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# Regulation X and Investor-Lender Margin Violation Disputes

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## Note: Regulation X and Investor-Lender Margin Violation Disputes

### I. THE PROBLEM

Since November 1, 1971, securities investors have been subject to Regulation X<sup>1</sup> which was issued by the Federal Reserve Board pursuant to Title III of the Bank Records and Foreign Transactions Act.<sup>2</sup> Regulation X requires investors to conform to federal margin regulations which limit the amount of credit an investor may receive in a securities transaction. Formerly the margin regulations had been construed to place the "onus of compliance" only on lenders.<sup>3</sup> Thus, absent misrepresentation<sup>4</sup> or conspiracy,<sup>5</sup> the lender bore the risk of any loss arising from a transaction in violation of the margin requirements, even when

1. 12 C.F.R. § 224 (1972). Section 224.2(a) provides:

(a) *Credit obtained from within the United States.*—A borrower shall not obtain any purpose credit from within the United States unless he does so in compliance with the following conditions:

(1) Credit obtained from a G-lender shall conform to the provisions of Part 207 (Regulation G), which is hereby incorporated in this part (Regulation X). When the term "G-lender" is used in this part (Regulation X), it means a person who is not a broker/dealer or bank, who in the ordinary course of business extends, maintains, or arranges credit that is secured, directly or indirectly, in whole or in part, by collateral that includes any margin securities and who is subject to the registration requirement of section 207.1(a) of Part 207 (Regulation G).

(2) Credit obtained from a broker/dealer shall conform to the provisions of Part 220 (Regulation T), which is hereby incorporated in this part (Regulation X). When the term "broker/dealer" is used in this part (Regulation X), it means a person who is a broker or dealer, including every member of a national securities exchange and includes a foreign branch or subsidiary of a broker/dealer.

(3) Credit obtained from a bank shall be subject to the provisions of Part 221 (Regulation U), except for section 221.2 (i). Except for such section, Part 221 (Regulation U) is hereby incorporated in this part (Regulation X). When the term "bank" is used in this part (Regulation X), it means a bank that is subject to Part 221 (Regulation U).

2. Public Law 91-508, Oct. 26, 1970; 15 U.S.C. § 78(g) (f).

3. See, e.g., *Avery v. Merrill, Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677 (D.D.C. 1971).

4. See, e.g., *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd* 409 F.2d 1360 (2d Cir. 1969), *cert. denied* 396 U.S. 904 (1969).

5. See, e.g., *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968).

the investor was aware that he was receiving illegal credit.<sup>6</sup> The question that arises after the promulgation of Regulation X is whether knowledgeable investors, that is, investors aware of their participation in margin violations,<sup>7</sup> should continue to be protected from loss as they had been under prior case law. This issue will be examined through an analysis of (1) the margin rules, their purpose, and the manner of their violation, (2) the legal basis of investor relief prior to Regulation X, and (3) the legislative history of the statute implemented by the Regulation.

## II. MARGIN CONTROLS

The Securities Exchange Act of 1934, which first established margin controls, was enacted as a reaction to the stock market crash of 1929.<sup>8</sup> Encouragement of speculation through the excessive use of credit in securities transactions was thought to have been a factor in the market crash and resulting economic depression.<sup>9</sup> Thus, "for the purpose of preventing the excessive use of credit for the purchase or carrying of securities," Section 7 of the Exchange Act authorized the Board of Governors of the Federal Reserve System to "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security."<sup>10</sup> Pursuant to this authority, the Federal Reserve Board has promulgated the margin rules regulating extension of credit by broker-dealers (Regulation T),<sup>11</sup> banks (Regulation U), and other lenders (Reg-

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6. If a loss occurred through a change in market price which would not have occurred if there had been compliance with the margin rules the investor could shift the loss to his creditor through a private suit for damages. See, e.g., *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), where the lender failed to liquidate the purchase at the required time and the market had subsequently decreased by the time of liquidation so that the plaintiff suffered a loss from the margin violation. Furthermore, if any loss was borne by the creditor, the investor could interpose the margin violation as a defense to a subsequent claim by the creditor. See, e.g., *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd* 409 F.2d 1360 (2d Cir. 1969), *cert. denied* 396 U.S. 904 (1969).

7. An innocent mistake in violation of the margin rules is not a violation of Regulation X. 12 C.F.R. § 224.6(a) (1972).

8. See Note, *Federal Margin Requirements as a Basis for Civil Liability*, 66 COLUM. L. REV. 1462, 1463 (1966).

9. *Id.*

10. 15 U.S.C. § 78g(a) (1971).

