Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities

William F. Hagerty, IV
Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*

"The repo market is as complex as it is crucial. It is built upon transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions."1

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I. INTRODUCTION

Repurchase agreements, more commonly known as "repos," have become a major concern in United States financial markets.\(^2\)

2. The following hypothetical explains the mechanics of a repurchase agreement transaction. Assume that a savings and loan S wishes to attract short-term funds from the general public P. S sells P an undivided interest in a security that S owns. S then transfers legal title to the underlying securities to its correspondent bank to hold for the benefit of P. The agreement between S and P sets forth the maturity date of the repurchase agreement. Although repurchase agreements typically mature in less than 90 days, they always mature before the maturity date of the underlying securities. Once the term of the agreement has expired, S must repurchase P's interest in the underlying securities at an agreed upon price that reflects P's initial "principal" payment plus a premium that corresponds to the prevailing market rate of interest for other short-term obligations. S pays the repurchase price to P from its general funds. An increase or decrease in the market value of the underlying securities does not affect the repurchase price S pays P. Consequently, P does not experience any gain or loss stemming from changes in the market value of the underlying securities. See Porter, Retail Repurchase Agreements Revisited, 99 Banking L.J. 676, 679-80 (1982).

3. Congressman Benjamin S. Rosenthal publicly voiced this concern in a letter to the Federal Home Loan Bank Board (FHLBB). Letter from Congressman Benjamin S. Rosenthal to Richard T. Frott, Chairman of the FHLBB, reprinted in Am. Banker, Aug. 13, 1981, at 4, col. 1. In his letter, Congressman Rosenthal expressed concern that retail repo customers were not receiving adequate information about the risks of investing in retail repos. Id. He specifically described four factors that increase the riskiness of repo investing. First, when the market value of the securities underlying the repo transaction drops significantly, the value of the securities may not be sufficient to back the entire repo obligation. Second, if a savings and loan institution that issues repos fails, repo investors probably will become only general creditors of the savings and loan because most investors hold only unperfected security interests in the underlying securities. Third, some savings and loans back the repos
One party to a repo agreement sells securities or an interest in securities to another party and simultaneously agrees to repurchase the same or similar securities at a later date for a somewhat higher price. Although repos typically are short-term debt instruments, investors now enjoy the option under federal law to renew them automatically for an indefinite period of time. The premium that the repurchasing party pays reflects the prevailing interest rate for similar short-term debt instruments. Government securities that the United States Treasury or other federal agencies issue typically back these transactions.

Two types of repos—wholesale and retail—have evolved since 1949. Wholesale repos typically are large-denomination, short-term contracts to sell and repurchase government securities. They may serve one of two main purposes. First, the Federal Reserve Board (Fed), operating through the Federal Reserve Bank of New York, uses wholesale repos to carry out its monetary policy. The Fed temporarily injects money into the economy by...
purchasing the securities that underlie repurchase agreements with government securities dealers.\textsuperscript{13} The Fed also temporarily withdraws money from the economy by selling securities to dealers under reverse repos\textsuperscript{14} to repurchase the same or similar securities at a later time.\textsuperscript{15} Second, institutions such as government securities dealers use wholesale repos to distribute or acquire short-term funds.\textsuperscript{16} Although government securities dealers have benefited significantly because of their ability to obtain short-term funds in this manner, the recent failures of two securities firms\textsuperscript{17} that participated heavily in this second use of wholesale repos\textsuperscript{18} have caused investors in United States financial markets to question the safety of wholesale repos\textsuperscript{19} and have demonstrated that repo investors currently receive inadequate protection against these dangers.\textsuperscript{20}

Retail repos differ from wholesale repos in several respects. First, retail repos usually are obligations of depository institutions,\textsuperscript{21} backed by either an interest in a security or a pool of securities.\textsuperscript{22} These securities either are direct obligations of the federal government or at least are guaranteed by the federal government.\textsuperscript{23} Second, investors purchase retail repos in denominations up to a

\begin{enumerate}
\item \textsuperscript{13} Holland, supra note 8, at 10.
\item \textsuperscript{14} Repos and reverse repos merely are labels given to the two sides of a repo agreement depending upon whether the perspective is that of the seller or buyer of the underlying securities. The party that agrees to sell the securities and repurchase them at a later date technically enters a repo. The party that agrees to buy the securities and resell them at a later date technically enters a reverse repo. \textit{Id.} at 8; see supra note 2.
\item \textsuperscript{15} Holland, supra note 8, at 10. If the Fed desires to inject funds into or withdraw funds from the economy permanently, it typically buys or sells the securities outright without entering a repurchase agreement. \textit{Id.}
\item \textsuperscript{17} See infra notes 40-59 and accompanying text.
\item \textsuperscript{18} \textit{Id.}; see \textit{Holland, supra note 8, at 10-11.}
\item \textsuperscript{20} See infra notes 84-156 and accompanying text for an analysis of possible legal characterizations of repurchase agreements that would give repurchase agreement investors financial protection under the Bankruptcy Code and the securities laws.
\item \textsuperscript{21} Although not every repurchase agreement issuer is a depository institution, the vast majority of issuers are banks or savings and loans. 46 \textit{Fed. Reg.} 48,637 (1981) (reprinting SEC Exchange Act Release No. 34-18122).
\item \textsuperscript{22} \textit{Id.} at 48,637-38.
\item \textsuperscript{23} \textit{Id.}
maximum of $100,000, but they typically buy wholesale repos in much larger denominations.\textsuperscript{24} Last, parties to wholesale repos ordinarily are sophisticated investors who desire to lend large sums of money for a very short time;\textsuperscript{25} depository institutions and securities dealers, however, mass-market retail repos to purchasers\textsuperscript{26} who possess varying levels of financial expertise\textsuperscript{27} and who desire to invest smaller amounts of money\textsuperscript{28} for somewhat longer periods of time.\textsuperscript{29} Consequently, many small investors participate in the retail repo market, often with a very limited understanding of the repo transaction.

Although investors have entered wholesale repo transactions for many years, the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Federal Home Loan Bank Board (FHLBB) in August 1979 jointly promulgated new regulations\textsuperscript{30} that for the first time authorized banks and other depository institutions to offer their customers retail repos.\textsuperscript{31} These agreements did not gain significant popularity, however, until mid-1981, when banks and savings and loans began offering retail repos at competitive interest rates that attracted all-savers' deposits and deterred the depletion of deposits which customers caused by placing their money in money market funds.\textsuperscript{32} Retail repos subsequently have gained immense popu-
larity, and approximately 5591 institutions offered them as of July 31, 1982. 83

Retail repos are attractive to many investors because they offer high liquidity and because depository institutions may pay repo investors interest rates that exceed federal interest rate ceilings on deposits. 84 Despite these attractive characteristics of retail repos, however, the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) insure only transactions that federal regulations characterize as deposits; 85 and since federal regulations specifically define deposits to exclude repos, 86 these federal agencies do not insure repo investments. 87 Federal regulatory authorities do require repo issuers to back the agreements with United States government securities of a value at least equal to the issuer's obligation under the repo. 88 Recent failures of several banks and other

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instruments: Money Market Deposit Accounts (MMDA), which have been available since December 14, 1982, and Super-NOW accounts, which have been available since January 5, 1983. Super- NOW and MMDA accounts are available in denominations of $2500 with no interest rate ceilings. Id. MMDA's allow up to six account transfers per month, and Super- NOW accounts give account holders unlimited check-writing privileges. Id.

