UNITED STATES OF AMERICA
FILE NO. 3-6370

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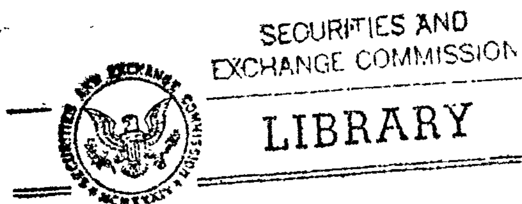
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

RFG OPTIONS COMPANY (8-24148)
EUGENE V. RINTELS
ANDOR A. FLEISCHMAN
DENNIS G. GUY

SUPPLEMENTAL INITIAL DECISION



Washington, D.C.
March 25, 1986

Ralph Hunter Tracy
Administrative Law Judge

ADMINISTRATIVE PROCEEDING
FILE NO. 3-6370

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APPEARANCES: Joan M. Fleming and Thomas D. Rafter for the Division of Enforcement.

Michael B. Roche, L. Andrew Brehm, David J. Shukovsky for the respondents.

BEFORE: Ralph Hunter Tracy, Administrative Law Judge

On December 11, 1985, the Commission ordered that these proceedings be remanded to this administrative law judge for the purpose of taking additional testimony from expert witnesses. At the original hearing only one expert witness, Steven Givot, was allowed to testify; offers of proof were taken, also concerning two others, Burton Malkiel and Robert Gordon, on behalf of respondents. The Division's attempt to offer rebuttal testimony was rejected.

Following review of the record, the Commission directed that Malkiel and Gordon be permitted to testify; also that four other witnesses whom respondents sought to call be permitted to make offers of proof and allowed to testify if they were qualified as experts and if their proposed testimony were relevant and not unduly repetitious. The Division was also to be permitted to adduce the testimony of the witnesses it sought to call in an effort to rebut respondents' evidence, if such witnesses qualified as experts.

The reopened hearing was held in Washington, D.C. on February 13 and 14, 1986, and all respondents were represented by counsel. Proposed findings of fact, conclusions of law, and supporting briefs were filed by all parties.

The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.

At the outset of the hearing it was stipulated between Division counsel and respondents' counsel that the offers of proof concerning the testimony of Robert C. Merton, J.C. Penney Professor of Management at Massachusetts Institute of Technology, and Daniel L. Schneid, an Associate Professor of Finance at Central Michigan University, would be accepted as their testimony for respondents, without cross-examination. Accordingly, these offers of proof were received as respondents' exhibits. The offer of proof for George M. Constantinides, Professor of Finance, Graduate School of Business, the University of Chicago, was accepted as his direct testimony, and he appeared at the proceeding to be cross-examined.

MALKIEL

The first witness called by respondents, Burton G. Malkiel, 53 years of age, is currently Dean of the Yale School of Organization and Management, a position he has occupied for five years. He has an AB and MBA degrees from Harvard, and a PhD from Princeton. The PhD degree was in economics specializing in corporate finance, financial markets, and money and banking. He was a member of President Ford's Council of Economic Advisors from mid-1975 through January 20, 1977. He is the author of several books dealing with financial subjects including A Random Walk Down Wall Street, first published in 1973, and The Inflation Beater's Investment Guide, first published in 1980.

Dean Malkiel was qualified as an expert witness, without objection, and testified at some length concerning the concept of arbitrage and its current history and practice. He covered the period from the 17th century to the 1930s to illustrate the development of monetary and financial economics. He then described dividend reinvestment plans in general with special reference to the particulars of the RFG program. Finally, he concluded that in his opinion the transactions involved in the FRG program were indeed true instances of arbitrage.

GORDON

Robert Neal Gordon is 32 years of age and following one year of college has spent his entire career in the securities industry. He has taken a three-year program in securities given by the Securities Industry Institute and run by the Wharton School of Finance and was awarded a certificate upon completion. He has also passed examinations given by the NASD and is now teaching courses at the Securities Industry Institute, including courses in arbitrage and risk arbitrage. Gordon is presently president and 50 percent owner of Twenty-First Securities a registered broker-dealer.

He previously was a partner in Oppenheimer & Co., a large brokerage firm, where he was in charge of the arbitrage, the risk arbitrage, and the tax departments.