11. Regulation T, 12 C.F.R. § 221 (1972), implements Section 7 of the Securities Exchange Act, 15 U.S.C. § 78g(c) (1971), which provides: It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly to extend or maintain credit or arrange for the extension or main-

ulation G).<sup>12</sup>

Margin rules restrict the use of credit in securities transactions by establishing the maximum "loan value" for a securities purchase. The "margin" represents the capital which must be furnished by the investor in a purchase or short sale.<sup>13</sup> For example, in a purchase through a general account<sup>14</sup> in which he has no other securities, the investor may borrow only the loan value of the purchased securities. The investor has five full business days after the purchase to deposit the "margin" or the remainder of the purchase price.<sup>15</sup> If the customer has additional securities in his account the margin due is reduced by the loan value of those securities.<sup>16</sup>

Violations of margin regulations occur in two contexts. First, a securities transaction may be illegal at its inception and involve the participation of both the lender and the investor. For example, a loan by a bank to an investor for the purchase of securities is an immediate violation of Regulation U if the

tenance of credit to or for any customer

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under sections (a) and (b) of this section . . .

12. Regulation U, 12 C.F.R. § 221 (1972), and Regulation G, 12 C.F.R. § 207 (1972), were authorized by Section 7 of the Securities Exchange Act, 15 U.S.C. § 78g(d) (1971), which provides:

It shall be unlawful for any person not subject to subsection (c) of this section to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Board of Governors of the Federal Reserve Board shall prescribe. . . .

13. The loan value is currently 45% of the market value of regulated securities. Thus the margin required is 55%. 12 C.F.R. § 207.5 (1972); 12 C.F.R. § 220.8 (1972); 12 C.F.R. § 221.4 (1972).

14. See 12 C.F.R. § 220.3(a) (1972) for a description of a general account.

15. 2 C.F.R. § 220.3(b) (1972) provides that:

A creditor shall not effect for or with any customer in a general account . . . any transaction which . . . creates an excess of the adjusted debit balance of such account over the maximum loan value of the securities in such account . . . unless in connection therewith the creditor obtains, as promptly as possible and in any event before the expiration of 5 full business days following the date of such transaction, the deposit into such account of cash or securities in such amount that the cash deposited plus the loan value of the securities deposited equals or exceeds the excess so created . . . .

16. *Id.* For example, if the investor wishes to purchase stock for \$10,000, he must provide the \$5,500 margin since the stock would have a loan value of \$4,500 as collateral. See note 13 *supra*. If he already has other stock worth \$10,000 in his account he can receive credit for the loan value of \$4,500 so that he need provide only \$1,000 in cash.

amount of the loan exceeds the "loan value" of the securities.<sup>17</sup> Second, a securities purchase initially lawful may subsequently become illegal. For example, Regulation T allows a grace period following the initial purchase during which the investor must deposit with the broker the margin in the case of a general account, or the total purchase price in the case of a cash account.<sup>18</sup> If the investor fails to do so, the transaction must be liquidated by the broker.<sup>19</sup> If the broker does not sell the securities or otherwise liquidate<sup>20</sup> the transaction at the end of

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17. *E.g.*, *Remar v. Clayton Securities Corp.*, 81 F. Supp. 1015 (D. Mass. 1949).

18. Regarding general accounts see note 15 *supra*. For special cash accounts, 12 C.F.R. 220.4(c) (1972) provides:

(c) (1) In a special cash account, a creditor may effect for or with any customer bona fide cash transactions in securities in which the creditor may:

(i) Purchase any security for, or sell any security to, any customer, provided funds sufficient for the purpose are already held in the account or the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment for the security and that the customer does not contemplate selling the security prior to making such payment.

(ii) Sell any security for, or purchase any security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be promptly deposited in the account.

19. For a general account, 12 C.F.R. § 220.3(e) (1972) provides: In any case in which the deposit required by paragraph (b) of this section, or any portion thereof, is not obtained by the creditor within the 5-day period specified therein, margin nonexempted securities shall be sold . . . prior to the expiration of such 5-day period, in such amount that the resulting decrease in the adjusted debit balance of such account exceeds, by an amount at least as great as such required deposit or the undeposited portion thereof, the "retention requirement" of any margin or exempted securities sold. . . .

For special cash accounts, 12 C.F.R. § 220.4(c) (1972) states:

(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3) through (7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof.

