

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 78-63

May 19, 1978

PROPOSED AMENDMENT TO REGULATION T--
CREDIT BY BROKERS AND DEALERS

Credit by Brokers and Dealers on Nonconvertible
Corporate Debt Securities Not Listed on a National
Securities Exchange; Uniform Loan Value For All Eligible
Nonconvertible Corporate Debt Securities

TO ALL BANKS, BROKERS/DEALERS,
REGULATION C REGISTRANTS, AND
OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

Following is the text of a statement issued by the Board of Governors of
the Federal Reserve System:

The Board of Governors of the Federal Reserve System today
(May 4) proposed to amend its Regulation T (Credit by Brokers and
Dealers) to permit a broker or dealer to extend and maintain credit on
certain nonconvertible corporate bonds, with a 30 percent margin
requirement.

The Board asked for comment by June 15, 1978.

The proposal would affect certain corporate bonds sold on the Over-
the-Counter (OTC) market, rather than on a national securities exchange.
The existing Regulation T allows credit to be extended and maintained on
only those bonds which are listed on national securities exchanges.

The Board maintains a list of some 1,100 stocks sold over-the-
counter on which brokers and dealers may extend credit up to a limit,
currently 50 percent, established by the Board. The existing OTC
Margin List includes five convertible corporate bonds (debt issues
that may be converted to equity issues) on which margin credit may
be given.

The Board proposed that margin credit be extended and maintained
by brokers and dealers on nonconvertible corporate debt issues sold on
the OTC market which have the following characteristics:

- At the time credit is extended, the outstanding principal amount of the issue is not less than \$25 million.
- All payments of principal and interest on the issues are current at the time credit is extended.
- The issue was registered with the Securities and Exchange Commission and the issuer is providing current reports under SEC regulations.

The Board proposed that the margin (down payment) required for nonconvertible corporate bonds, sold either on the OTC market or on national exchanges, should be 30 percent. The margin requirement for convertible corporate bonds on the Board's OTC list, or registered on a national exchange, remains 50 percent.

Printed on the following pages is a copy of the Board's order as submitted for publication in the FEDERAL REGISTER. Comments on the proposed amendment should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All comments must be received by June 15, 1978, and should refer to Docket No. R-0080.

Sincerely yours,

Robert H. Boykin

First Vice President

Proposed Rulemaking

FEDERAL RESERVE SYSTEM

[12 CFR 220]

[Reg. T; Docket No. R-0080]

Credit by brokers and dealers on nonconvertible corporate debt securities not listed on a national securities exchange; uniform loan value for all eligible nonconvertible corporate debt securities.

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board proposes to amend Regulation T to permit a broker or dealer to extend and maintain credit on nonconvertible corporate debt securities not listed on a national securities exchange which satisfy certain criteria as to size of issue, availability of information and current payments of principal and interest. In addition, the proposal provides a uniform loan value for all nonconvertible corporate debt securities, whether listed or unlisted, that are eligible for loan value.

DATE: Comments must be received on or before June 15, 1978.

ADDRESS: Secretary, Board of Governors of the Federal Reserve System, Washington, D. C. 20551. All materials submitted shall be in writing and should include the docket number R-0080.

FOR FURTHER INFORMATION CONTACT: Robert S. Plotkin, Assistant Director, or Laura M. Homer, Chief Attorney, Securities Regulation, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D. C. 20551, (202) 452-2782.

SUPPLEMENTARY INFORMATION: In July 1968, Congress amended Section 7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g) ("the Act") to authorize the Board to control credit extended or maintained by banks, brokers, dealers and others with respect to securities that are not listed on a national securities exchange but rather are traded in the "over-the-counter" ("OTC") market. Prior to this amendment, the Board's authority was limited, with respect to brokers and dealers, to credit extended for the purpose of purchasing or carrying securities listed on a national securities exchange, and the Act contained an absolute prohibition against the extension of credit by a broker or dealer on all other securities. "Exempt securities" (generally Federal and municipal obligations) have always been excluded from the Board's authority to set margin requirements. Since 1968, the Board has exercised its new authority by adopting criteria and selecting those equity securities traded in the OTC market that are eligible for margin credit. The Board publishes a List of OTC Margin Stocks, which is revised periodically; some 1,100 issues are presently on the List. For purposes of Regulation T, a debt security convertible into an equity security is considered to be an equity security and there are presently five convertible debt securities on the Board's List of OTC Margin Stocks.