Although Super- NOW and MMDA accounts have deterred deposit depletion in depository institutions by competing with money market funds for customer money investment, neither account seems as attractive to small investors as repurchase agreements. First, depository institutions and securities dealers sell retail repos in denominations ranging from $1000 to $100,000, see What You Don't Know About Repos Could Hurt You, A.B.A. Banking J., Oct. 1981, at 114, while the Super- NOW and MMDA accounts have fixed minimum denominations of $2500, Judd, supra, at 1, col. 1. Second, the yield on retail repurchase agreements is higher than on the Super- NOW and MMDA accounts because the repurchase agreements are not subject to reserve requirements, while Super- NOW accounts are subject to a 12% reserve requirement and MMDA's may be subject to reserve requirements as high as 3%. Id. at 2, col. 2. Last, retail repurchase agreements are available to both business investors and individuals, while Super- NOW accounts are available only to individuals and MMDA's are subject to reserve requirements for nonpersonal accounts. Id. at 2, col. 2; id. at 3, col. 2. A factor that favors Super- NOW accounts and MMDA's, however, is that the federal government insures them, while a repurchase agreement issuer's general funds and the securities underlying the agreement are the only sources of security backing repurchase agreements. See 46 Fed. Reg. 48,637 (1981) (reprinting SEC Exchange Act Release No. 34-18122).

33. Holland, supra note 8, at 8. The national dollar volume of the retail repo market was approximately $21 billion as of August 1982. Raylux, supra note 25.


REPOS AS SEPARATE PURCHASES

financial institutions that issue retail repos, however, demonstrate that this requirement does not protect retail repo investors from some significant risks that accompany repo investing.

In light of the actual and potential financial harm that repo investors faced after failures of several repo market participants, this Note proposes a new legal characterization of repos and argues for adoption of proposed Bankruptcy Code amendments pertaining to repos. Both of these suggestions would give repo investors significant future financial protection without destroying the financially attractive characteristics of repurchase agreements. Part II of this Note begins laying the foundation for this proposal by discussing current repo market problems that the failures of several repo issuers have exposed. Part II discusses new policies concerning the appropriate uses of the collateral securities underlying repo transactions, the rights of repo investors against insolvent repo issuers, and the need for disclosure to repo investors of financial information concerning repo issuers. Part III analyzes the possibility and economic feasibility of characterizing repos as loans, as separate securities, or as separate purchases and sales of the underlying securities. Part III concludes that characterizing repos as separate purchases and sales of the underlying securities would best protect repo investors from financial loss and preserve the attractive financial characteristics of repo transactions. Finally, Part IV analyzes the legal consequences of characterizing repos in this manner under the securities laws and the Bankruptcy Code. This analysis reveals that a characterization as separate purchases and sales of the underlying securities would exempt repos from the costly and time-consuming securities laws registration requirements, yet still would protect repo investors under the antifraud provisions of the securities laws. This classification also should yield favorable treatment of repo investors under the Bankruptcy Code. Congress, however, should adopt current proposed amendments to the Bankruptcy Code that will insure the safety and liquidity of the repo market irrespective of which judicial characterization courts apply to repos.

II. CURRENT PROBLEMS IN THE REPO MARKET

The failure of several repo issuers since 1982 raised new issues that have tarnished the attractiveness of investing in repos. These issues concern the appropriateness of various uses of the securities

39. See infra text accompanying notes 50-83.
that underlie the repos, the rights of repo investors under the Uniform Commercial Code and the Bankruptcy Code, and the necessity for disclosure to repo investors of financial information concerning repo agreements and their issuers.

A. Appropriate Uses of the Underlying Collateral

The May 1982 failure of Drysdale Government Securities, Inc. focused the attention of financial markets on the permissible uses of the securities that underlie repos. The repo transactions that Drysdale executed utilized currently impermissible methods to take advantage of a pricing anomaly in the repo market. This scheme seemed to be the primary cause of Drysdale's failure. The company obtained securities under repos that it transacted primarily through Chase Manhattan Bank with other securities lenders and dealers. At that time repo prices typically did not include interest accrued on the securities. Drysdale then sold these securities in the cash market for a price that included the securities' accrued interest. Drysdale then replaced the securities that originally backed the repos with different securities which had equal face values but later maturity dates and less accrued interest. Drysdale intended to profit from the differential between the accrued interest rate on the securities that it sold on the cash market and the securities which it substituted in the repos.

Drysdale's scheme failed because the financing costs stemming from the securities sales and substitutions consumed its profits and eventually led to its insolvency. Chase Manhattan Bank and other intermediaries in Drysdale's repo transactions reimbursed injured repo participants for losses in excess of $140 million that resulted from the Drysdale failure. In response to this failure, the New York Fed altered its policy regarding the permissible uses of

40. Undercapitalized speculation with repo-generated funds apparently caused Drysdale's failure. Donoghue, Investing With Care in a Post-Drysdale Market, 121 Tr. & Est. 20, 20 (1982). One commentator has estimated total losses from the Drysdale failure to be over $140 million. Id.
41. Id.
42. Chase Manhattan Bank and several other institutions served as conduits between Drysdale and securities lenders and dealers. Holland, supra note 8, at 11.
43. Id.
44. Id.
45. Id.
46. See id.
47. Id.
48. See Donaghue, supra note 40, at 20.
the securities underlying repurchase agreements by requiring that
the price of repos include interest that has accrued on the underly-
ing securities. This change will insure uniform pricing of all repo
transactions and will prevent similar Drysdale-type ploys in the
future.

B. Rights Against an Insolvent Repo Participant

The recent failure of two repo market participants also fo-
cused the financial market’s attention on the potential loss of li-
quidity and security that parties to repo transactions could incur
under the Bankruptcy Code if another party to the transaction be-
comes insolvent. In 1982 Lombard-Wall, Inc., a government securi-
ties dealer that sold securities under repo agreements to obtain
funds, became insolvent and filed for bankruptcy under Chapter
11 of the Bankruptcy Code. When Lombard-Wall filed its peti-
tion, investors who had entered repurchase agreements with Lom-
bard-Wall had effective possession of the securities that backed
their repos and wanted to know whether they could liquidate the
securities. If the bankruptcy court characterized their repos as
loan agreements, then the investors would have had to obtain the
court’s permission to sell the underlying securities; but if the court
chose to characterize the transactions as separate purchases and
sales of the securities, then the repo holders could have sold the
securities without court approval.

49. Id.
50. Holland, supra note 8, at 11.
52. See Holland, supra note 8, at 11.
53. Id. The following excerpts from a letter to Congressman Benjamin S. Rosenthal
from Mr. Thomas A. Russo contain useful information concerning the consequences of repo
characterization under the Bankruptcy Code and applicable insolvency laws:

The most important legal uncertainty concerning repos . . . is whether they will
ultimately be characterized, for purposes of the code or other applicable insolvency
laws, as secured loans or as independent contracts for the sale and repurchase of
securities.