For an example of liquidation other than by sale, see *Avery v. Merrill, Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 67 (D.D.C. 1971), where a short sale was liquidated by the purchase of the stock "sold short" by the investor, thus the sale was consummated and the loss to the broker (the difference between the purchase price and sale price) was deducted from the investor's account.

20. *E.g.*, *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970).

the grace period, he has unilaterally extended credit in violation of the margin rules.<sup>21</sup>

Violations of Reserve Board regulations theoretically are subject to sanction by the SEC through injunctions,<sup>22</sup> writs of mandamus,<sup>23</sup> and revocation of broker-dealer registrations.<sup>24</sup> The SEC may also transmit evidence of such violations to the Attorney General for possible criminal prosecution.<sup>25</sup> Compliance with margin regulations is also encouraged by the rules of the National Association of Securities Dealers, Inc.<sup>26</sup> and the stock exchanges<sup>27</sup> and by private causes of action by investors against creditors who violate the margin rules.

### III. PROTECTION OF KNOWLEDGEABLE INVESTORS PRIOR TO REGULATION X

Violation of margin requirements often involves culpability on the part of both creditor and investor. Both parties may be aware that the transaction violates margin requirements and yet knowingly proceed with their bargain. Nevertheless, prior to Regulation X courts recognized private causes of action by investors against creditors to recover losses resulting from margin violations, and in addition, permitted the investor to raise the violation as a defense to lender claims. Courts thus recognized three theories as bases for protecting investors against lenders in instances of margin violations. First, under a traditional tort approach, the investor was considered to be within the special class of persons the margin rules were designed to protect. He was thus given a cause of action against his creditor which was not defeated by the fact that he had consciously participated in the violation. Second, Section 29(b) of the Securities Exchange Act of 1934 was construed to mean that the contracts

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21. However, 12 C.F.R. § 220.4 C (6) (1972) provides with respect to a special cash account that an appropriate committee of a national securities exchange or a national securities association may extend this time period in exceptional circumstances.

22. 15 U.S.C. § 78u(e) (1971).

23. 15 U.S.C. § 78u(f) (1971).

24. 15 U.S.C. § 78o(b)(5) (1971).

25. 15 U.S.C. § 78u(e) (1971).

26. See, e.g., In the Matter of Pabombi Securities Co., Inc., Securities Exchange Act Release No. 6961 (1962), where violations of margin rules resulted in expulsion of a dealer from the association and revocation of his registration.

27. See Securities Exchange Act of 1934, 15 U.S.C. § 78f(b) (1971), which provides that before a securities exchange may be registered it must provide rules for disciplining members who wilfully violate the Exchange Act or regulations.

for purchase or sale of securities made in violation of its regulations were voidable at the investor's option. The investor was therefore permitted either to sue the creditor on the contract or set up the creditor's violation as a defense to the creditor's claim. Third, public policy was considered to require recognition of private causes of action as a supplement to official enforcement of the margin regulations. In addition the equitable doctrine of *in pari delicto*, which denies relief to a plaintiff at equal fault with the defendant, was generally not accepted.<sup>28</sup>

*Remar v. Clayton Securities Corp.*<sup>29</sup> is the leading case expounding traditional tort law as a basis of recovery by knowledgeable investors. In *Remar* the plaintiff sued a broker who had arranged a bank loan in violation of Regulation U. Finding that at least a subsidiary purpose of the margin regulations was to protect investors, the court stated the plaintiff's participation in the violation was immaterial since Congress regards investors as incapable of protecting themselves. Citing the *Restatement of Torts*, the court held that where a statute is designed to protect a special class of persons, plaintiffs within such a class have a cause of action in tort for violation of the statute. While other cases have apparently agreed that the sophistication of an investor is not a bar to recovery where the investor consciously violates margin rules,<sup>30</sup> the rationale of *Remar* has been criticized on the grounds that such special protection was not intended in the authorization of margin controls in the Exchange Act<sup>31</sup> and that the tort rule applies only to exceptional statutes.<sup>32</sup>

A second basis for investor protection has been found in Section 29(b) of the Securities Exchange Act which provides:

Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . and every contract . . . the performance of which involves the violation of . . . any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person

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28. See, e.g., *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd* 409 F.2d 1360 (2d Cir.), *cert. denied* 396 U.S. 904 (1969).

29. 81 F. Supp. 1014 (D. Mass. 1949).