Gordon was qualified as an expert in arbitrage without objection. Gordon testified that on the basis of his review and analysis of the exhibits and other factors present in this proceeding he had formed an opinion that the program operated by RFG constitutes a bona fide arbitrage. He testified that the basis for his opinion was that in a dividend reinvestment transaction there is a simultaneous purchase and sale of the stock being made in two different markets, the new issue, or primary market, and the NYSE or trading, secondary market. Twenty-First Securities has done some dividend reinvesting for its proprietary account but has never borrowed stock for that purpose. He also testified that his firm does not extend credit to customers as it clears through Bear, Stearns who makes the determination as to the applicability of Regulation T to any transactions. In other words, while he must have a working knowledge of margin requirements and Regulation T he does not define or apply it.

CONSTANTINIDES

George M. Costantinides is 39 years old and Professor of Finance at the Graduate School of Business at the University of Chicago. He was awarded the Marvin Bower Fellowship for the period September 1985 to June 1986 and in that capacity is presently conducting research as a visiting professor

at Harvard University. Professor Costantinides' research involves arbitrage concepts. His current research project, which represents a continuation of prior research conducted by him, concerns transactions involving convertible bonds.

Constantinides received a BA in physics from Oxford University, Oxford, England in 1970; a MBA from Indiana University in 1972; a MA from Oxford in 1974, and a DBA from Indiana University that same year.

Constantinides was qualified as an expert for purposes of this proceeding pursuant to stipulation between the Division and the respondents. In his offer of proof, which was received in evidence as his direct testimony, Constantinides described the following examples as meeting his definition of bona fide arbitrage:

(a) The purchase of a convertible bond accompanied by a short sale of the stock at as nearly the same time as is practicable. The transaction would be closed by converting the bond and using the shares so obtained to eliminate the short stock position;

(b) The nearly simultaneous purchase of a call option, the exercise of that option, and a sale of the underlying stock;

(c) The purchase of rights to obtain a stock, coupled with an offsetting sale of the stock;

(d) The sale of a Standard and Poor ("S&P") 500 futures contract accompanied by purchases of the stocks comprising S&P 500 index. The transaction would be closed by delivering the stocks upon expiration of the futures contract.

Constantinides testified on cross-examination that in his opinion all of the above examples come within the arbitrage exemption as contained in Regulations U and T; he is aware that the FRB has issued rulings wherein it did not consider some of the transactions of the type described in paragraph (b) as being arbitrage transactions. Also, the testimony of the FRB expert who testified for the Division, contradicts Constantinides as to paragraph (d) in that the FRB has ruled that this operation utilizing the sale of the Standard and Poor (S&P) 500 futures contracts is not eligible for exempt credit.

Based upon his prior study of the margin rules, Constantinides states that they were designed to avoid activities that were likely to have a destablizing effect on the financial markets and, further, that they were designed to limit the amount of credit devoted to stock market speculation. In Constantinides opinion FRG's program does not involve speculation or the injection of credit into the securities market; therefore, he concludes, RFG's program was not in any way inconsistent with the purposes of the limitations contained in the margin rules.

Finally, it is Constantinides' opinion that RFG's program of dividend reinvesting constitutes a bona fide arbitrage. This opinion applies to both his personal definition of bona fide arbitrage and to the definition contained in Regulation T and U. In addition, it is his opinion that RFG's activities have the beneficial economic impact of promoting capital formation.

MERTON

Robert C. Merton is 42 years of age and is currently the J.C. Penney Professor of Management at Massachusetts Institute of Technology (MIT), a position he has held since 1980. He has been on the MIT faculty since 1970; he was an assistant professor from 1970 to 1973; an associate professor from 1973-1974; and a full professor from 1974-1980. He received his BS in engineering mathematics from Columbia in 1976; a MS is applied mathematics from the California Institute of Technology in 1967; and a PhD in economics from MIT in 1970.

Merton's offer of proof was accepted as his direct testimony, cross-examination was waived by the Division, and he was accepted as an expert witness without objection. According to his offer of proof Merton, in his analysis of particular transactions, employs a personal definition of arbitrage that is unique and distinct from the definition utilized by respondents' other experts. In its most theoretical sense, Merton defines an "arbitrage transaction" as any collection of positions in securities, commodities, financial assets, or real assets which require zero net investments and which yield a sure cash profit where this profit will be earned within a time period of definite duration.

Merton explained that he understands the definition of "*bona fide* arbitrage" in Regulations T and U to include: (1) an offsetting purchase and sale; (2) of the same security; (3) in different markets; (4) at as nearly the same time as is practicable; (5) for the purpose of taking advantage of a difference in price in the two markets.

Merton is familiar with dividend reinvestment plans offered by various issuers. This familiarity is based upon his knowledge of the various ways in which issuers raise equity capital and his review of various issuers' dividend reinvestment plan prospectuses. Merton testified that in his opinion RFG's dividend reinvestment arbitrage program constitutes a *bona fide* arbitrage transaction within the meaning of his personal definition of arbitrage and the definition of "*bona fide* arbitrage" contained in Regulations T and U.

