in the public interest or for the protection of investors, to exempt additional securities from those provisions of the Act, such as § 7, which do not apply to exempted securities. See, e.g., text accompanying notes 65-67 infra.
15 WEISS, supra note 8, at 73. Although section 7(a) of the Exchange Act directs the Board to require the maintenance of certain margins, the only maintenance requirement in Regulation T is a prohibition against withdrawals whose effect would be to undermargin the account. 12 C.F.R. § 220.3(b)(2) (1972); 2 Loss, supra note 3, at 1250-51.
16 12 C.F.R. § 220.3(c) (1972). Regulation T also includes provisions for numerous "special" accounts which are not relevant to this discussion as they contain modified margin requirements or do not involve extensions of credit at all. See, e.g., 12 C.F.R. §§ 220.4(b), (d), (f) (1972).
17 12 C.F.R. § 220.3(f) (1972).
as much of the transaction as is necessary to bring the account within the margin requirements.\textsuperscript{18}

Section 7(a) of the Regulation prevents a broker or dealer from doing indirectly what he cannot do directly: he cannot arrange for someone else to extend credit to an investor on terms other than those which the broker or dealer could have extended himself.\textsuperscript{19} Finally, section 8, the Supplement to Regulation T, does not permit brokers or dealers, for the purpose of purchasing or carrying securities, to assign any loan value to any security that is not (1) registered on a national securities exchange, (2) included on the Board's Over-the-Counter (OTC) Margin List,\textsuperscript{20} or (3) exempted by statute from the regulation.\textsuperscript{21}

The power to enforce the rules established by the Board rests primarily with the SEC.\textsuperscript{22} The Exchange Act provides for both administrative and criminal sanctions against brokers or dealers for violations of the Board's rules and regulations.\textsuperscript{23} In addition, section 7(f) of the Exchange Act now extends such sanctions to the

\textsuperscript{18} 12 C.F.R. § 220.3(c) (1972).

\textsuperscript{19} A creditor [broker or dealer] may arrange for the extension or maintenance of credit to or for any customer of such creditor by any person upon the same terms and conditions as those upon which the creditor, under the provisions of this part, may himself extend or maintain such credit to such customer, but only upon such terms or conditions.\ldots

\textsuperscript{20} The Regulation originally did not include securities traded over the counter. In 1968 § 7 of the Exchange Act was amended by deleting "registered on a national securities exchange" and "who transacts a business in securities through the medium of any such member" wherever they occurred. 15 U.S.C. § 78g (1970), amending 15 U.S.C. § 78g (1964).

\textsuperscript{21} 12 C.F.R. § 220.8 (1972). See note 13 supra.

\textsuperscript{22} 2 LOSS, supra note 3, at 1262.

\textsuperscript{23} The primary administrative sanctions are found in § 15(b)(5) of the Exchange Act, 15 U.S.C. § 78o(b)(5) (1970), and include censure, denial of registration, revocation, and suspension of a broker's registration for up to 12 months. In addition, the broker may be suspended or excluded from the National Association of Securities Dealers (NASD). Exchange Act §§ 15a(l)(1), (2), 15 U.S.C. §§ 78a-3(l)(1), (2) (1970). Under § 21(e) the SEC can seek to enjoin violations of Regulation T. 15 U.S.C. § 78u(e) (1970). The authority to seek criminal prosecution, Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1970), rarely has been used against brokers and dealers. 2 LOSS, supra note 3, at 1263.

In addition to the sanctions imposed by the Exchange Act, the courts have implied a civil remedy for violations of Regulation T. In many instances the customer has been permitted to recover any financial loss suffered as a result of the broker or dealer's action in allowing the illegal extension of credit. See, e.g., Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677 (D.D.C. 1971); Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd, 409 F.2d 1360 (2d Cir. 1968), cert. denied, 396 U.S. 904 (1969); Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949).
Thus it is important that the scope of Regulation T be clearly defined so that investors, as well as brokers and dealers, are aware of their responsibilities.