In assessing the significance of this issue it is important to note that upon filing of
a bankruptcy petition under the Code a creditor is automatically stayed from setting
off obligations of the debtor to the creditor against obligations of the creditor to the
debtor and from liquidating any property which is property of the estate of the debtor.

If a repo to the debtor was treated as a secured loan from the debtor to a borrower
for which the borrower had provided securities to the debtor as collateral, the borrower
might have difficulty in obtaining the securities from the debtor or trustee (if one was
appointed) upon tender of payment if the securities had increased in value.
The bankruptcy court for the Southern District of New York in *In re Lombard-Wall, Inc.* effectively held that the securities underlying repo agreements were collateral for loans despite the actions of the New York Fed and two securities reporting firms—Solomon Brothers and Goldman, Sachs & Company—that intervened in the bankruptcy proceedings to argue that repos are purchases and sales of the underlying securities. Despite its holding, the bankruptcy court has granted several Lombard-Wall repo holders individual permission to dispose of the securities that backed their repos. If other courts strictly follow *Lombard-Wall*'s repo characterization, repo purchasers will face a serious but latent risk of financial harm. The bankruptcy of a repo issuer will make the unsecured repo holders only general creditors of the bankrupt issuer, thereby forcing them to suffer loss of liquidity while await-

Although the borrower might successfully maintain a so-called reclamation proceeding to force the debtor or trustee to return the securities to the borrower on the theory that the securities were merely collateral and not property of the estate, it is likely that substantial delay and expense would be involved.

If a reverse repo to the debtor was treated as a secured loan from a lender to the debtor for which securities had been delivered by the debtor to the lender as collateral, the lender would be automatically stayed by the filing of a petition from setting off the reverse repo against other obligations of the debtor to the lender and from liquidating the securities held as collateral.

In a reorganization proceeding, however, this decision would not be required to be made... until confirmation of the reorganization plan, an event which might occur several years after the petition was filed.

The manifold uncertainties concerning the treatment of repos in a bankruptcy context provides a strong incentive to repo market participants to avoid entering into, or to attempt to extricate themselves from, commitments with firms who have or are rumored to have financial difficulties.


54. 23 Bankr. 165 (S.D.N.Y. 1982).

55. Reporting government securities dealers regularly submit financial statements, daily position reports, and daily volume reports to the Federal Reserve Bank of New York. Presently, 36 firms are reporting government securities dealers. These firms are market makers in United States Treasury securities, and they typically purchase from 35% to 75% of the total amount of new issues that the Treasury sells at each auction. *See* Public Securities Association, Government Securities Newsletter (May 9, 1983).


57. *Id.*
ing the bankruptcy court's permission to liquidate their underlying securities. Moreover, the Bankruptcy Code would give the bankruptcy trustee discretion concerning liquidation of the underlying securities. Thus, if the underlying securities have decreased in value, the trustee may avoid the executory repo contract to repurchase the securities.

A situation similar to Lombard-Wall occurred on August 6, 1982, when federal regulators closed the Mount Pleasant Bank & Trust Company, a small Iowa bank with assets of approximately $25.5 million, and left bank customers who held retail repos scrambling to recover their investments. The FDIC, acting as receiver for Mount Pleasant, transferred the bank's deposits to the Hawk-eye Bancorporation of Des Moines, but did not transfer Mount Pleasant's repos and other liabilities. The FDIC then faced the issue whether under Iowa's version of the UCC the investors of $353,500 in retail repos held a perfected or unperfected security interest in the government securities underlying the agreements. If the FDIC had determined that the repo investors held a perfected security interest in the government securities, Iowa law would have entitled them to treatment as secured creditors and to reimbursement upon sale of the securities. In late September 1982, however, the FDIC held that the repo investors did not hold a properly perfected security interest. The repo investors consequently became only general creditors of Mount Pleasant without any special claim to the underlying securities. Thus, the repo investors will wait months or possibly years with other general creditors to receive a pro rata share of Mount Pleasant's liquidated assets.

59. A bankruptcy trustee would disavow the executory contract to resell the securities underlying a repo transaction to the original seller only when the securities would bring more money on the open market than by resale pursuant to the repo agreement. See id.
61. Id. at col. 3; Am. Banker, Sept. 20, 1982, at 3, col. 1.
64. Why the 'Repo' Market Bothers Regulators, Bus. Wk., Sept. 6, 1982, at 36.
65. The Mount Pleasant repo investors did not hold a perfected security interest in the securities underlying the agreement because neither the investors nor Mount Pleasant placed the securities in a valid trust with a third party pursuant to Iowa law. Am. Banker, Sept. 20, 1982, at 3, col. 1.
67. Id.
C. The Need for Disclosure of Information Concerning the Repo Agreement and the Issuing Institution

Although United States government securities typically back repos, these agreements essentially are general obligations of the issuing institution. A repo issuer's financial ability to fulfill its financial obligations, therefore, is a critical concern of repo investors. These investors also should know whether, under state commercial law, they hold perfected or unperfected security interests in the repo's underlying securities, because only a perfected security interest will insure that the investor enjoys the status of a secured creditor if the repo issuer becomes insolvent. Absent full disclosure of financial information pertinent to these concerns, investors may make uninformed decisions concerning repo investments that primarily rely upon the apparent safety and liquidity of a repo's underlying securities, rather than upon the legal nature of the purchaser's interest in the securities or the financial soundness of the issuing institution. The failure of the Fidelity Savings and Loan Association of San Francisco (Fidelity) in 1982 illustrates this problem.

Fidelity commenced its retail repo program during June 1981 and issued repos to the public in denominations of $2500 to $100,000. In advertising its retail repos, Fidelity implied that the repos were virtually risk-free investments, when in fact several serious undisclosed risks accompanied investment in these agreements. For example, Fidelity repo advertisements suggested investment safety by stating that "retail repo investors had a 'security interest' in 'pledged' government securities" which a custodial bank "held in trust" for the benefit of all purchasers. These advertisements, however, did not disclose that further steps might be necessary to perfect a security interest in the underlying securities and consequently that the investors risked classifica-

68. See supra notes 62-67 and accompanying text.
70. Id. at 85,241.
71. Id. at 85,242.
72. Id.
73. Id. In a published report of a private investigation that the Division of Enforcement conducted concerning false and misleading statements which Fidelity made in connection with its offer and sale of repos, the SEC made the following statement about whether Fidelity's repo investors held perfected security interests in the underlying securities:

In order for the security interest to provide safety to retail repo investors in the event
tion as only unsecured general creditors if Fidelity became insolvent. Moreover, the Fidelity advertisement that a custodial bank would hold the securities backing the repos in trust for the benefit of investors was a misrepresentation because Fidelity never attempted to execute a trust agreement under California law.