SCHNEID

Daniel L. Schneid is 50 years old and presently an Associate Professor of Finance at Central Michigan University, Mt. Pleasant, Michigan. His offer of proof was accepted by stipulation to be his direct testimony and the Division waived cross-examination. He was accepted as an expert witness without objection.

Schneid received a BS in electrical engineering from West Virginia Institute of Technology in 1959; a MS in management from Florida State University in 1967; and a PhD in finance from Ohio State University in 1974. From 1959 to July 1972, Schneid pursued an engineering career. In 1968 he began teaching part-time graduate courses for Central Michigan in its off-campus programs in Detroit, Michigan, Dayton, Ohio, and Columbus, Ohio. From 1978 to the present he has been an Associate Professor of Finance at Central Michigan.

Schneid's testimony is limited to the benefits and economic effect of dividend reinvestment plans, and the effect of RFG participation. Schneid is the author of an article entitled "Packaging The Dividend Reinvestment Plan" which appeared in _Financial Executive_, Vol. XLIX, No. 6 (June 1981) p. 19. This article considers the advantages of dividend reinvestment plans and the costs associated with instituting such plans.

Schneid testified that dividend reinvestment plans are designed to provide the issuer with new equity capital; that he understands that RFG can only borrow shares of stock if the beneficial owner of those shares has not elected to reinvest the dividends. Accordingly, RFG's program increases the aggregate amount of participation in the issuer's dividend reinvestment program, and promotes

capital formation. Thus, he concludes, it serves a beneficial economic function in that it provides capital savings for those issuers in whose dividend reinvestment plans RFG participates.

Schneid did not testify concerning arbitrage or Regulations T and U, which are the subject of this proceeding.

<u>HOMER</u>

Laura McHale Homer was called as the Division's expert rebuttal witness. Ms. Homer received a BA from the University of Connecticut in 1948 and a JD from the University of Miami in 1968. She also obtained a graduate degree in banking from Stonier Graduate School of Banking, Rutgers University in 1976. She was qualified as an expert for purposes of this proceeding without objection.

Ms. Homer has been employed by the FRB since 1971 and is presently a member of the official staff with the title of "securities credit officer." She is responsible for administering the Board's responsibilities in the area of securities regulation. Her office responds to inquiries in this area from the stock exchanges, options exchanges, the NASD, and anyone with questions concerning securities regulations.

Ms. Homer appeared at the proceeding as a designated spokesperson for the FRB and not just to give a staff opinion. She testified that Regulations T and U were last amended by the Board in 1983, with amended Regulation T becoming effective on November 21, 1983, and amended Regulation U becoming effective on August 31, 1983. The proposals to amend the Regulations were sent out to the securities and financial community for comments before being adopted by the FRB. No coments were received concerning dividend reinvestment plans.

Ms. Homer testified that she was familiar with the charges against RFG that the respondents violated or aided and abetted violations of Regulation U by causing a bank to lend them more money than it should have lent for securities, and violating Regulation T by borrowing stock for purposes not permitted under the regulation.

Ms. Homer stated that an issuer selling directly to its shareholders is not a market as contemplated by Regulation T; that the FRB concept of a market is one in which you buy and sell, e.g. issuers giving stock under Regulation G where there are employees stock option plans are not considered markets.

In response to the respondents' argument that it is not necessary that there be a reduction in the disparity of

prices between markets as a result of bona fide arbitrage Ms. Homer pointed out that it is necessary in order to come within the special credit rules. She said, "that is the only reason that the Board allows this special credit because they feel, and they have said this repeatedly, that these things perform a market function by tending to equalize prices between markets or to equalize prices between related securities."

> Q. In your opinion did RFG's activities contribute to a reduction in the disparity of prices?
>
> A. Where you get a security at a five percent off from whatever price it is, it appears to me you are not going to reduce the disparity.

Ms. Homer was not in agreement with respondents' argument that RFG's dividend reinvestment activities were not the type the margin rules were designed to prohibit in that they did not infuse excessive credit into the market. She testified that her review of the Sperry Co. transaction [1/] shows a record date of April 10, 1984 and a payable date of May 15, 1984, so that the money used to collateralize the stock borrowing was borrowed a month before the alleged arbitrage. It was well in excess of

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1/ Resp. Ex. Y. involving the purchase of Sperry Co., stock pursuant to a reinstatement dividend offer by that company.

the amount needed to purchase the stock and then sell it. RFG borrowed $7,612,800.00 and used it to invest $93,696.00. Accordingly, RFG had a bank borrowing many times greater than needed to finance an arbitrage. She testified:

> Regulation T does not permit the borrowing of stock for arbitrage. If it is incidental to a transaction because it is either a short sale or a delayed delivery in a bona fide arbitrage, it obviously would be, but in this instance they borrowed the stock so that they could put it up as collateral against the borrowed money. That was for a purpose of their own, not to do the arbitrage.