The sharp increase in tax-sheltered programs and the varied methods which promoters have developed to finance them have created increasing concern about their regulation. These programs, which include, *inter alia*, "oil and gas exploration programs, real estate syndications (except real estate investment trusts), citrus grove developments and cattle programs," are generally organized as unincorporated associations, offering investors substantial flow-through tax benefits. In addition, these programs often contain provisions that allow payment to be made in installments. When the potential investor contracts to buy an interest in the program, which is usually organized as a limited partnership, he need only make a down-payment. The balance of the purchase price is then paid in installments, often continuing over a period of years. The investor, however, becomes entitled to the benefits and subject to the risks of his investment at the time he enters into the contract. In effect, therefore, credit is being extended to the purchaser until he has fulfilled his contractual obligation.

In its ruling, the Board stated that tax-shelter programs of this type are "securities" within the meaning of both the Securities Act

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24 15 U.S.C. § 78g(f)(1) (1970). The effect in the area of implied civil remedies of this extension of liability to the investor is not yet clear. The investor's civil remedy was based, at least in part, on the fact that while brokers and dealers were prohibited from extending credit in violation of Regulation T, customers were not forbidden to accept it. Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970). Under Regulation X, 12 C.F.R. § 224 (1972), promulgated pursuant to § 7(f), both the broker and the investor are in violation of the Regulation and those judges who have dissented from the gradual but steady expansion of implied civil remedies may yet win the battle. See id. at 1145-49 (Friendly, J., dissenting). For the proposition that Regulation X does not mandate overruling prior decisions see Note, Regulation X and Investor-Lender Margin Violation Disputes, 57 MINN. L. REV. 208 (1972).

25 The Investment Company Amendments Act of 1970, as passed by the Senate, contained sections which would have brought certain tax-sheltered oil and gas programs within its regulatory provisions. Those sections were deleted before the Act was passed with the understanding that the oil and gas industries would develop appropriate legislation in conjunction with the SEC. H.R. REP. No. 1631, 91st Cong., 2d Sess. 27 (1970). *See also note 49 infra & accompanying text.*


27 Thus the investor is able to obtain directly the tax advantages provided in the Internal Revenue Code for the association. *See, e.g.,* INT. REV. CODE OF 1954, §§ 701-708.

28 This general description of tax-shelter programs is based on the Board's general characterization of tax-shelter programs within the ruling itself. 37 Fed. Reg. 6568 (1972), 2 CCH FED. SEC. L. REP. ¶ 22,282(b) (1972).
of 1933 (Securities Act) and the Exchange Act. The broad manner in which the term "security" is defined in both Acts coupled with the equally broad interpretation of this term by the courts seem to support the Board's conclusion. Tax-shelter programs are, therefore, securities for the purpose of Regulation T and must comply with the credit requirements of that regulation. Since tax-shelter programs are not registered on a national securities exchange, included on the Board's OTC Margin List, or exempted by statute from the provisions of Regulation T, section 8 of the Regulation prohibits brokers or dealers from assigning any loan value to these programs. Thus, the Board concluded that the sale of tax-shelter


The numerous variations conceived to finance tax-shelter programs have been unable to avoid the broad scope given to the term "security" by the statutes and the courts. "It embodies a flexible rather than a static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946). Generally courts will look beyond the form of financing to the substance of the plan. E.g., SEC v. Universal Serv. Ass'n, 106 F.2d 232 (7th Cir. 1939). For a detailed discussion of unsuccessful attempts to avoid the definition of "security" in the oil and gas industries, see Jordan, Regulation of the Sale of Oil and Gas Interests — Ohio and Federal, 26 OHIO ST. L.J. 567, 578 (1965).