Fidelity also misled its repo investors by not adequately informing them of its severe financial difficulties. Although Fidelity began experiencing financial difficulties in 1980, it did not inform repo investors of these troubles until February 1982, some time after its auditor, Peat Marwick Mitchell & Company, warned in a disclaimer of opinion to Fidelity's 1981 financial statement that Fidelity faced insolvency unless it reversed its trend of financial loss. On February 24, 1982, in response to a letter from the San...
Francisco FHLBB advising it to terminate its retail repo program for failing to comply with FHLBB and securities law guidelines concerning financial disclosure.\textsuperscript{78} Fidelity began sending information to each of its retail repo investors stating that it was operating at a loss and was below federal and state regulatory net-worth requirements.\textsuperscript{79} Additionally, Fidelity issued a press release\textsuperscript{80} in late January that "gave the impression of business as usual, although with losses."\textsuperscript{81}

According to an SEC investigatory report, neither of these disclosures adequately conveyed the severity and immediacy of Fidelity's precarious financial situation, as exemplified by Fidelity's failure to acknowledge publicly that its independent auditors contemplated issuing a letter disclaiming an opinion on Fidelity's financial statements for the year ending December 31, 1981.\textsuperscript{82} Fortunately, Fidelity satisfied all of its $67 million in repo debts before federal regulators forced Fidelity to close and placed it in receivership in April 1982.\textsuperscript{83} Nevertheless, the injury the Fidelity scenario could have caused repo investors demonstrates the need for repo issuers to disclose fully information concerning their financial stability and the hidden risks underlying repo investment.

unless future net cash requirements can be funded without the conversion of noncash assets to cash at substantial losses, stockholders' equity will be fully depleted during 1982 and Fidelity Financial Corporation and its subsidiary [the Association] may be unable to continue in existence.

\textit{Id.}

78. \textit{Id.} at 85,244.

79. \textit{Id.}

80. Corporations have a duty, under well-established principles of law, to ascertain that disclosures in their press releases are not misleading. \textit{Id.} at 85,244 & n.6. Courts have enforced this duty "in part, to enhance public confidence in the availability of material corporate information and in the resulting open and honest character of trading." \textit{Id.} at 85,244.

81. \textit{Id.} The SEC's investigatory report concerning Fidelity's failure stated that:

On January 29, 1982, Fidelity issued a press release which reported a net loss for the quarter ($19.7 million) and for the year ($56.9 million) ended December 31, 1982 and a decline in savings deposits in 1981 (from $1.6 billion to $1.4 billion). At the same time it reported increased revenue (from $75.9 to $77.7 million) and assets (an increase of 1.9% to $2.9 billion).

\textit{Id.}

82. \textit{Id.}

III. LEGAL CHARACTERIZATION OF REPURCHASE AGREEMENTS

The financial problems and risks that presently accompany repo investment persist partly because neither courts nor federal regulatory bodies have given repos a clear legal characterization. In reaching a legally sound and equitable characterization of repos under existing law, courts and federal regulators should attempt both to preserve the attractive financial characteristics of repos and to protect repo investors from financial injury. Part III of this Note examines three possible legal characterizations of a repo transaction: as a loan, as a separate security, and as a purchase and sale of the securities underlying the agreement.

A. The Repo as a Loan

Repos potentially are classifiable as commercial loans because several characteristics of both retail and wholesale repo transactions closely resemble short-term loan agreements. First, repo issuers, like ordinary borrowers, must pay interest to the repo holder for the privilege of using the repo holder's money. Second, as in some loan agreements, the repo issuer pledges securities to the repo holder as collateral that supposedly assures the repo holder of reimbursement of the money investment. Third, although repo transactions technically resemble the sale and repurchase of an interest in certain securities, these securities serve the same function as collateral in loan transactions. Last, when the issuer repays the repo holder by repurchasing the underlying securities, the holder expects to receive only the amount of money that he originally invested plus a fixed rate of interest on his money that the market value of the underlying securities does not affect. The risk of fluctuation in the value of the underlying securities remains with the repo issuer even though the holder tech-

84. See supra notes 40-83 and accompanying text.
85. This Note limits its discussion to the potential characterization of repos as collateralized loans of a commercial nature. A repo characterized as a short-term commercial loan is beyond the scope of the federal securities laws. McClure v. First Nat'l Bank, 497 F.2d 490, 492 (5th Cir. 1974). If a court characterizes repos as an investment-type loan, then the antifraud and registration provisions of the securities laws apply. See C.N.S. Enter. v. G. & G. Enter., 508 F.2d 1354, 1361 (7th Cir. 1975); Annot., 39 A.L.R. Fed. 357, 365 (1978). Given the short-term fully-collateralized nature of repos, a commercial loan characterization is more appropriate.
86. See Holland, supra note 8, at 8.
87. Id.
89. See id.
nically owns the securities during the life of the agreement.\textsuperscript{90}

Despite these similarities, other characteristics of repos distinguish them from loans. Unlike most loans, for example, if a repo issuer exclusively backs a repo with United States government or agency securities, federal regulations exempt repos from federal loan limitations,\textsuperscript{91} interest rate ceilings,\textsuperscript{92} and reserve requirements.\textsuperscript{93} Other significant legal and policy consequences of treating repos as loans, however, provide stronger reasons for rejecting this characterization.

First, classifying repos as loans would not allow courts or the SEC to enforce the antifraud and disclosure requirements of the federal securities laws against repo issuers.\textsuperscript{94} Thus, scenarios such as those that arose during the failures of Lombard-Wall,\textsuperscript{95} Mount Pleasant Bank,\textsuperscript{96} and Fidelity Savings and Loan,\textsuperscript{97} in which many repo investors unnecessarily remained uninformed of the riskiness of repo investments\textsuperscript{98} or the financial conditions of repo issuers, could recur and injure future repo investors.

Second, the value of the underlying securities, which represents the repo holder's security interest, increases and decreases depending upon fluctuations in the securities' market value.\textsuperscript{99} If

\textsuperscript{90} Id. The market value of the government securities that back repos varies inversely with the market rate of interest for similar securities. For example, if government security \textit{A} pays a fixed short-term interest rate of 10\% and the market rate of interest rises to 12\%, investors will purchase security \textit{A} at 10\% only if they can pay a discounted purchase price that would make security \textit{A}'s effective yield to maturity approximately equal to the 12\% rate of interest that other similar securities pay.

\textsuperscript{91} See 12 C.F.R. § 7.1131 (1983). The Comptroller of the Currency determined that: "[t]he purchase or sale of securities by a bank, under an agreement to resell or repurchase at the end of a stated period is not a borrowing subject to 12 U.S.C. § 82 (1982) [limiting indebtedness incurred by a national bank to the amount of paid-in capital stock plus 50\% of unimpaired surplus] nor an obligation subject to the lending limit of 12 U.S.C. § 84 (1982) [limiting the liability of any person to a national bank to 15\% of paid-in capital and unimpaired surplus]."


\textsuperscript{93} Regulation D, 12 C.F.R. § 204.2(a)(vii)(B) (1983).

\textsuperscript{94} The securities laws will not apply to repos if courts characterize them as loans. See Bellah v. First Nat'l Bank, 495 F.2d 1109, 1114 (5th Cir. 1974).

\textsuperscript{95} See supra notes 50-57 and accompanying text.

\textsuperscript{96} See supra notes 60-67 and accompanying text.

\textsuperscript{97} See supra notes 69-83 and accompanying text.