30. See *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd* 409 F.2d 1360 (2d Cir.), *cert. denied* 396 U.S. 904 (1969). However, the court considered the investor's sophistication in light of his misrepresentation which induced the lender violation and held such wrongful conduct a bar to the investor's request for damages.

31. Note, *Federal Margin Requirements as a Basis for Civil Liability*, 66 COLUM. L. REV. 1462 (1966).

32. *Id.* See also *Moscarella v. Stamm*, 288 F. Supp. 453, 459 (E.D. N.Y. 1968).

who in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract . . .<sup>33</sup>

Rather than rendering a contract which violates margin requirements void as to both parties, Section 29(b) has been construed to mean that such a contract is void as to the lender but only voidable as to the investor. Thus, at his option, the investor has been allowed to sue on the contract for damages,<sup>34</sup> to seek rescission and restitution,<sup>35</sup> to enforce the contract,<sup>36</sup> or to void the contract as a defense to a lender's suit.<sup>37</sup>

In *Pearlstein v. Scudder & German*,<sup>38</sup> recovery by an investor who was aware that the transaction violated margin requirements was allowed on a third theory that private causes of action supplement official enforcement of margin regulations.<sup>39</sup> As already noted, however, numerous official sanctions exist against lenders who violate margin regulations.<sup>40</sup> Moreover, as Judge Friendly argued in dissent, allowing knowledgeable investors to bring private actions may encourage margin compliance by lenders while encouraging margin violations by investors.<sup>41</sup> Nevertheless, the court stated that

[t]he danger of permitting a windfall to an unscrupulous investor is outweighed by the salutary policing effect which the threat of private suits for compensatory damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities and Exchange Commission.<sup>42</sup>

In addition to recognizing private causes of action, courts

33. 15 U.S.C. § 78cc(b) (1971).

34. See *Warshaw v. H. Hentz & Co.*, 199 F. Supp. 581 (S.D.N.Y. 1961).

35. See *Avery v. Merrill, Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677 (D.D.C. 1971).

36. See *Myer v. Shields & Co.*, 25 App. Div. 2d 126, 267 N.Y.S.2d 872 (1966).

37. See *Goldenberg v. Bache & Co.*, 270 F.2d 675 (5th Cir. 1959) (lender's counterclaim denied).

38. 429 F.2d 1136 (2d Cir. 1970).

39. A similar theory was earlier advanced by the Supreme Court in *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964), where the court permitted private stockholder suits with respect to proxy violations upon the theory that private enforcement of proxy rules supplemented SEC enforcements.

40. See text accompanying notes 22-26 *supra*.

41. However, consider Judge Friendly's dissenting argument:

Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who, under the majority's view, is placed in the enviable position of "heads-I-win-tails-you-lose."

429 F.2d at 1148.

42. 429 F.2d at 1141.

have protected knowledgeable investors by denying creditors the common law defense of *in pari delicto*. Conceptually, a knowledgeable investor is at equal fault with the creditor in a margin rule violation and recovery should thus be precluded by the defense.<sup>43</sup> However, the court in *Pearlstein* indicated that an investor who simply has knowledge of the violation is not subject to the defense since "Congress has placed responsibility for observing margins on the broker."<sup>44</sup>

The case of *Avery v. Merrill, Lynch, Pierce, Fenner & Smith*<sup>45</sup> recently reiterated this holding in denying a lender the defense of *in pari delicto*, observing that

[i]t was the clear intent of Congress to regulate excessive speculation on credit and that the means the Congress chose were the margin requirements which clearly place the onus of meeting certain minimum margin percentages on the brokers and dealers and not on their customers.<sup>46</sup>

In refusing to allow the defense of equal fault, the *Avery* court also recognized the "private enforcement" rationale of *Pearlstein*,<sup>47</sup> but placed primary emphasis upon the clear intent of Congress to impose the burden of compliance with margin requirements upon the lender and reluctantly allowed recovery by the knowledgeable investor.

Regulation X provides a potential basis for abrogating each of these rationales which presently protect knowledgeable investors. Literally the Regulation merely requires investor compliance with margin requirements and does not provide a resolution of investor-lender conflicts arising from mutual margin violations. However, since Regulation X specifically covers investors it clearly rejects the view that Congress has placed the burden of compliance with margin regulations solely upon lenders. The impact of Regulation X upon other bases for investor protection should not be determined without an analysis of the legislative history of the Act enabling Regulation X.

#### IV. REGULATION X AND LEGISLATIVE HISTORY OF TITLE III OF THE BANK RECORDS AND FOREIGN TRANSACTIONS ACT

##### Title III of the Bank Records and Foreign Transactions Act

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43. See text accompanying note 73 *infra*, for qualified view.