Regulation T adopts the definition of security as stated in the Exchange Act. 12 C.F.R. § 220.2(a) (1972). Whether all tax-shelter programs are securities for the purposes of Regulation T is not entirely free from doubt. The Board has previously indicated that there is no violation of Regulation T when a broker-dealer participates in the installment sale of certain real estate investment contracts secured by mortgages with separate service contracts available at the option of the investor. [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. § 78,072 (FRB April 26, 1971). However, the factual pattern on which this opinion was based is virtually identical to that in SEC v. W. J. Howey Co., 328 U.S. 293 (1946). The Court in Howey held that such real estate programs constituted securities and found the test to be "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." Id. at 301. The Court emphasized that it is immaterial "whether there is a sale of property with or without intrinsic value." Id. See also Coffey, supra note 31, at 373-76, 386-90. In light of Howey, therefore, it would seem that if the Board's letter was based on a determination that real estate investment contracts are not securities, then it was incorrect. Alternatively, if the Board concluded that real estate investments contracts were securities, but were not subject to Regulation T, then the recent ruling would seem to overrule that determination, at least to the extent that real estate investment contracts are required to be registered under § 5 of the Securities Act.

30 See text accompanying notes 19-21 supra.
programs on an installment basis by brokers and dealers constituted "arranging for credit" on terms more favorable to the investor than the broker or dealer himself could have offered, and that, therefore, such sales violated section 7 of Regulation T.\textsuperscript{84}

Perhaps the most intriguing question raised by the Board's ruling relates to the scope of Regulation T. The ruling is addressed specifically\textsuperscript{85} to tax-shelter programs registered pursuant to section 5 of the Securities Act.\textsuperscript{86} Regulation T, however, was developed pursuant to the authority granted to the Board by section 7 of the Exchange Act, and its application would appear to be limited only by the provisions of that Act. The Board admits that tax-shelter programs are "securities" within the definition of that term in the Exchange Act.\textsuperscript{87} Section 7 of the Exchange Act grants to the Board the power to regulate "the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security)."\textsuperscript{88} Regulation T forbids brokers or dealers from assigning loan values to any security not meeting the standards of section 8 of that Regulation.\textsuperscript{89} There is no indication in section 7 of the Exchange Act, in the definition of "security" in the Exchange Act,\textsuperscript{90} in any other section of that Act, or in Regulation T itself,\textsuperscript{91} of any intent to limit the scope of margin regulation to securities registered under section 5 of the Securities Act. The language of the Exchange Act and of Regulation T clearly indicates a contrary intent. Yet the Board's ruling, if it is read to exclude by inference any securities not registered under the Securities Act, makes it entirely possible for tax-shelter programs that are "securi-

\textsuperscript{84} 37 Fed. Reg. 6568 (1972), 2 CCH Fed. Sec. L. Rep. \S 22,282(f) (1972). The Board is, therefore, concluding that when a broker or dealer participates in the sale of a program which is designed to be bought in installments, he is arranging for the extension of credit to investors even though he is doing nothing more than passing the program through from the promoter to the investor.

\textsuperscript{85} Id., 2 CCH Fed. Sec. L. Rep. \S 22,282(a) (1972). The Board's ruling was apparently the result of a letter from the NASD seeking a clarification of the "arranging for credit" provisions of Regulation T with specific reference to the distribution of tax-shelter oil and gas programs. The NASD letter \textit{presumes} that the programs have been registered pursuant to section 5 of the Securities Act. Letter from National Association of Security Dealers, Inc. to Board of Governors of the Federal Reserve System, August 16, 1971, on file at Case Western Reserve Law Review.


\textsuperscript{88} 15 U.S.C. \S 78g(a) (1970) (emphasis added).

\textsuperscript{89} 12 C.F.R. \S 220.8 (1972).