\textsuperscript{98} If courts characterized repos as loans and a repo issuer filed for bankruptcy, the securities underlying the repo would become property of the bankrupt issuer's bankruptcy estate under § 541 of the Bankruptcy Code. Am. Banker, Sept. 10, 1982, at 18, col. 1. Thus, repo holders would lose their ability to liquidate the securities underlying the repos to recover their investment. \textit{Id.}

\textsuperscript{99} Repo issuers typically bear the risk that the securities underlying a repo will fluc-
the repo issuer files for bankruptcy, section 541(a)(1) of the Bankruptcy Code deems the securities property of the issuer's bankruptcy estate and therefore subjects them to the repo holder's lien. If the repo holder has a perfected security interest in the securities, the repo holder becomes a secured creditor of the bankrupt issuer. If, however, the repo holder does not hold a perfected security interest, he becomes an unsecured creditor of the issuer, and the bankruptcy trustee can avoid the holder's lien and

100. The Bankruptcy Code does not cover bank insolvencies. 11 U.S.C. § 109(b)(2) (1982); see S. REP. No. 989, 95th Cong., 2d Sess. 31 (1978), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 6265, 6275 (“Banking institutions . . . are excluded from liquidation under . . . [the] bankruptcy laws because . . . alternative provision is made for their liquidation under various state or federal regulatory laws.”).

101. A bankruptcy debtor's estate, subject to certain exceptions not applicable to repos, consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541(a)(1) (1982).

102. To perfect an interest in United States government securities, which typically back repos and exist in book-entry or uncertificated form, the repo parties must comply with the following procedures:

A transfer or a pledge of book-entry [government securities] to a Reserve Bank . . . or to any transferee or pledgee eligible to maintain an appropriate book-entry account in its name with a Reserve Bank under this subpart, is effected and perfect, notwithstanding any provision of law to the contrary, by a Reserve Bank making an appropriate entry in its records of the [securities] transferred or pledged.

31 C.F.R. 350.4(a) (1983) (emphasis added); see also 31 C.F.R. § 306.115(d) (1983) (“'Book-entry Treasury security' means a Treasury bond, note, certificate of indebtedness, or bill issued under the Second Liberty Bond Act, as amended, in the form of an entry made as prescribed in this subpart on the records of a Reserve Bank.”).

These federal procedures expressly preempt the perfection requirements of the UCC. Mitchell, Repurchase Agreements, N.Y.L.J., Jan. 26, 1983, at 3. Once a federal reserve bank makes the appropriate book entry, the repo purchaser acquires a perfected security interest in the underlying government securities. Id. The Treasury's automatic perfection regulations apply only to book-entry transfers, to federal reserve banks, and to the accounts of Federal Reserve System member banks. Id. Nonmember banks and other financial institutions must comply with separate Treasury regulations providing for the perfection of security interests in book-entry government securities that member banks deposit for the accounts of their customers. Id. When the nonmember banks and other financial intermediaries act as custodians for their customers' accounts, these regulations require that they accomplish perfections "by any means that would be effective under applicable law to effect a transfer or to effect and perfect a pledge of the [government securities], or any interest therein, if the [securities] were maintained by the Reserve Bank in bearer definitive form." 31 C.F.R. §§ 306.118(b), 350.4(b) (1983). The phrase "applicable law" in 31 C.F.R. §§ 306.118(b), 350.4(b) usually refers to the appropriate state's version of the UCC. Compliance with state UCC procedures ensures that a repo purchaser's claim is superior to the claims of other creditors of the repo issuer in the event of insolvency. Mitchell, supra, at 3.

103. See RAYLUX, supra note 25.
liquidate the securities in the open market.\textsuperscript{104} The issuer's bankruptcy proceedings, therefore, could force repo holders to wait months or even years before receiving complete or partial repayment of their repo investments.

Last, if an insolvent repo issuer is a federally insured depository institution and federal regulators place it into receivership,\textsuperscript{105} the repo holder's desire to enforce the repo contract might compete directly with the federal insurer's interest in protecting depositors of the defunct bank.\textsuperscript{106} Thus, these three negative implications of a loan characterization demonstrate convincingly that courts should not characterize repo transactions as loans.

\textbf{B. The Repo as a Separate Security}

Although the SEC has determined that wholesale repos are not separate securities for purposes of the federal securities law,\textsuperscript{107} the literal meaning of two provisions in the Securities Act of 1933 (1933 Act) and the Securities and Exchange Act of 1934 (1934 Act) suggests that courts could characterize retail repos as separate securities. Section 2(1) of the 1933 Act\textsuperscript{108} and section 3(10) of the 1934 Act\textsuperscript{109} specifically define a security "as any note, . . . evidence of indebtedness, . . . investment contract, . . . [or] guarantee of . . . any of the foregoing."\textsuperscript{110} Despite the name that parties give to a transaction, courts will characterize it as a "security" within the meaning of the 1933 and 1934 Acts if the "underlying economic substance or reality" of the transaction suggests this characterization.\textsuperscript{111} Retail repos, therefore, arguably are classifiable as securities because they resemble an investment contract or evidence of indebtedness between repo issuers and purchasers.

A separate security characterization, however, would devastate

\textsuperscript{104} Section 544(a) gives bankruptcy trustees the rights and powers of a creditor that obtains a judicial lien on the property of a debtor's bankruptcy estate. 11 U.S.C. § 544(a) (1982). A judicial lien has priority over unsecured claims and unperfected security interests. See 11 U.S.C. § 506 (1982).

\textsuperscript{105} See supra notes 60-67 and accompanying text.

\textsuperscript{106} The FDIC, as receiver for Mount Pleasant Bank and Trust, argued that it had priority over unsecured repo holders in the securities underlying Mount Pleasant repos. Am. Banker, Sept. 20, 1982, at 3, col. 1. In September 1982 the FDIC decided that Mount Pleasant repo investors were only general creditors of Mount Pleasant with no special interest in the underlying securities. N.Y. Times, Sept. 29, 1982, at 35, col. 1.


the repo market by subjecting repurchase agreements to the expensive and time consuming registration requirements of the 1933 and 1934 Acts.\textsuperscript{112} This classification would force repo issuers to file formal registration statements with the SEC for all repo transactions.\textsuperscript{113} This formal process is tedious and time consuming. For example, after a repo issuer completed an elaborate registration statement,\textsuperscript{114} the SEC then would review the repo transaction.\textsuperscript{115} This inspection could last for days or weeks depending upon the volume of filings before the SEC.\textsuperscript{116} In addition, the cost of registration—including filing expenses, underwriter’s commissions, and attorneys’ fees—can be enormous.\textsuperscript{117} The SEC has estimated that the average cost of filing an S-1 registration statement\textsuperscript{118} exceeds $100,000.\textsuperscript{119}

Judicial characterization of repos as separate securities, and the resulting requirement that repo issuers register them with the SEC, would destroy the two most financially attractive characteristics of repos: high liquidity and low transaction costs.\textsuperscript{120} A registra-

\begin{center}
\begin{tabular}{l|c}
\hline
Printing and Engraving & $32,750 \\
Legal Fees & 43,828 \\
Accounting Fees & 25,500 \\
Miscellaneous & 5,590 \\
\hline
\end{tabular}
\end{center}

112. The costs of registering a transaction under the securities laws, including registration fees, underwriter’s commissions, attorneys’ fees, and printing costs, are substantial. The SEC, for example, itemized the following schedule of estimated costs for a typical offering of securities when the registering party uses an S-1 registration statement:

\begin{center}
\end{center}


114. See supra note 112.

115. Under the SEC’s current operating policy, an SEC branch chief or examiner advises registrants, within five calendar days after registration, whether the SEC will review their registration statement. If the SEC does not select a registration statement for review, the statement may become effective within 48 hours. Palm, Registration Statement Preparation and Related Matters, 433 PRAC. L. INST. 101, 135 (1983).