44. 429 F.2d 1136, 1141 (2d Cir. 1970).

45. 328 F. Supp. 677 (D.D.C. 1971).

46. *Id.* at 680.

47. "The Court concludes that civil liability is a helpful and beneficial adjunct to criminal and administrative sanctions in implementing the purpose of the Act . . ." 328 F. Supp. 677, 681 (D.D.C. 1971).

of 1970 amended section 7 of the Securities Exchange Act of 1934 to prohibit the receipt of loans by investors in violation of margin regulations.<sup>48</sup> Regulation X expressly implements Title III<sup>49</sup> and is designed to regulate credit in the securities markets in order to ensure compliance with margin regulations.<sup>50</sup> The Regulation thus provides that an investor may not obtain credit unless the loan conforms with the requirements of Regulation T, Regulation U, or Regulation G, depending upon the type of lender involved in the transaction.<sup>51</sup> A good faith innocent mistake on the part of a borrower does not violate Regulation X, provided that the borrower remedies the mistake promptly after discovery.<sup>52</sup>

Regulation X was promulgated by the Federal Reserve Board, which has general authority to prescribe rules and regulations governing credit in securities transactions.<sup>53</sup> Although promulgated by the Board, Regulation X should nevertheless be construed in accordance with the purposes of Title III.<sup>54</sup> Thus, a proper interpretation of Regulation X and its effect on prior case law necessarily entails an examination of the legislative history of Title III.

Title III was recommended by the House Committee on Banking and Commerce as an amendment to the Bank Records

48. It is unlawful for any United States person . . . to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities . . . if, under this section of rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited or would be prohibited if it had been made . . . in a State.

15 U.S.C. § 78g(f) (1) (1971).

49. 12 C.F.R. § 224.1 (1972).

50. The stated purpose of Regulation X is to prevent the infusion of unregulated credit obtained both outside and within the United States into U.S. securities markets in circumvention of the provisions of the Board's margin regulations or by borrowers falsely certifying the purposes of a loan or otherwise wilfully and intentionally evading the provisions of those regulations.

12 C.F.R. § 224.1 (1972).

51. 12 C.F.R. § 224.2 (1972).

52. 12 C.F.R. § 224.6 (1972).

53. 15 U.S.C. § 78g(a) (1971).

54. For example, the Board may exempt classes of persons, but only if such exemptions are consistent with the purposes of Title III.

The Board of Governors of the Federal Reserve System may, in its discretion and with due regard for the purposes of this section, by rules or regulation exempt any class . . . from the application of this subsection [the Title III Amendment to the Securities Exchange Act].

15 U.S.C. § 78g(f) (3) (1971).

and Foreign Transactions Act. As originally introduced, the Act was designed solely to correct problems of tax evasion and criminal activities which were being facilitated by the use of secret foreign bank accounts<sup>55</sup> and contained no reference to margin regulations. The House Committee was not initially concerned with problems specifically related to the securities market.<sup>56</sup> However, testimony before the Committee later indicated that unregulated foreign credit contributed to market instability, and aided corporate takeovers, market manipulation and insider abuse.<sup>57</sup> In addition, it was indicated that margin regulations were being frustrated by foreign lenders and domestic lenders operating through foreign bank accounts which were not subject to domestic margin controls.<sup>58</sup> In response to the problems cre-

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55. The House Report summarized the abuses disclosed during the committee hearings:

Secret foreign bank accounts and secret foreign financial institutions have permitted proliferations of "white collar" crime; have served as the financial underpinning of organized criminal operations in the United States; have been utilized by Americans to evade income taxes, conceal assets illegally and purchase gold; have allowed Americans and others to avoid the law and regulations governing securities and exchanges; have served as essential ingredients in frauds including schemes to defraud the United States; have served as the ultimate depository of black market proceeds from Vietnam; have served as a source of questionable financing for conglomerate and other corporate stock acquisitions, mergers and takeovers; have covered conspiracies to steal from U.S. defense and foreign aid funds; and have served as the cleansing agent for "hot" or illegally obtained monies.

H.R. REP. No. 975, 91st Cong., 2nd Sess. 12 (1970).

56. The author, Rep. Patman, indicated that initial committee concern was with the "problems posed by the use of secret foreign bank accounts for illegal purposes. It was our first inclination to draft a simple piece of legislation that would have outlawed the use of secret accounts unless there was complete disclosure." 91 CONG. REC. 16951 (1970).

