

FEDERAL RESERVE BANK  
OF NEW YORK

[ Circular No. 5044 ]  
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INTERPRETATION OF REGULATION U

To All Banks in the Second Federal Reserve District:

Printed below is a copy of an interpretation, issued by the Board of Governors of the Federal Reserve System, of the meaning of the phrase "secured . . . indirectly by any stock" in section 221.1 of Regulation U. Although the interpretation will be published in the *Federal Reserve Bulletin*, it is being sent to you now so that you may have prompt advice of its contents.

Additional copies of this circular will be furnished upon request.

ALFRED HAYES,  
*President.*

Loan Which is Secured Indirectly by Stock

A question has been presented to the Board as to whether a loan by a bank to a mutual investment fund is "secured . . . indirectly by any stock" within the meaning of section 221.1 of Regulation U, so that the loan should be treated as subject to the regulation.

Briefly, the facts are as follows. Fund X, an open-end investment company, entered into a loan agreement with Bank Y, which was (and still is) custodian of the securities which comprise the portfolio of Fund X. The agreement includes the following terms, which are material to the question before the Board:

(1) Fund X agrees to have an "asset coverage" (as defined in the agreements) of 400 per cent of all its borrowings, including the proposed borrowing, at the time when it takes down any part of the loan.

(2) Fund X agrees to maintain an "asset coverage" of at least 300 per cent of its borrowings at all times.

(3) Fund X agrees not to amend its custody agreement with Bank Y, or to substitute another custodian without Bank Y's consent.

(4) Fund X agrees not to mortgage, pledge, or otherwise encumber any of its assets elsewhere than with Bank Y.

In 1958 Federal Reserve Bulletin, at page 1279, the Board stated that because of "the general nature and operations of such a company", any "loan by a bank to an open-end investment company that customarily

purchases stocks registered on a national securities exchange . . . should be presumed to be subject to Regulation U as a loan for the purpose of purchasing or carrying registered stocks" ("purpose loan"). The Board's interpretation went on to say that "This would not be altered by the fact that the open-end company had used, or proposed to use, its own funds or proceeds of the loan to redeem some of its own shares. . . ."

Accordingly, the loan by Bank Y to Fund X was and is a "purpose loan". However, a loan by a bank is not subject to Regulation U unless (1) it is a purpose loan and (2) it is "secured directly or indirectly by any stock". In the present case, the loan is not "secured directly" by stock in the ordinary sense, since the portfolio of Fund X is not pledged to secure the credit from Bank Y. But the word "indirectly" must signify some form of security arrangement other than the "direct" security which arises from the ordinary "transaction that gives recourse against a particular chattel or land or against a third party on an obligation" described in the American Law Institute's *Restatement of the Law of Security*, page 1. Otherwise the word "indirectly" would be superfluous, and a regulation, like a statute, must be construed if possible to give meaning to every word.

The Board has indicated its view that any arrange-

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ment under which stock is more readily available as security to the lending bank than to other creditors of the borrower may amount to indirect security within the meaning of Regulation U. In an interpretation published at 1959 Federal Reserve Bulletin 256 it stated

"The Board has long held, in the . . . 'purpose' area, that the original purpose of a loan should not be determined upon a narrow analysis of the technical circumstances under which a loan is made. . . .

"Where security is involved, standards of interpretation should be equally searching."

In its pamphlet issued for the benefit and guidance of banks and bank examiners, entitled "Questions and Answers Illustrating Application of Regulation U", the Board said

"In determining whether a loan is 'indirectly' secured, it should be borne in mind that the reason the Board has thus far refrained . . . from regulating loans not secured by stock has been to simplify operations under the regulation. This objective of simplifying operations does not apply to loans in which arrangements are made to retain the substance of stock collateral while sacrificing only the form."

A wide variety of arrangements as to collateral can be made between bank and borrower which will serve, to some extent, to protect the interest of the bank in seeing that the loan is repaid, without giving the bank a conventional direct "security" interest in the collateral. Among such arrangements which have come to the Board's attention are the following:

(1) The borrower may deposit stock in the custody of the bank.

An arrangement of this kind may not, it is true, place the bank in the position of a secured creditor in case of bankruptcy, or even of conflicting claims, but it is likely effectively to strengthen the bank's position. Section 221.3(f) of Regulation U, which provides that

"A loan need not be treated as collateralized by securities which are held by the bank only in the capacity of custodian, depository or trustee, or under similar circumstances, if the bank in good faith has not relied upon

such securities as collateral in the making or maintenance of the particular loan."

does not exempt a deposit of this kind from the impact of the regulation unless it is clear that the bank "has not relied" upon the securities deposited with it.

(2) A borrower may not deposit his stock with the bank, but agree not to pledge or encumber his assets elsewhere while the loan is outstanding.

Such an agreement may be difficult to police, yet it serves to some extent to protect the interest of the bank if only because the future credit standing and business reputation of the borrower will depend upon his keeping his word. If the assets covered by such an agreement include stock, then, as under (1) and (3), the stock is "indirect security" for the loan within the meaning of Regulation U.

(3) The borrower may deposit stock with a third party who agrees to hold the stock until the loan has been paid off.

Here, even though the parties may purport to provide that the stock is not "security" for the loan (for example, by agreeing that the stock may not be sold and the proceeds applied to the debt if the borrower fails to pay), the mere fact that the stock is out of the borrower's control for the duration of the loan serves to some extent to protect the bank.

The three instances described above are merely illustrative. Other methods, or combinations of methods, may serve a similar purpose. The conclusion that any given arrangement constitutes "indirect security" may, but need not, be reinforced by facts such as that the stock in question was purchased with proceeds of the loan, that the lending bank suggests or insists upon the arrangement, or that the loan would probably be subject to criticism by supervisory authorities were it not for the protective arrangement.

Accordingly, the Board concludes that the loan by Bank Y to Fund X is indirectly secured by the portfolio of the fund and must be treated by the bank as a regulated loan.