\textsuperscript{91} See 12 C.F.R. \S 220.2 (1972).
ties" within the meaning of the Securities Act and the Exchange Act to escape the credit restrictions of Regulation T if they qualify for exemption from the registration requirements of the Securities Act.\textsuperscript{42} The Board's ruling, therefore, could be interpreted as excluding from margin regulation tax-shelter programs which are exempt from registration such as private offerings,\textsuperscript{43} intrastate offerings,\textsuperscript{44} or limited public issue offerings specifically exempted by the SEC.\textsuperscript{45}

While it is possible that the Board was simply limiting its ruling to the factual situation which had been presented for determination,\textsuperscript{46} subsequent statements by the Board and the National Association of Securities Dealers (NASD) indicate confusion as to the scope of the ruling. It is not surprising that the NASD strongly disagrees with the Board's position and has already indicated its intent to support legislation, drafted principally by the oil and gas industries, which would include provisions permitting the installment sale of oil and gas programs through brokers and dealers.\textsuperscript{47} Periodic payment plans are, in the opinion of the NASD, simply methods of insuring that income will be available to the enterprise as it becomes needed, rather than methods of extending credit in excess of the credit regulations.\textsuperscript{48} Oil and gas programs do not

\textsuperscript{42} For a discussion of these exemptions, see Jordan, \textit{supra} note 30, at 580-89.
\textsuperscript{44} Id. § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970).
\textsuperscript{45} The SEC may exempt any class of securities if it finds enforcement of the Act is not necessary in the public interest or for the protection of investors due to the small amount involved or the limited character of the public offering. Securities Act § 3(b), 15 U.S.C. § 77c(b) (1970). For example, Regulation A permits a limited registration for certain types of securities where the aggregate offering price of the issue does not exceed 500,000 dollars. SEC Reg. A, 17 C.F.R. §§ 230.251-263 (1972). Similarly, Regulation B permits a limited registration for offerors of fractional undivided interests in oil and gas rights if the aggregate amount of the offering does not exceed 250,000 dollars. SEC Reg. B, 37 Fed. Reg. 23829 (1972), 1 CCH FED. SEC. L. REP. § 2399 (1972).
\textsuperscript{46} While this interpretation is buttressed by the NASD letter to the Board, see note 35 \textit{supra}, its validity is questionable in light of the Board's subsequent clarifying letter to the NASD. See note 51 \textit{infra}.
\textsuperscript{47} NAT'L ASS'N OF SEC. DEALERS, INC., TAX SHELTERED PROGRAMS 8 (1972). See text accompanying notes 55-58 \textit{infra}.
\textsuperscript{48} Id. The NASD prefers the term "periodic payments" as opposed to "installment payments," apparently because the latter term is too closely associated with the extension of credit. The NASD does not explain, however, how changing the name of these payments makes them any less credit extensions. If the customer is going to accept the benefits and be subject to the risks of his interest at the time he makes a down-payment, then, to the extent that he has not paid the full purchase price, he is being extended credit. The fact that the program may not need the full purchase price at the time of the investment seems irrelevant to a determination of whether, in fact, credit has been extended.
need, and, the NASD claims do not want, all of the money investors commit themselves to pay until it is actually needed in the program.\textsuperscript{49} In terms of general policy, the NASD has maintained that periodic payment plans, at least in the oil and gas field, are entirely consistent with the public interest, and if not exempted entirely from credit regulation, should be regulated in a more liberal manner than Regulation T would permit.\textsuperscript{66}

In view of the NASD’s policy position, it is only logical that they would attempt to interpret the scope of the Board’s ruling as narrowly as possible. Thus, it is surprising that the NASD interprets the ruling as a bar to the distribution by brokers and dealers of “interstate programs of any kind which provide for periodic payments...”.\textsuperscript{51} If valid, the NASD interpretation might imply that the Board’s decision was limited to securities registered under section 5 of the Securities Act based on what it considered to be jurisdictional limitations. The implication that some type of interstate program is necessary to confer jurisdiction on the Board for the pur-

\textsuperscript{49} Id. If the programs were offered in the form of conditional sales contracts, the investor would have no rights or obligations under the interest purchased until he had paid the full purchase price. Thus, there is no credit extension and Regulation T would not apply. Another approach would be to structure the installment payments so that they are not mandatory. The investor’s interest in this program would increase only in proportion to his actual investments. If there is no binding obligation on the investor to make subsequent payments, and certain other conditions are met, the broker-dealer is no longer arranging for the extension of credit. [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. § 78,075 (FRB April 26, 1971). However, the NASD rejects this approach as unworkable since “before a program can commence... operations, it must know with a reasonable degree of certainty the amount of money it has at its disposal.” Letter from National Association of Securities Dealers, Inc., supra note 35, at 4.

