

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. 4015 ]  
September 9, 1953

**INTERPRETATIONS OF REGULATIONS T AND U**

*To all Banks, Members of National Securities Exchanges, and  
Others Interested, in the Second Federal Reserve District:*

The Board of Governors of the Federal Reserve System has issued two interpretations, one of Regulations T and U and the other of Regulation U. These interpretations are reproduced below. Although the interpretations will be printed in early issues of the *Federal Reserve Bulletin* and the *Federal Register*, they are being sent to you now so that you may have prompt advice of their contents.

Additional copies of this circular will be furnished upon request.

ALLAN SPROUL,  
*President.*

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**INTERPRETATION OF REGULATIONS T AND U**  
**Arranging for Extensions of Credit to be Made by a Bank**

The Board has recently had occasion to express opinions regarding the requirements which apply when a person subject to Regulation T—for convenience, called here simply a broker—arranges for a bank to extend credit.

The matter is treated generally in section 7(a) of Regulation T, and is also subject to the general rule of law that any person who aids or abets a violation of law by another is himself guilty of a violation. It may be stated as a general principle that any person who arranges for credit to be extended by someone else has a responsibility so to conduct his activities as not to be a participant in a violation of Regulation T which applies to brokers, or Regulation U, which applies to banks.

More specifically, in arranging an extension of credit that may be subject to Regulation U, a broker must act in good faith and, therefore, must question the accuracy of any non-purpose statement (i.e., a statement that the loan is not for the purpose of purchasing or carrying registered stocks) given in connection with the loan where the circumstances are such that the broker from any source knows or has reason to know that the statement is incomplete or otherwise inaccurate as to the true purpose of the credit. The requirement of "good faith" is of vital importance. While the application of the requirement will necessarily vary with the facts of the particular case, the broker, like the bank for whom the loan is arranged to be made, must be alert

to the circumstances surrounding the loan. Thus, for example, if a broker or dealer is to deliver registered stocks to secure the loan or is to receive the proceeds of the loan, the broker arranging the loan and the bank making it would be put on notice that the loan would probably be subject to Regulation U. In any such circumstances they could not in good faith accept or rely upon a statement to the contrary without obtaining a reliable and satisfactory explanation of the situation. The foregoing, of course, applies the principles published at page 27 of the 1947 Bulletin (12 CFR, 222.101).

In addition, when a broker is approached by another broker to arrange extensions of credit for customers of the approaching broker, the broker approached has a responsibility not to arrange any extension of credit which the approaching broker could not himself arrange. Accordingly, in such cases the statutes and regulations forbid the approached broker to arrange extensions of credit on unregistered securities for the purpose of purchasing or carrying either registered or unregistered securities. The approaching broker would also be violating the applicable requirements if he initiated or otherwise participated in any such forbidden transactions.

The above expression of views to the effect that certain specific transactions are forbidden, of course, should not in any way be understood to indicate approval of any other transactions which are not mentioned.

(OVER)

## INTERPRETATION OF REGULATION U

### Reliance in "Good Faith" on Statement of Purpose of Loan

Certain situations have arisen from time to time under Regulation U wherein it appeared doubtful that, in the circumstances, the lending banks may have been entitled to rely upon the statements accepted by them in determining whether the purposes of certain loans were such as to cause the loans to be not subject to the regulation.

The use by a lending bank of a statement in determining the purpose of a particular loan is, of course, provided for by section 3(a) of the regulation. However, under that section a lending bank may "rely" upon any such statement *only if* it is "accepted by the bank in good faith". As the Board stated in the interpretation published in the 1947 Federal Reserve Bulletin, p. 27 and at 12 C.F.R., 221.101, the "requirement of 'good faith' is of vital importance"; and, to fulfill such requirement, "it is clear that the bank must be alert to the circumstances surrounding the loan".

Obviously, such a statement would not be accepted by the bank in "good faith" if at the time the loan was made the bank had knowledge, from any source, of facts or circumstances which were contrary to the natural purport of the statement, or which were sufficient reasonably to put the bank on notice of the questionable reliability or completeness of the statement.

Furthermore, the same requirement of "good faith" is to be applied whether the statement accepted by the bank is signed by the borrower or by an officer of the bank. In either case, "good faith" requires the exercise of special diligence in any instance in which the borrower is not personally known to the bank or to the officer who processes the loan.

The interpretation mentioned above contains an example of the application of the "good faith" test. There it was stated that "if the loan is to be made to a customer who is not a broker or dealer in securities, but such a broker or dealer is to deliver

registered stocks to secure the loan or is to receive the proceeds of the loan, the bank would be put on notice that the loan would probably be subject to the regulation. It could not accept in good faith a statement to the contrary without obtaining a reliable and satisfactory explanation of the situation".

Moreover, and as also stated by the aforementioned interpretation, the "purpose" of a loan, of course, "cannot be altered by some temporary application of the proceeds. For example, if a borrower is to purchase Government securities with the proceeds of a loan, but is soon thereafter to sell such securities and replace them with registered stocks, the loan is clearly for the purpose of purchasing or carrying registered stocks". The purpose of a loan, therefore, should not be determined upon a narrow analysis of the immediate use to which the proceeds of the loan are put. Accordingly, a bank acting in "good faith" should carefully scrutinize cases in which there is any indication that the borrower is concealing the true purpose of the loan, and there would be reason for special vigilance if registered stocks are substituted for bonds or unregistered stocks soon after the loan is made, or on more than one occasion.

Similarly, the fact that a loan made on the borrower's signature only, for example, becomes secured by registered stock shortly after the disbursement of the loan usually would afford reasonable grounds for questioning the bank's apparent reliance upon merely a statement that the purpose of the loan was not to purchase or carry registered stock.

These examples are, of course, by no means exhaustive. They simply illustrate the fundamental fact that no statement accepted by a bank is of any value for the purposes of the regulation unless "accepted by the bank in good faith", and that "good faith" requires, among other things, reasonable diligence to learn the truth.