In connection with the Sperry transaction it should be noted that Merton used the same transaction to show that RFG's "investment" (i.e., carrying costs associated with its stock borrowings and transaction costs associated with the stock sales made as part of the program) were $1,072.93. More-ever, the example reveals that RFG earned a net profit of $3,041.07. Thus, RFG received an approximate 280 percent return on its investment, over a period of one month. Therefore, Merton concluded, the 3 or 5 percent discount offered by the issuers in whose dividend reinvestment plans RFG's participated made it virtually certain that RFG's program would generate a rate of return far in excess of the returns available in riskless securities during the relevant period.

Homer testified that the first time that the possible application of the _bona fide_ arbitrage exemption to dividend reinvestment plans came to her attention was in this proceeding

involving RFG. She stated that there had been two inquiries in 1980 or 1981 by telephone, one from Merrill Lynch and one from a Texas brokerage firm as to whether it was permitted to borrow stock for the purpose of using it for a dividend reinvestment plan. There was no mention of arbitrage in either case. The callers were told that it was not permitted and the FRB heard nothing further.

Homer testified that late in 1983 or early 1984 she had received a request from the Commission's Chicago Regional Office for a ruling concerning the use of borrowed stock in connection with a dividend reinvestment plan. Homer replied by letter of March 2, 1984, stating that the procedures outlined in the request violated section 220.16 of Regulation T, because the stock was not borrowed for a permitted purpose. Also, the transaction did not qualify as a _bona fide_ arbitrage and was therefore not permitted under Section 220.7. [2/] Ms. Homer testified that the ruling in her letter of March 2, 1984, was not formally adopted by the FRB but will be today if that is her position today.

Homer testified that even if RFG's dividend reinvestment program was qualified as a _bona fide_ arbitrage nonetheless it still violated Regulation T because the stock borrowing was

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2/ The ruling in this letter is reproduced in full in the Initial Decision, page 22. Homer testified that she only learned that the facts applied to RFG when she was called to testify in this supplemental hearing.

not for a permitted purpose:

> All right, Regulation T spells out the specific conditions under which you can borrow stock. Those conditions are for short sales, delayed deliveries and like situations. The borrowing of stock for a bona fide arbitrage as RFG did was not within those permitted positions. It was not a like situation. The like situations would have to be delivery of stock, the use of the stock by a person who has bought stocks as in a short sale and does not even know it is in a short sale and is entitled to own it, or delayed delivery, you have bought the stock and for some reason it did not come in. Those are like situations.
>
> Borrowing it for this kind of a situation is entirely different.

In concluding Ms. Homer testified that the revision of Regulation T that became effective as of November 21, 1983, did not change its meaning.

CONCLUSION

In their brief respondents argue that all six of the experts called supported their position and therefore, their testimony should be determinative of this proceeding. In contrast to their impressive array of highly qualified experts they denigrate the Commission's one expert and state that she offered only unsupported pontifications. Respondents maintain that the substantial disparity between the expertise of respondents' witnesses and Ms. Homer compels a decision in their favor.

The testimony of respondents' experts was concerned

primarily with the definition of "arbitrage" as it appears in Regulation T. The fact that six experts appeared on behalf of respondents as opposed to one for the Division is not persuasive. In United States v. Simons,[3/] the defendants called eight experts as against two for the government, one of whom was the Chief Accountant of the Commission. The Court said:

> The defendants called eight expert independent accountants, an impressive array of leaders of the profession.
>
> * * * *
>
> With due respect to the Government's accounting witnesses, an SEC staff accountant, and, in rebuttal its chief accountant, who took a contrary view, we are bound to say that they hardly compared with defendants' witnesses in aggregate auditing experience or professional eminence.

In rejecting defendants' contention that instruction should have been given which would have made their expert accountants testimony decisive in favor of the defendants' position, the Court observed at 806:

> We think the judge was right in refusing to make the accountants' testimony so nearly a complete defense.