\textsuperscript{60} Tax Shelter Programs, supra note 47, at 8. The unanswerable question, however, is why programs which are not registered on securities exchanges should receive more favorable credit treatment that those which are registered. Exactly the opposite would seem more realistic and consistent with the underlying rationales of securities regulation and monetary control. See notes 2-4 supra. But see letter from National Association of Securities Dealers, Inc., supra note 35, at 5-9.

\textsuperscript{51} Id. (emphasis added). The NASD interpretation appears to be a wholesale acceptance of statements made by the Division of Supervision and Regulation of the Federal Reserve Board in a letter to the NASD, which states in part: “The interpretation... does not cover securities exempted from [registration under the Securities Act] under § 77c(a) (11) or transactions exempted from such registration under § 77d(a) [sic] of that Act, the so-called ‘intra-state’ and ‘private offering’ exemptions.” Letter from Laura M. Homer, Attorney for Division of Supervision and Regulation to George Warner, National Association of Securities Dealers, Inc., April 4, 1972, on file at Case Western Reserve Law Review. Apparently the NASD assumed that the Board’s enumeration of securities not covered by the ruling was all-inclusive. Consequently the NASD concluded that securities falling within the § 3(b) exemption of the Securities Act, 15 U.S.C. § 77c(b) (1970), i.e., Regulation A and Regulation B securities, must be included within the Board’s ruling. This conclusion, of course, is in direct conflict with the plain language of the ruling itself which speaks only to securities registered under § 5 of the Securities Act.
pose of triggering the credit restrictions of Regulation T is not supported by federal jurisdictional concepts. If the Board sees its jurisdiction as coextensive with the jurisdictional coverage of the registration provisions of the Securities Act, then all that is required is the "use of any means or instruments of transportation or communication in interstate commerce or of the mails. . . ." Thus, even if the Board's jurisdiction is identical with that of the Securities Act, or, for example, the jurisdiction of the SEC over brokers and dealers under section 5 of the Exchange Act, it has the authority to regulate all tax-shelter programs, whether they are exempted from registration under the Securities Act or not, provided use is made of the mails or any instrument of transportation or communication in interstate commerce. While there is no direct statutory authority on the Board's section 7 jurisdiction, the 1968 amendments to that section so substantially broadened the scope of the Board's regulatory power that it is difficult to believe the Board limited its ruling on this ground.

That the Board has authority to regulate all tax-shelter programs appears to be supported by proposed legislation recently submitted to Congress by the SEC in conjunction with the oil and gas industry. This legislation would apply liberal credit requirements to oil and gas programs which are neither registered under the Securities Act nor exempt from registration under Regulation B. Section 16(b) of this proposed legislation specifically exempts tax-shelter oil and gas programs that are in compliance with the credit require-

52 15 U.S.C. § 77e(a)(1) (1970). Interstate commerce is defined so broadly in the Securities Act that recent court decisions have even indicated that there is no need to actually cross state lines. Even intrastate telephone calls in connection with the sale may bring the transaction within federal jurisdiction on the theory that the telephone system is itself an instrument of interstate commerce. Levin v. Marder, 343 F. Supp. 1050 (1972); Lennenb v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964). Contra, Burke v. Triple A Machine Shop, 438 F.2d 978 (9th Cir. 1971). Indeed, the SEC has indicated, at least within the context of rule 10b-5, 17 C.F.R. § 240.10b-5 (1972), that intrastate sales by telephone are subject to the rules of the Exchange Act. See SEC Exchange Act Release No. 7693, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. § 77,279 at 82,443 n. 4 (Aug. 31, 1965); 4 Loss, supra note 3, at 2316.