57. Irving M. Pollack, Director, Division of Trading and Markets, Securities and Exchange Commission, *Hearings on H.R. 15023 Before the House Comm. on Banking and Currency*, 91st Cong., 1st & 2d Sess. 176-77 (1970).

58. First, under existing margin rules as interpreted by the federal court in the MGM litigation, foreign lenders can make loans to Americans for the purchase of securities in American markets on any terms they care to. Obviously, to the extent that margin rules attempt to prevent unwise market credit extension and "pyramiding," the extension of credit by foreign lenders without regard to the margin restrictions defeats these objectives.

Second, we have the problem of policing the margin rules against the activity of domestic lenders, who disguise their participation in transactions by effecting them through foreign intermediaries.

*Id.* at 179.

ated by foreign credit the House Committee recommended Title III to curb evasion of margin regulations. With respect to Title III, however, the House Committee Report primarily emphasized the role of foreign bank accounts in tax evasion, criminal activities, and corporate takeovers.<sup>59</sup> Although the Report indicated that requiring domestic investors to comply with margin requirements would ameliorate margin violations, these violations had been examined only within the context of secret foreign bank accounts and foreign credit.<sup>60</sup> Thus it appears that regulation of domestic credit was merely incidental to the primary legislative purposes of Title III as indicated in the House Committee Report.<sup>61</sup>

Like the House Committee, the Senate Committee on Banking and Commerce Report on Title III stressed the effect of secret, unregulated foreign credit on market stability and criminal activities.<sup>62</sup> Although the Senate Committee which considered the bill acknowledged that both domestic credit and foreign credit were regulated by Title III, the Committee hearings indi-

59. Representative Wright Patman commented in a House debate on Title III:

This amendment [Title III] was found necessary if we were to wholly and completely deal with the problems created by the use of secret foreign financial institutions for illegal purposes.

. . . . Through a simple device of making the margin requirements applicable to the borrower as well as to the lender, we will be equipping the Securities and Exchange Commission . . . with sufficient legal and investigative weapons to require adequate *disclosure* of foreign financing.

91 CONG. REC. 16954 (1970) (emphasis added).

It is not clear how disclosure of foreign financing would be required under Title III. However, such view coincides with the initial purposes of the Foreign Bank Act. See note 54 *supra*, which indicates original desire to force disclosure.

60. For example, the House Report noted that:

Americans and others, using the facade of secret foreign banks, can purchase securities in our market ignoring the Federal Reserve Board's regulations on margin requirements and for the purpose of evading income taxes. American companies are subject to takeovers or the acquisition of substantial interests by those about whom little or nothing is known. Criminal elements infiltrate and control substantial segments of American businesses through securities purchases and financing by secret foreign sources. Several of the recent corporate takeovers and acquisitions have involved security considerations in that defense contractors or other sensitive American industries became the target.

H.R. REP. NO. 975, 91st Cong., 2d Sess. 14 (1970).

61. The failure of the committee to consider the domestic effects of the proposed bill was criticized by one of the committee members, Rep. William Widnall. 91 CONG. REC. 16957 (1970).

62. S. REP. NO. 1139, 91st Cong., 2d Sess. 9 (1970).

cated that domestic regulation was justified as a measure to prevent margin violations occasioned by investor deception.<sup>63</sup> Yet, investor deception already was a recognized exception to court protection of investors in margin disputes,<sup>64</sup> thus the committee acceptance of domestic control does not bear upon investor-lender disputes absent investor deceit.

Resort to Congressional intent, then, is of little aid to the courts in determining the effect of Title III and Regulation X on actions between investors and lenders relating to margin violations. Although Title III literally applies to domestic investors, there is little evidence in its legislative history for requiring margin compliance by non-deceptive investors receiving domestic credit. Both the Senate and the House Committees were primarily concerned with secret foreign credit, its use in criminal activities, and its possible destabilizing effect on the securities

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63. Sen. William Proxmire noted the application of Title III to domestic credit in questioning Homer H. Budge, then Chairman of the SEC:

Senator Proxmire: It has been suggested that the penalties apply to the borrower only insofar as he borrows abroad. . . .

Mr. Budge: I have not specifically considered that, Mr. Chairman, nor has the Commission. I see no reason for the distinction. . . .

Senator Proxmire: Wouldn't it be easier to enforce the domestic law if you could get at the borrower as well as the lender?

Mr. Budge: I am sure that it would be.