The National Association of Securities Dealers, Inc. ("NASD") has requested the Board to amend Regulation T to permit brokers and dealers to extend and maintain credit on any unlisted nonconvertible

corporate debt securities which meet certain minimum standards with respect to size of issue and rating by at least one nationally recognized statistical rating service.

The Board believes that the NASD's request has considerable merit. Extending marginability to unlisted corporate bonds would promote competitive equality and improve the efficiency of capital markets. Such action may, moreover, aid companies in marketing new issues of debt securities and facilitate the trading of debt securities more easily in the national market system contemplated by the Securities Act Amendments of 1975. On the other hand, the Board has responsibility to prevent destabilizing credit from being extended, and it is generally agreed that certain criteria should be established, so that there is a reasonable likelihood that debt collateral can be liquidated in an orderly manner. To this end, the Board is seeking to adopt a self-executing rule with criteria readily ascertainable by the securities industry and the investing public - thereby eliminating the need for a published List. The Board proposes therefore that unlisted nonconvertible corporate debt securities be eligible for margin credit by brokers and dealers if:

- (1) A principal amount of not less than \$25 million of the issue is outstanding at the time of the extension of credit;
- (2) All payments of principal or interest are current and not in default at the time of the extension of credit; and,
- (3) The issue is registered under the Securities Act of 1933 and current reports are provided by the issuer in accordance with the Securities Exchange Act of 1934.

Comments are requested on the advisability of using this criteria, particularly the requirement of a principal amount of bonds outstanding of not less than \$25,000,000.

The Board further considered the level of margin to be required, should the proposed regulation be adopted. It noted that whereas present Regulation T requirements could conceivably permit 100% loan value to be extended on listed corporate bonds, the major securities exchanges impose a 25% maintenance requirement and many brokerage houses require a somewhat higher margin (generally 30%). Although price and volume information is generally available for exchange-traded bonds, the Board noted that such information for corporate OTC bonds is minimal, and markets for some issues may, at times, be "thin". Accordingly, the Board believes that it is necessary to set a specific level of margin with respect to credit that will be extended on unlisted corporate bonds in order to prevent speculative excesses and possible erosion of equity cushions in margin accounts. In view of the economic similarity of both the listed and unlisted markets for bonds and in order to promote regulatory equality, the Board is of the opinion that the same level of margin that may be required for unlisted corporate bonds should also be required for listed corporate bonds. At the present time, the Board is considering setting the level of margin required for both listed and unlisted corporate bonds at 30%, and the public is invited to submit comments on the appropriateness of that amount.

The proposed requirements will affect only extensions of credit by brokers and dealers subject to Regulation T and will not affect banks subject to Regulation U since the Act specifically prohibits the Board from applying margin requirements to credit extended by banks on non-equity securities.

Pursuant to Sections 7 and 23 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78g and w), the Board proposes to amend Regulation T (12 CFR 220) as set forth below:

§ 220.4 -- SPECIAL ACCOUNTS

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(i) Special bond account.

In a special bond account a creditor may extend and maintain credit on exempted securities and margin non-equity securities. The maximum loan value of an exempted security shall be determined by the creditor in good faith. The maximum loan value of a margin non-equity security shall be as prescribed from time to time in § 220.8 (the Supplement to Regulation T). Call options may be issued, endorsed or guaranteed in this account on any underlying equity security which is held in this account because it is an exempted security. For the purpose of this paragraph, the term "margin non-equity security" means a debt security which is listed on a national securities exchange or a debt security which meets all of the following requirements:

- (1) At the time of the extension of credit, a principal amount of not less than \$25,000,000 of the issue is outstanding.

(2) The issue was registered under section 5 of the Securities Act of 1933 and the issuer either files periodic reports pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 or is an insurance company which meets all of the conditions specified in section 12(g)(2)(G) of the Act.

(3) At the time of the extension of credit, the creditor has a reasonable basis for believing that the issuer is not in default on interest or principal payments.

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§220.8 -- SUPPLEMENT

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(b) Maximum Loan Value for a Special Bond Account.

The maximum loan value of a margin non-equity security shall be 70 per cent of its current market value as determined by any reasonable method.

To aid in consideration of this matter by the Board, interested persons are invited to submit relevant data, views, comments, or arguments. All material should include the docket number R-0080. Such material will be made available for inspection and copying upon request, except as provided in § 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).

By order of the Board of Governors, May 1, 1978.

(signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]