54 The confusion over "jurisdictional means" may stem from the fact that, when Congress removed the phrases "registered on a national securities exchange" and "who transacts a business in securities through the medium of any such member," § 7 no longer contained any specific jurisdictional supports to guide the Board. See note 20 supra.

55 S. 1050, 93d Cong., 1st Sess. (1973). This bill can be found in substantially the same form in Regulation of Oil and Gas Programs, CCH Fed. Sec. L. Rep. (Special Report No. 428, 1972).

ments of proposed section 16(a) from the margin requirements of Regulation T. The SEC inclusion of section 16(b) strongly implies that oil and gas programs which would be registered under this proposed legislation are presently subject to the credit restrictions of Regulation T notwithstanding the limited scope of the Board's ruling. For example, programs which qualify for the section 3(a) (11) intrastate exemption under the Securities Act are not covered by the Board's ruling. Yet these same programs are considered oil programs for the purposes of the SEC legislation and are, therefore, exempted from the "arranging for credit" provisions of Regulation T assuming they comply with section 16(a).

The apparent disagreement between the SEC and the Board on the scope of Regulation T is further confused by earlier indications from the SEC clearly implying that there are securities with respect to which brokers and dealers may extend or arrange credit without being subject to margin regulation. Rule 15c2-5, adopted by the SEC in 1962, imposes broad disclosure and suitability determination requirements on any broker or dealer (whether or not registered under Exchange Act section 15) who offers to extend or arrange credit under circumstances not covered by Regulation T. This rule was prompted by the development of "equity funding" programs in the insurance industry. In 1969, however, credit extensions by brokers and dealers in connection with the sale of these "equity funding" programs became subject to Regulation T. In 1972, as a result of this inclusion, the SEC amended rule 15c2-5 in

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67 Id. § 16(b):

The sale of a program participation issued by an oil program, the purchase price of which is payable in installments in compliance with subsection (a) shall not be deemed to be an extension of credit by any person for the purposes of the Securities Exchange Act of 1934, nor shall the distribution of such a security involve an arrangement for the extension of credit for such purpose.

68 See text accompanying note 44 supra.


60 These programs have also been referred to as "secured funding" or "life funding" programs. The SEC now refers to all of these programs as "insurance premium funding" programs. 37 Fed. Reg. 16409 (1972). In a typical program, securities, particularly mutual funds, are sold to customers who then apply those securities as collateral on a loan. The customer then applies the loan he received to the premium on a life insurance policy which he purchased at about the same time. As the cash value of the life insurance increases, further loans are then made on the life insurance policy thus providing additional funds for investment. Finally, additional loans may also be made on the appreciated value of the securities. 27 Fed. Reg. 5190 (1962).

order to insure its continued application to "equity funding" programs now regulated under Regulation T. The SEC's comments accompanying the proposed amendment to rule 15c2-5 indicate that, while the rule was adopted primarily to regulate "equity funding" programs, "it was broadly worded to encompass other types of arrangements which would involve the borrowing of funds by customers in a manner other than by conventional margin security transactions governed by Regulation T." Implicitly, the SEC seems to be indicating that there may be broker-dealer transactions in securities to which the margin requirements of Regulation T are not applicable.

The vagueness and confusion within the SEC concerning the scope of Regulation T may to some extent stem from an over-cautious attitude developed as a result of the Board's ruling. For example, the report of the SEC Real Estate Advisory Committee (REAC) late in 1972 proposed that installment payments for the purchase of real estate securities be permitted where the minimum

63 37 Fed. Reg. 16409 (1972), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,932 (Aug. 10, 1972). The SEC, however, did not specify any security or class of securities, other than equity funding programs, which would not be subject to Regulation T.