*Hearings on S. 3678 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. 84 (1970).* Senator Proxmire later questioned Robert W. Haack, President of the New York Stock Exchange, on the desirability of regulating domestic credit indicating concern for deceived lenders:

Senator Proxmire: The SEC and other enforcement officials have testified that the margin requirements can be better enforced if they apply both to the borrower as well as the lender regardless of whether the borrower borrows here or abroad. After all, the lender depends upon the certifications made by the borrower as the purpose for the loan. Hence, if the borrower *deceives* the lender in order to circumvent the margin requirements, why shouldn't the borrower be prosecuted?

M. Haack: This is a very interesting provision in the bill, and we think it is ingenious, but we think it might go too far.

*Id.* at 296 (emphasis added). Also note the Senate report, which stated that

The bill would apply the margin requirements to borrowers regardless of whether they borrow from a domestic or foreign lender. The enforcement of the margin requirements with respect to purely domestic credit transactions would thus be enhanced since a borrower at times may *deceive* a lender by falsely certifying the purpose of a loan thus causing the lender to unknowingly violate the margin requirements. . . .

S. REP. NO. 1139, 91st Cong., 2d Sess. 9, 10 (1970) (emphasis added).

64. *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd* 409 F.2d 1360 (2d Cir.), *cert. denied* 396 U.S. 904 (1969).

market. Thus, Title III was apparently not intended to affect prior case law which attributed responsibility for margin violations to lenders. The only relevant purpose of Title III that can be gleaned from its legislative history would appear to be that Congress intended margin rules to be followed and considered it desirable to sanction investors as well as lenders for margin violations.

## V. IMPACT OF REGULATION X

Since the literal language of Regulation X requires all investors to comply with the margin rules, two rationales used in prior cases to permit investor recovery would seem to have been vitiated. First, the investor's right of recovery premised on the tort theory that he was a member of a special class protected by statute is negated by Regulation X. By requiring investor compliance with the margin rules Title III and Regulation X clearly anticipated sanction rather than protection of the investor. Second, investor protection based upon Section 29(b) is prevented by Regulation X. Section 29(b) provides that a contract which violates a regulation is void with respect to any person who is violating the regulation.<sup>65</sup> Prior cases construed this section to permit the investor either to sue for damages, seek rescission, enforce the contract, or void the contract at the investor's option. However, investors are now subject to the margin regulations and therefore when stock agreements violate margin rules investors violate Regulation X. Such contracts are then void as to the investor and enforcement and recovery of damages based on the contract are precluded. The success of an action for restitution would not require a valid contract but would depend on whether *in pari delicto* is still a viable defense.

*In pari delicto*, the general defense of the plaintiff's equal fault, might, in light of Regulation X, again be advanced to deny any type of investor relief. As discussed above, the primary rationale for permitting recovery by the investor who has knowledge of the margin violation, was predicated upon a finding that Congressional intent was to place the burden of compliance with margin rules solely upon lenders.<sup>66</sup> Since it is now illegal for investors to receive credit in contravention of the margin rules, they also have a "burden of compliance." Arguably, therefore, the lender's defense of *in pari delicto* should no

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65. See text accompanying note 33 *supra*.

66. See text accompanying note 44 *supra*.

longer be denied. However, even courts which have placed primary emphasis upon the creditor's burden of compliance in denying the defense have recognized that private investor suits supplement official enforcement of the margin regulations.<sup>67</sup>

The defense of *in pari delicto* has been disallowed expressly on the "enforcement" rationale in other areas of the law. In *Perma Life Mufflers, Inc. v. International Parts Corp.*, the Supreme Court denied the defense in an anti-trust action, reasoning that private suits would further public policy and encourage compliance with anti-trust laws.<sup>68</sup> This rationale also has been applied to deny the defense with respect to violations of Section 10(b) of the Securities Exchange Act.<sup>69</sup> In *Nathanson v. Weiss, Voisin, Cannon, Inc.*,<sup>70</sup> where a "tippee" sued an "insider", the defense was denied upon the theory that private suits protect the economy from security violations. Similarly, the application of *in pari delicto* to margin violations disputes should continue to be determined as in *Pearlstein* in order to enhance enforcement of the margin regulations. This approach would not only be consistent with the rejection of the defense in other types of private actions but would advance the only clear legislative policy behind Title III—that there should be compliance with the margin regulations.