116. “The average time between filing and effectiveness of registration statements selected for full review is currently in excess of 25 days for repeat registrants and over 30 days for first-time registrants.” Id. at 136.

117. See supra note 112.

118. Registrants use an S-1 form when the securities laws specifically do not allow them to use a shorter form. S-1 forms require complete disclosure of information describing the registrant’s business, properties, and management arrangements. The S-1 form also requires the applicant to submit a complete financial statement to the SEC. See Palm, supra note 115, at 113.

119. See supra note 112.

tion requirement would replace the traditional liquidity that characterizes repo transactions with substantial timing uncertainties that commonly accompany long-term securities.121 The increased repo transaction costs due to registration expenses also would cause government securities dealers, who rely on repos as a major method of acquiring short-term funds to finance floatation of new government debt,122 to use other money market instruments to perform this financing function. The combined effect of increased transaction costs and lost liquidity would devastate the repo market.

C. The Repo as a Purchase and Sale

Courts most effectively could solve the problems that currently cloud the wholesale and retail repo market123 by characterizing repos as separate purchases and sales of the underlying securities. Section 2(3) of the 1933 Act124 and section 3(a)(14) of the 1934 Act125 similarly define the term “sale.” Section 2(3) states that a sale includes “every contract of sale or disposition of a security or interest in a security, for value,” while section 3(a)(14) defines the term to “include any contract to sell or otherwise dispose of” securities.126 Although the 1933 Act does not define the term “buy” or “purchase,” the 1934 Act defines these terms to “include any contract to buy, purchase, or otherwise acquire” securities.127 Courts should construe these definitions to encompass repos because repos are closely analogous to other transactions that courts

121. See supra note 116.
122. Primary dealers in United States government securities use repos as a principal means of financing the purchase and floatation of newly issued government securities. Other securities dealers also use repos to obtain newly issued government securities from primary securities dealers. If courts characterize repos as separate securities and subject repo issuers to the securities law registration requirements, the cost of repo financing will increase significantly and will force these repo participants to search for less costly financing devices. This increase in financing costs also could increase interest rates and the cost of government borrowing. See 129 Cong. Rec. E3183 (daily ed. June 27, 1983) (comments of Rep. Fauntroy).
123. Although the repo market was one of the fastest growing segments of United States financial markets, many repo participants left the repo market in 1982 after the financial collapse of Drysdale Government Securities, Inc. and Lombard-Wall, Inc. Wall St. J., Jan. 30, 1984, at 41, col. 3.
already have characterized as purchase and sale transactions and because the SEC already has characterized wholesale and, in certain circumstances, retail repos as separate purchases and sales of the underlying securities.

1. Pledge of Securities as Collateral for a Loan Characterized as a “Sale” of Securities

The Supreme Court characterized a transaction that was very similar to a repo as a sale and purchase of a security in *Rubin v. United States*. This action strongly suggests that courts also should treat repos in the same manner. In *Rubin*, Tri-State Energy, Inc., a financially troubled energy exploration and production corporation, fraudulently represented its stock in six companies as good and marketable with a value of approximately $1.7 million. Tri-State pledged this stock as collateral for a loan from the Bankers Trust Company. A jury subsequently convicted Tri-State of conspiracy to violate various federal antifraud statutes, including section 17(a) of the 1933 Act. The Court granted certiorari solely to consider whether a pledge of securities as collateral for a loan is an “offer or sale” of securities within the meaning of section 17(a) of the 1933 Act.

The Court upheld Tri-State’s section 17(a) conspiracy conviction by holding that the pledges of securities as collateral for the Bankers Trust loan constituted an offer or sale of the securities and therefore fell under the jurisdiction of the antifraud provisions of the securities laws. The Court first reasoned that although the pledges transferred less than absolute title to the securities, they “contemplated a self-executing procedure under a power that could, at the option of the pledgee (the bank) in the event of a

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128. See infra notes 130-47 and accompanying text.
129. See infra notes 148-56 and accompanying text.
132. *Id.* at 425-26.
133. The securities that Tri-State pledged as collateral were practically worthless. *Id.* Most of the securities were either restricted securities that a shell corporation issued or rented securities that Tri-State did not own. *Id.*
134. *Id.*
135. *Id.* at 427 n.4.
136. *Id.* at 427.
137. *Id.* at 428.
138. *Id.* at 431.
default, vest absolute title and ownership.”139 Second, the Court suggested that the pledges were offers or sales by noting that Bankers Trust paid substantial consideration for “the inchoate but valuable interest under the pledges and concomitant powers”140 and by emphasizing that the Act does not require full title to pass to a transferee “for the transaction to be an ‘offer’ or a ‘sale.’”141 Last, the Court reasoned that the economic considerations and realities present when a lender loans money and accepts a pledge of securities as collateral are similar in important respects to the risks that an investor incurs when purchasing securities.142 The Court stated that both the lender and investor must rely on the value of the securities and upon the transferor’s representations about the securities “regardless of whether the transferor passes full title or only a conditional and defeasible interest to secure repayment of a loan.”143

The Court’s holding and reasoning in Rubin strongly suggest that courts also should characterize repos as sales and purchases of the underlying securities. Unlike the pledge in Rubin, repos technically pass full title in the underlying securities to the repo holder.144 In return, the repo holder, like the lender in Rubin, loans money to the repo issuer at a specified interest rate.145 Unlike the lender in Rubin, however, repo holders typically receive a right of substitution,146 which allows the holder to use or sell the securities underlying the repurchase agreement and replace them with other securities of the same issue that have the same accrued interest as the original securities.147 Thus, repos more closely resemble sales and purchases than did the pledged securities and loan in Rubin. Therefore, courts similarly should characterize repurchase agreements as separate sales and purchases of the underlying securities.