64 In addition, a close reading of rule 15c2-5 makes one wonder why any program would want to avoid the margin requirements of Regulation T if the alternative is meeting the detailed suitability determination requirements of 15c2-5. In margin transactions, brokers and dealers must fully disclose all credit terms. SEC rule 10b-16, 17 C.F.R. § 240.10b-16 (1972). Registered brokers or dealers who are not members of a registered association (i.e. NASD) must meet two additional requirements: (1) they must have "reasonable grounds" for their belief that the recommended purchase, sale, or exchange is "not unsuitable" for the customer, 17 C.F.R. § 240.15b10-3 (1972), and (2) they must have kept a customer record indicating all the factors considered in making the recommendation, 17 C.F.R. § 240.15b10-6 (a) (1) (B) (1972). Those securities not subject to Regulation T, however, must also meet the requirements of rule 15c2-5. In addition to disclosing credit terms, the broker-dealer must make a complete suitability study. He must then inform the investor of the risks and advantages of the entire transaction as well as the basis for his determination that the entire transaction is suitable for that individual. The requirement of affirmatively establishing suitability places a greater burden on the broker or dealer than the requirement of simply negating unsuitability. 37 Fed. Reg. 22612 (1972).

The SEC staff has recently determined that sales on credit of resort condominium units with a rental management contract, arranged through broker-dealers, constituted a sale of securities and as such were exempt from the provisions of the Truth in Lending Act. 15 U.S.C. §§ 1601-81t (1970). Nevertheless, the staff indicated it would recommend no enforcement action for violation of rule 10b-16 if there was full compliance with Regulation Z, 12 C.F.R. §§ 226.1-12 (1972), of the Truth in Lending Act. Compliance with Regulation Z, however, does not nullify the apparent violation of the "arranging for credit" provisions of Regulation T. Yet the respective staff replies of the Board and the SEC do not even suggest the possibility of Regulation T violations. Freedman, Silverberg & Lewis, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,930 (SEC June 9, 1972).
unit of participation is at least 5,000 dollars and where a minimum of 25 percent of the total purchase price is paid in the initial installment. REAC recommended that these arrangements should be exempted from Regulation T if such an exemption "would not substantially negate the application of Regulation T as a monetary tool." The REAC recommendation implies that all real estate programs sold on an installment plan through brokers or dealers would presently be in violation of Regulation T. The Committee comments, however, indicate that REAC simply did not know, in light of the Board's ruling, where Regulation T was applicable to all real estate programs and consequently worded their report broadly enough to encompass a number of interpretations.

If the Board's ruling is properly interpreted as excluding tax-shelter programs exempted from registration under section 5 of the Securities Act, an additional problem appears. Section 7(a) of the Exchange Act grants the Board broad powers to "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security)." The authority to exempt additional securities from the operation of the Exchange Act and the regulations promulgated thereunder, however, is specifically granted to the SEC by section 3(a) (12) of that Act. Section 7, as originally enacted, set specific margin rates as temporary guidelines for the Board. Although the Board is granted broad powers to raise or lower those rates based on the national economy and present credit extensions and conditions, it is not explicitly granted the power to completely eliminate margin requirements for any securities. Al-

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66 Id.
67 The REAC comments state in part:
Thus the [Board's] interpretation clearly applies to the public offering of limited partnership interests involving real estate programs and in effect prohibits the public offering sale of real estate tax-shelter programs on an installment basis. . . .
Should the [Board's] interpretation be deemed to apply to private offerings or to intra-state offerings, the Committee feels that they too should be subject to the recommended exemption.
Id. at 63, 67.
70 See note 9 supra.
though the argument can be made that the power to set margin requirements implies the power to eliminate them, the fact that the explicit power to exempt securities from margin regulation is specifically granted by the same Act to the SEC undermines this contention.\footnote{This is not to deny that the Board has, in effect, set different margins for certain securities transactions. Even conceding that the Board can abolish margin trading altogether, as it did in 1946, there appears to be no authority for the Board to eliminate credit regulation altogether. \textit{See generally 2 Loss, supra note 3, at 1244-48.}} If the Board has, as this analysis implies, exempted securities not registered under the Securities Act from the credit regulations of the Exchange Act, it has usurped the authority of the SEC.