Of the respondents' six witnesses Schneid did not discuss arbitrage. One other, Merton, used a misleading example to illustrate the profitability of RFG's program. (supra, p. 13). Actually, there was no 280 percent profit, there was a profit of $3,041.07 on a borrowing of $7,612,800.00 and investment of $93,696.00

3/ 425 F.2d 796, 805 (2d Cir. 1969); cert. denied 90 S.Ct 1235 (1970).

In discussing as to whether or not there were two markets as defined by the FRB, Malkiel testified, as follows:

> Q. And you testified at some length concerning the issuer market. Isn't the issuer market a limited market that only owners of the stock can participate in the particular market?
>
> A. That is correct.
>
> Q. Would that make any difference in the overall definition of a market?
>
> A. In my judgment it does not. In my judgment the definition of a market is a place where a well defined commodity is exchanged at some price. And a well defined commodity, namely the stock and newly issued stock of the company in question, is exchanged between the company and its shareholders at a well defined price. So that is a limited market. To be sure, it is not the same as the New York Stock Exchange where you have many different buyers and many different sellers. It is a different market, but it meets my definition and my understanding as an economist of what a market is.

If, for the sake of argument, it is assumed that there are two markets it is evident that the issuer market is a limited one and an investor cannot participate in it unless he is qualified by being a shareholder of the particular issuer that is offering the shares at discount. Therefore, it is not the same as a public offering market where anyone can participate. Under FRB regulations arbitrage contributes to the efficiency of the market by helping to decrease the disparity of prices. Here, RFG is profiting

by reason of a disparity which its actions will not reduce, and hence, it is not a true arbitrage.

If RFG went out to buy stock in order to become eligible for a dividend reinvestment plan it would have to abide by the FRB's margin requirements. It is not persuasive that they should be able to evade these requirements by simply borrowing the same stock. Respondents define "arbitrage" and "market" in their own terms [4/] and then say, ipso facto, the exemption applies. They do not confront the specifications that have to be met, which are in Ms. Homer's testimony, supra, p. 15, and on pages 21-24 of the Initial Decision.

As stated in the Initial Decision at page 21, FRB is the agency specifically designated by Congress to promulgate the rules controlling the use of credit through margin requirements. Therefore, its interpretations concerning the application of its own rules warrant serious consideration. In this connection the Supreme Court has often repeated the general proposition that considerable respect is "due the interpretation given (a) statute by the officers or agency charged with its administration. [5/] An agency's construction of its own

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4/ "When I use a word it means just what I choose it to mean -- neither more nor less." Humpty Dumpty in Alice in Wonderland, Chapt. 6.

5/ Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 566 (1980), citing Zenith Radio Corp. v. United States, 437 U.S. 443, 450 (1978), quoting Udall v. Tallman, 380 U.S. 1, 16 (1965); see e.g. Power Reaction Co. v. Electricians 367 U.S. 396, 408 (1961).

regulations has been regarded as especially due that respect." [6/]

What respondends are claiming is an exemption from the margin rules or requirements promulgated by the FRB pursuant to the Congressional directions contained in Section 7 of the Securities Exchange Act of 1934. In order to claim such exemptive privilege they first used "specialist" on their purpose forms and then when that usuage appeared to be no longer applicable they resorted to using "arbitrage." Their emphasis on the words "specialist" and "arbitrage" and their attempt to define arbitrage so as to fit the FRB exemption ignores the specific provisions spelled out by the language of the exemptive section.

The Division submits that the evidence received at the supplemental hearing constitutes additional proof of the alleged violations and requests that the sanctions previously imposed be reaffirmed. Respondents request that the Initial Decision be vacated or, in the alternative, if a violation is found, that no sanctions be imposed.

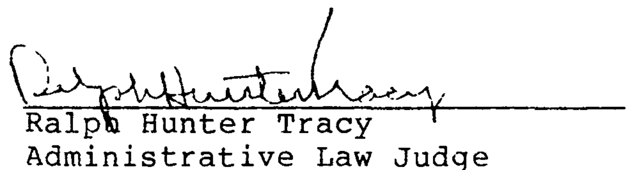
A careful review of the record in this supplemental proceeding compels the determination that the findings and conclusions reached in the Initial Decision be affirmed.

6/ Bowles v. Seminole Rock Co., 325 U.S. 410, 413-414 (1945).

Accordingly, IT IS ORDERED that the findings and conclusions reached and the sanctions imposed in the Initial Decision are affirmed.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice. 7/

Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.



Ralph Hunter Tracy
Administrative Law Judge

March 25, 1986
Washington, D.C.

7/ All proposed findings, conclusions, and contentions have been considered. They are accepted to the extent they are consistent with this decision.