139. Id. at 429.
140. Id. at 429-30.
141. Id. at 430.
142. Id.
143. Id.
145. See Holland, supra note 8, at 8.
146. See Miller, 495 F. Supp. at 469.
2. SEC Characterization of Repos as Separate Purchases and Sales of Securities

(a) Wholesale Repos

In October 1981 the SEC issued a policy statement in which it characterized wholesale repos as separate purchases and sales of the underlying securities.\(^{148}\) The effects of this classification are twofold. First, the burdensome registration requirements in the 1933 and 1934 Acts do not apply to most wholesale repos because the securities laws exempt from these requirements purchases and sales of the United States government securities that typically back wholesale repos.\(^{149}\) Second, the SEC stated that the antifraud provisions of the securities laws\(^{150}\) still would apply to wholesale repos, despite the available exemption from registration.\(^{151}\)

Courts should adopt this characterization of wholesale repos for several reasons. First, it will provide the parties that invest billions of dollars in the wholesale repo market with the antifraud protection of the federal securities laws. Second, the antifraud laws would impose a threat of liability on wholesale repo issuers for fraudulent dealing and would promote investment safety in the repo market. Last, this characterization would allow the SEC to use its financial sophistication in the wholesale repo market to police the conduct of wholesale repo transactions. These positive contributions to the wholesale repo market not only would instill a stronger sense of responsibility on the part of repo issuers, but also would increase the dwindling confidence of investors.\(^{152}\) This additional certainty would enhance the vigor of the wholesale repo market. Consequently, the economy would enjoy the concomitant effects of healthy investment: the Fed more easily could execute short-term domestic monetary policy, securities dealers more easily could acquire funds to finance the floatation of new government debt, and institutional investors could enjoy more liquidity and security in their short-term investments.\(^{153}\)

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149. Id. at 48,638 n.7.
150. 15 U.S.C. §§ 77q(a), 78j(b) (1982).
(b) Retail Repos

In addition to its policy statement concerning wholesale repos, the SEC, in two no-action letters, implicitly treated repo transactions as sales and purchases of securities.\footnote{154} The SEC first stated that federal securities law registration requirements did not apply to retail repo transactions because exempt United States securities backed the agreement.\footnote{155} The SEC, however, then warned that the antifraud provisions of the securities laws would apply to the offer and sale of the retail repos.\footnote{156} This treatment of retail repos by the SEC effectively classifies them as separate purchases and sales of the underlying securities. Courts should adopt this characterization of retail repos because it would protect the many unsophisticated purchasers against issuer fraud and would force retail repo issuers to provide potential purchasers with sufficient information to alert them to the hidden risks accompanying retail repo investment.

IV. THE LEGAL CONSEQUENCES OF CHARACTERIZING REPOS AS SEPARATE PURCHASES AND SALES OF THE UNDERLYING SECURITIES

A. Securities Law Consequences

Although a judicial characterization of repos as separate purchases and sales of the underlying securities will not require repo issuers to register the transactions under the securities laws, it will subject repo issuers to the antifraud provisions of the 1933 and 1934 Acts.\footnote{157} The antifraud provisions will threaten repo issuers with liability for making fraudulent statements to repo purchasers and will insure that the issuer provides purchasers with current information concerning the transactions.\footnote{158}

The threat of liability under the antifraud provisions should force retail repo issuers\footnote{159} to make full and accurate disclosures in

\footnote{155} Id. at 48,637-38.
\footnote{156} Id. at 48,638.
\footnote{157} A separate purchase and sale characterization would exempt repos backed by United States government securities from registration requirements. See 15 U.S.C. §§ 77c(a)(2), 78c(a)(12), 781(a) (1982). No similar antifraud exemption exists under either the 1933 or 1934 Act. See 15 U.S.C. §§ 77q(a), 78j(b) (1982).
\footnote{159} Wholesale repo issuers, unlike retail repo issuers, usually market repos to financially sophisticated institutional and corporate investors or financial intermediaries
all documents and representations that they make concerning retail repo transactions, including all advertisements, promotions, offering documents, financial statements for prospective investors, and the repo agreements themselves. These disclosures, at a minimum, should include the following information: an accurate, detailed, and up-to-date statement of the issuer's financial condition; a conspicuous statement on the face of the agreement that the FDIC does not insure repos and that the United States government does not guarantee them; a description of the underlying securities and disclosure of the appropriate market value of the securities; a warning that the market value of the underlying securities could depreciate before the repo matures, thereby making the holder an unsecured creditor of the issuer for the difference between the repurchase price and the market value of the securities; and information advising the customer whether he has a perfected security interest in the underlying securities under state law, explaining the procedures for perfecting a security interest, and describing the legal ramifications of not acquiring a perfected security interest in the securities. These and other disclosures should insure that retail repo investors, especially unsophisticated ones, appreciate the hidden risks of retail repo investment.

B. Bankruptcy Law Implications

The investor apprehension currently dampening the repo market stems in part from uncertainty concerning the various legal consequences to repo agreement participants when one of them files for bankruptcy. The Bankruptcy Code presently does not apply expressly to repos, and only the Bankruptcy Court for the rather than to the general public. Wholesale repos usually are shorter in duration than retail repos, often only lasting overnight, and usually concern much larger amounts of money. See Holland, supra note 8, at 8. These differences suggest that stringently enforcing the securities law disclosure requirements in wholesale repo contexts would be impractical. The threat of liability that underlies the disclosure provisions, however, should deter wholesale repo issuers from making fraudulent or misleading representations in repo transactions. See 15 U.S.C. §§ 77q(a), 78j(b) (1982).

162. Id.
163. Id.
164. Id.
165. Id.
Southern District of New York—in In re Lombard-Wall, Inc.—has considered the issue. In Lombard-Wall the bankruptcy court implicitly held that the automatic stay provision in section 362 of the Bankruptcy Code applied to wholesale repo holders and prevented them from liquidating the underlying securities to recoup their repo investments. The Lombard-Wall court, however, reached this decision only after implicitly characterizing wholesale repos as collateralized loan transactions. Under a separate purchase and sale repo characterization, Bankruptcy Code treatment of repo parties would depend upon the type of parties who enter the agreement and whether the transaction is wholesale or retail. These confusing and varying treatments demonstrate convincingly that Congress should pass the proposed amendments to the Bankruptcy Code which expressly concern repos because the amendments would treat all parties to repo transactions uniformly.

1. Potential Applicability of Section 555 to Wholesale Repos Between Securities Dealers, Brokers, and Clearing Agencies

In 1982 Congress enacted section 555 of the Bankruptcy Code to prevent the insolvency of a single securities dealer from adversely affecting others. Although the court in Lombard-Wall did not discuss section 555, the provision technically seems to apply to repo transactions. Section 555 provides that the automatic stay provision...
stay and avoidance provisions of the Bankruptcy Code do not apply to securities dealers who possess a contractual right to liquidate securities contracts such as repos. Thus, if a court finds it applicable, section 555 should allow securities dealers who have entered wholesale repos with other securities dealers to recover their investments by selling the underlying securities if the issuing dealer goes into bankruptcy.

2. Bankruptcy Code Treatment of Retail Repos Issued by Nondepository Institutions and Wholesale Repos Not Covered Under Section 555

If courts choose not to apply section 555, then repo holders' rights against insolvent issuers will fall within the provisions of other applicable sections of the Bankruptcy Code. Under a separate purchase and sale characterization, repo holders not subject to section 555 would enjoy different rights under the Bankruptcy Code than the court gave them in *Lombard-Wall*. If courts adopted a separate purchase and sale classification, then the securities backing repos would not be property of the issuer's bankruptcy estate. Executory repo contracts, however, would become property of the estate, and the bankruptcy trustee would have the discretion to assume or reject any of the executory repo contracts pursuant to section 365 of the Bankruptcy Code.

bankruptcy or insolvency of a debtor "shall not be stayed, avoided, or otherwise limited by operation of any provision of this title" or by an order of any "court or administrative agency in any proceeding under this title" unless specifically allowed under the Securities Investor Protection Act of 1970 (15 U.S.C. § 78aaa et seq. (1982)). 11 U.S.C. § 555 (1982). Section 555 should cover repos under a separate purchase and sale characterization if the repo contract includes a right to liquidate the underlying securities when a repo issuer files for bankruptcy. See, e.g., Repurchase Agreement Between Dauphin Deposit Bank and Trust Company and Lombard-Wall, Inc., reprinted in 290 PRAc. L. INsT. 343, 347-49 (1982).