Finally, whether or not tax-shelter programs that are exempted from section 5 of the Securities Act are subject to Regulation T, they may be subject to the prohibitions of section 11(d) of the Exchange Act.\footnote{15 U.S.C. § 78k(d) (1970).} Both the NASD letter of inquiry and the Board's ruling ignore the possible effect of this section on tax-sheltered programs sold on an installment plan.\footnote{Although the SEC is responsible for the interpretation and enforcement of this section, the Board's failure to mention the possible application of § 11(d)(1) to the installment sale of tax-shelter programs is puzzling.} Section 11(d)(1) prohibits the extension, maintenance, or arrangement of credit by any individual who is both a broker and a dealer on any new issue of non-exempt securities if he has participated in the distribution of those securities "as a member of a selling syndicate or group within thirty days prior to such transaction."\footnote{15 U.S.C. § 78k(d) (1970). While there are exceptions to the general rule stated in § 11(d)(1), they are not specifically applicable to tax-shelter programs. \textit{See 17 C.F.R. § 240.11d1-1 (1972).}} The NASD admits that tax-shelter programs, particularly in the oil and gas industries, are generally purchased as part of a primary distribution (new issue) and are rarely, if ever, traded by the investor.\footnote{The purpose of § 11(d), as contrasted with the broad economic purposes of § 7 and Regulation T, \textit{see notes 3-4 supra & accompanying text, is to prevent an individual who is both a broker and a dealer from taking advantage of his relationship with his customers while he is a participant in the initial distribution of securities. \textit{See generally Weiss, supra note 8, at 87-88}} It would seem, however, that by their very nature many, if not most, tax-shelter programs would be handled by individuals who are brokers and dealers and members of the selling syndicate. Thus, regardless of the applicability of Regulation T, the sale of these programs on an installment plan would often result in a violation of section 11(d)(1) of the Exchange Act.

\footnote{Letter from National Association of Securities Dealers, Inc., \textit{supra} note 35, at 7-9. It should be noted that the oil and gas legislation now before Congress would take oil and gas programs registered pursuant to its provisions outside of § 11(d), as well as § 7 and Regulation T. \textit{See notes 55-57 supra & accompanying text.}}
Analysis of the Exchange Act and the credit restrictions of Regulation T fails to reveal any basis for limiting the application of the Regulation to tax-shelter programs registered pursuant to section 5 of the Securities Act. Even if we assume that the underlying policy rationales for credit regulation are not applicable to tax-shelter programs, the unambiguous statutory language of section 7 and the lack of difficulty in establishing federal jurisdiction can only lead to the conclusion that Regulation T is applicable to all securities (as defined in the Exchange Act and not specifically exempted from its requirements) which are handled by brokers and dealers. Yet the Board chose to limit its ruling to programs registered under the Securities Act. It is imperative that the Board clarify its position in view of the uncertainty and confusion engendered by this ruling among issuers, brokers, dealers, and investors.

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76 See notes 3-4 supra. The NASD argues, with some foundation, that a decision to exempt tax-shelter programs from margin requirements will have no effect on market speculation or price fluctuations. Letter from National Association of Securities Dealers, Inc., supra note 35, at 5-9. However, its characterization of potential investors as "sophisticated person[s] of substantial means" who are adequately protected by existing governmental and NASD rules and regulations is at least questionable. Id. See, e.g., SEC v. American Agronomics Corp., No. C72-331 (N.D. Ohio, Nov. 17, 1972) (settlement required "special counsel" to determine if investment was "unsuitable," and if so, issuer must offer recission to investor). Finally, the NASD assumption that the development of energy resources should be encouraged by liberal credit arrangements seems to imply that allocation of resource decisions should be made by someone other than the consumer when, in fact, the basic principle of resource allocation is founded on consumer decision-making in the market place. Letter from National Association of Securities Dealers, Inc., supra note 35, at 5-9.