It is not entirely clear, however, that permitting suits by investors does indeed supplement enforcement. Arguably such suits encourage compliance with margin requirements by deterring violations on the part of lenders. On the other hand, it is also possible that permitting investors to recover when they have consciously violated margin requirements encourages non-compliance on their part. Thus, it might be advantageous for an investor to disregard margin requirements since any loss could be recovered by a suit for damages against the creditor.

This same dilemma was present prior to the promulgation of Regulation X, however, and those courts which employed the

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67. See text accompanying note 47 *supra*.

68. 392 U.S. 134 (1968).

We have often indicated the inappropriateness of invoking broad common-law barriers to relief when a private suit serves important public purposes. . . . [T]he purposes of the anti-trust laws are best served by insuring that the private action will be an ever-present threat to deter anyone contemplating business behavior in violation of the antitrust laws.

*Id.* at 138-39.

69. 15 U.S.C. § 78j(b) (1971) (an anti-fraud provision).

70. 325 F. Supp. 50 (S.D.N.Y. 1971).

"enforcement" rationale did not consider it determinative.<sup>71</sup> Moreover, the investor is principally deterred from violating margin requirements by the legal sanctions to which he is now subject. As the United States Supreme Court reasoned in *Perma Life Mufflers, Inc.* with regard to anti-trust law violators: "[P]ermitting the plaintiff to recover a windfall does not encourage continued violations by those in his position since they remain fully subject to civil and criminal penalties for their own illegal conduct."<sup>72</sup>

Moreover, it is important to examine the particular context in which *in pari delicto* is raised. A point that has received little attention is the fact that different margin violations involve varying degrees of participation by the investor and lender.<sup>73</sup> For example, Regulation T provides a grace period during which any unpaid margin must be deposited with the broker after which the broker must liquidate the transaction if the investor fails to pay the amount when due.<sup>74</sup> Thus, it is the broker who still bears the primary responsibility for compliance and who most immediately violates Regulation T when he fails to liquidate the transaction at the end of the grace period. If *in pari delicto* is applicable only where the plaintiff is equally at fault with the defendant, then the defense should not bar private actions by investors under such circumstances.<sup>75</sup>

## VI. CONCLUSION

Prior to the promulgation of Regulation X, recovery by knowledgeable investors in private actions against lenders who violate margin regulations was the product of judicially created remedies. Regulation X, however, makes the margin rules spe-

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71. See note 41 *supra* and accompanying text.

72. 392 U.S. at 139. See also Judge Goldbold's dissent in *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 706 (5th Cir. 1969), which involved private suits arising from violations of section 10(b) of the Securities Exchange Act and echoed this aspect of the *Perma Life* rationale:

[L]itigation among guilty parties serves to expose their unlawful conduct and render them more easily subject to appropriate civil, administrative and criminal penalties.

73. *But see* *Billings Associates v. Bashaw*, 27 App. Div. 2d 124, 276 N.Y.S.2d 446 (1967) (dissent of Judge Marsh).

74. See text accompanying notes 18-21 *supra*.

75. Mr. Justice White, examining "equal fault," indicated that: Generally speaking, however, I would deny recovery where plaintiff and defendant bear substantially *equal responsibility* for injury resulting to one of them but permit recovery in favor of the one less responsible than the other. (emphasis added). *Perma Life Mufflers, Inc. v. International Parts*, 392 U.S. at 146 (concurring opinion).

cifically applicable to investors, thus raising the question of whether such private actions should still be permitted. Since the legislative history of Title III of the Bank Records and Foreign Transactions Act is unclear in this regard, courts should remain free to continue to permit or deny such recoveries in order to maximize compliance with the margin rules. This is especially true since there has been no specific Congressional or administrative determination as to which approach would maximize compliance. The applicability of the defense of *in pari delicto* would thus be determined as in other areas of the law permitting private causes of action. Moreover, this approach would be consistent with prior case law and the Congressional purpose behind Title III. Even though the variety of nefarious practices in which knowledgeable investors sometimes engage prior to seeking judicial relief may deafen the courts to investors' pleas,<sup>76</sup> courts should recognize that Regulation X does not mandate overruling the prior decisions.

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76. See, e.g., *In the Matter of Naftalin & Co., Inc.*, 333 F. Supp. 136, 145 (D. Minn. 1971).

It is extremely distasteful to this court to hold that the violation of the federal regulations by members of the industry can be used defensively by a completely and wholly undeserving, sophisticated and knowledgeable customer such as Naftalin. The court concludes, however, that such a holding, as harsh as it may seem, is consonant with the objectives and purposes of the 1934 Securities Exchange Act.