177. Section 541 states that, subject to certain exceptions not applicable to repos, all legal or equitable interests of the debtor as of the date the debtor filed for bankruptcy become property of the bankruptcy estate. 11 U.S.C. § 541(a)(1) (1982).
178. Section 365 of the Bankruptcy Code states in pertinent part:
(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the *trustee*, subject to the court's approval, may assume or
Three scenarios concerning executory repo contracts under section 365 of the Bankruptcy Code can arise: the trustee may assume the contract, reject the contract, or fail to do either. First, if a trustee assumes an executory repo contract, he simply will pay the repo holder the repurchase price plus interest in exchange for the securities. Second, when the value of the securities decreases below the agreed upon repurchase price after the issuer files for bankruptcy, the trustee probably will reject the executory repo contract. The repo holder will then receive the right to liquidate the securities and pursue an unsecured damage claim against the estate for the difference between the repurchase price and the amount that liquidation of the securities produced. Last, if a trustee in a Chapter 7 case neither assumes nor rejects an executory repo contract within sixty days after the issuer files for bankruptcy, or within an additional period of time that the bankruptcy

reject any executory contract or unexpired lease of the debtor.

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.


180. Id.

181. Section 365 (d)(1) of the Bankruptcy Code states:

In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.


182. See 11 U.S.C. § 365(a) (1982). A bankruptcy trustee probably will assume an executory repo contract when the market value of the underlying securities exceeds the repurchase price specified in the repo contract.

court may set during this sixty day period, section 365(d)(1) provides that the trustee effectively has rejected the contract.\(^{184}\) In this situation the remedies available to repo holders again are the right to liquidate the securities, and if liquidation yields less than the repurchase price plus interest, to pursue an unsecured damage claim against the estate for the difference.

3. Treatment of All Repo Transactions Under the Proposed Amendments to the Bankruptcy Code

In the wake of the *Lombard-Wall* opinion, Congress promptly began considering proposed amendments to the Bankruptcy Code\(^{185}\) that would protect parties to most repo transactions\(^{186}\) from the automatic stay and avoidance provisions of the Code.\(^{187}\) The proposed amendments would exempt repos from these provisions in precisely the same manner that section 555 currently exempts securities contracts.\(^{188}\) Fed Chairman Paul A. Volcker, in a letter to Senator Robert Dole, expressly supported adoption of the proposed amendments.\(^{189}\) The SEC, however, has not expressed an opinion concerning the proposed amendments, and the Department of the Treasury openly opposes their adoption.\(^{190}\) The Treasury Department reasoned that a continuation of the uncertainty that presently pervades the repo market is desirable because it will force repo market participants to evaluate carefully the creditworthiness of other repo parties.\(^{191}\) The need for a dependa-

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\(^{185}\) See *supra* note 168 for a discussion of the proposed Bankruptcy Code amendments that concern repos.

\(^{186}\) See 11 U.S.C. § 109(b) (1982) (stating that banks and savings and loan associations may not be debtors under the Bankruptcy Code).


\(^{190}\) Letter from Roger W. Mehle, Assistant Secretary of the Department of the Treasury, to Robert J. Dole (Mar. 16, 1983) (appended to Public Securities Ass’n, Memorandum Regarding Repo Bankruptcy Amendments (Mar. 30, 1983)).

\(^{191}\) See Public Securities Ass’n, Government Securities Newsletter (Apr. 5, 1983); Public Securities Ass’n, Memorandum Regarding Repo Bankruptcy Amendments (Mar. 30, 1983) (letter from Roger W. Mehle, Assistant Secretary of the Department of the Treasury, to Senator Robert J. Dole appended to memorandum). The Department of the Treasury stated that repo creditors deserve no better treatment under the Bankruptcy Code than any other secured creditors. The Treasury reasoned that “the perception of increased risk in the [repo] market is healthy, because it forces more responsibility in [repo] transactions by causing lenders to securities dealers to evaluate the financial condition of their borrowers.” *Id.* In an accompanying memorandum, the Public Securities Association refuted the Treas-
ble, highly liquid vehicle to conduct domestic monetary policy, to float government debt, and to provide short-term investment, however, outweighs the Treasury's argument. The certainty and uniformity that adoption of the proposed amendments would accord parties to most repos argues forcefully in favor of congressional adoption of the proposed amendments. Moreover, unless Congress adopts the proposed amendments, the investor fear that has pervaded repo markets since the failures of Drysdale and Lombard-Wall probably will continue to weaken the already dampened repo market.  

V. CONCLUSION

Retail and wholesale repos are important facets in both the public and private sectors of United States financial markets. The Federal Reserve Board, for example, actively uses wholesale repos to implement its monetary policy, and banks and savings and loan institutions mass-market retail repos to the general public as relatively inexpensive short-term financing devices. The recent failure of several repo market participants and the actual and potential financial harm these failures caused repo investors, however, revealed the latent financial risks of repo investment and the confusion concerning proper legal treatment of the problems that may arise from these transactions.

This confusion over the proper legal characterization of repos is partially responsible for the cloud of financial and legal uncertainty that currently overhangs the repo market. Courts, for example, could classify repos in three ways: as collateralized loans, as separate securities, or as separate purchases and sales of the securities that underlie the agreements. Each of these legal characterizations would yield different practical and legal consequences. A separate security characterization, for example, would protect repo investors by subjecting repo transactions to the antifraud provisions of the federal securities laws. This classification, however,
would impose very costly and time consuming federal securities law registration requirements on repos, thereby destroying their most attractive investment characteristics: low transaction costs and high liquidity. A commercial loan characterization, in the alternative, would not subject repos to either antifraud or registration provisions of the federal securities laws. This classification, therefore, would not give repo investors, particularly unsophisticated initiates, adequate legal protection against incomplete or fraudulent disclosure of information concerning the repo or the repo issuer's financial condition. A loan characterization also would subject repo investors to harsh treatment under the automatic stay and avoidance provisions of the federal bankruptcy laws.

Courts, therefore, should adopt a separate purchase and sale characterization of repos. This view would treat repo investors favorably under both federal securities and bankruptcy law, and also would preserve the agreements' attractive investment characteristics. As separate purchases and sales, repos would be exempt from the costly and time-consuming securities law registration requirements, yet still would fall within the protective ambit of the securities law antifraud provisions. The antifraud provisions should force repo issuers to disclose the hidden financial risks and legal ramifications of repo investing to prospective repo purchasers. When a repo issuer files for bankruptcy, a separate purchase and sale characterization also should result in favorable, although somewhat confusing, treatment of repo holders under the Bankruptcy Code. Congressional passage of proposed amendments to the Bankruptcy Code that concern repos, however, would clarify and improve future bankruptcy law treatment of repo investors. Thus, courts, by adopting a separate purchase and sale characterization of repos, and Congress, by passing the proposed amendments to the Bankruptcy Code that concern repos, would help lift the cloud of uncertainty currently overhanging the repo market.

William F. Hagerty, IV