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QUESTIONS AND ANSWERS ON REGULATION U

To All Banks and Trust Companies
in the Second Federal Reserve District:

Enclosed is a copy of a pamphlet, entitled "Questions and Answers Illustrating Application of Regulation U," issued by the Board of Governors of the Federal Reserve System. It is a revision of a similar pamphlet, issued June 15, 1959, and relates to the regulation as currently in effect.

Additional copies of the pamphlet will be furnished upon request.

ALFRED HAYES
President

Enclosure

QUESTIONS AND ANSWERS ILLUSTRATING APPLICATION of REGULATION U

LOANS BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED STOCKS

BOARD OF GOVERNORS
of the
FEDERAL RESERVE SYSTEM

May, 1963

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QUESTIONS AND ANSWERS ILLUSTRATING APPLICATION OF REGULATION U

Regulation U, relating to "Loans by Banks for the Purpose of Purchasing or Carrying Registered Stocks," is issued pursuant to section 7 of the Securities Exchange Act of 1934, particularly subsection (d) of the section. It applies to all banks (whether or not members of the Federal Reserve System), except banks which are members of a national securities exchange and therefore subject to Regulation T.

The following Questions and Answers have been prepared for the benefit and guidance of banks subject to the regulation and examiners concerned with determining compliance with the regulation. Of course, the Questions and Answers cannot be expected to cover in detail all aspects of the regulation. Furthermore, in any given case the Answers to particular Questions must necessarily depend on the specific facts and circumstances involved. Therefore, the following Questions and Answers, as indicated above, should be regarded as general aids to a better understanding of the principal features of the regulation, rather than an exhaustive, detailed explanation of the application of its various provisions.

References to sections are to the sections of the regulation as published in the Federal Register, 12 CFR 221, except that "221." is omitted at the beginning of each such reference. Thus, "section 3" refers to "section 221.3" in the Federal Register and the Board's May 1, 1962 reprint of the regulation.

GENERAL COVERAGE OF REGULATION:

(1) **Question.**—What type of loan is subject to the provisions of Regulation U? (Hereafter, such a loan will be referred to as a "regulated loan.")

Answer.—Any loan by a bank (including a loan of funds held by the bank as fiduciary) is subject to the regulation if it falls within at least one of the following four categories:

(a) A loan is subject to the regulation if it meets *both* the following tests:

i. The loan *is* for the purpose of purchasing or carrying stocks registered on a national securities exchange and is *not* excepted by

section 2 of the regulation. (Such a loan is sometimes referred to in these Questions and Answers as a "purpose loan.")

ii. The loan is secured directly or indirectly by *any* stock, whether registered or unregistered. [Sec. 1(a)]

(b) A loan is also subject to the regulation if it is so secured *and* is for the purpose of purchasing or carrying a "redeemable security" issued by an open-end investment company (sometimes known as a "mutual fund") whose assets customarily include registered stocks, whether or not the "redeemable security" itself is registered, since a loan for such purpose shall be deemed to be for the purpose of purchasing or carrying registered stocks. [Sec. 3(b)(2)]

(c) A loan can also be subject to the regulation, *regardless of whether it is secured by any stock,* if it is to a person subject to neither Regulation U nor to Regulation T, who is engaged principally or as an important activity, in the business of making loans for the purpose of purchasing or carrying registered stocks. Loans to such persons, unless unmistakably kept distinct from financing by the borrower of purchasing or carrying of registered stocks, will be deemed to be for such a purpose and therefore subject to section 3(q) of the regulation, which requires that such loans be secured.

(d) A loan made on or after June 15, 1959 for the purchase of a security other than a registered stock (principally convertible bonds) which is convertible into a registered stock becomes subject to the regulation at the time that conversion takes place and the registered stock is substituted as collateral for the loan. At this time the loan is not permitted to exceed the then maximum loan value of the collateral, except that any reduction of the loan or deposit of collateral to meet this requirement may be brought about within 30 days from such date. [Sec. 3(r)]

REGULATED LOAN:

(2) **Question.**—In general, when is a loan secured by stock?

Answer.—A loan is secured by stock when it is secured, directly or indirectly, by some stock, whether registered or unregistered, even though such stock be only a small portion of the total collateral. It is not possible for the same borrower to have at the bank both "unsecured" and secured *purpose* loans; all such indebtedness is considered as a unit, together with related collateral. This is because

section 1(b) of Regulation U states that the "entire indebtedness of any borrower to any bank incurred at any time for the purpose of purchasing or carrying stocks registered on a national securities exchange shall be considered a single loan, and all the collateral securing such indebtedness shall be considered in determining whether or not the loan complies. . . ."

(3) **Question.**—Is there any kind of loan, not secured by any stock, which can be subject to the regulation by reason of the nature of the borrower?

Answer.—Yes. Such a loan is one to a person not subject to either Regulation T or Regulation U, who is engaged principally, or as one of the person's important activities, in the business of making loans for the purpose of purchasing or carrying stocks registered on a national securities exchange. Such loans are deemed to be for the purpose of purchasing or carrying registered stocks unless the loan and its purposes are unmistakably separated and disassociated from any financing or refinancing for any such purpose. Unless such a loan is so "separated and disassociated" or is excepted by section 2 of the regulation, it is subject to the regulation, regardless of whether or not it is secured by any stock. No such loan may be made after June 15, 1959 without collateral; and it must be secured to the same extent as would be required if it were secured by stock. Such a loan, whether made before or after June 15, 1959 is subject to all of the other provisions of the regulation including provisions relating to withdrawal and substitution of collateral. [Sec. 3(q)]

(4) **Question.**—In general what determines whether a loan is for the purpose of purchasing or carrying stock registered on a national securities exchange?

Answer.—It is *substance,* rather than form, which determines whether a loan is for the purpose of purchasing or carrying registered stocks. A loan is not for "carrying" (as distinguished from "purchasing") under section 3(b)(1), unless the ultimate purpose of the loan is to enable the borrower to reduce or retire indebtedness incurred to purchase or carry registered stocks. But whether the loan is for "purchasing" or for "carrying," it should be remembered that the ultimate-purpose test cannot be defeated by any temporary application of the funds.

As noted in the Answer to Question 1, a loan for the purpose of

purchasing or carrying *a "redeemable security" of an open-end investment company* whose assets customarily include registered stocks is considered to be for the purpose of purchasing or carrying a registered stock. [Sec. 1(a); sec. 3(b)(2)]

(5) **Question.**—When would a loan be secured "indirectly" by any stock?

Answer.—An answer necessarily must depend upon the facts and circumstances of each case that arises. For example, it has been held that a purpose loan is subject to the regulation as one secured by stock where, although the pledge of the stock was delayed, both the bank and the borrower contemplated that the loan would be so secured.

In determining whether a loan is "indirectly" secured, it should be borne in mind that the reason the Board has thus far refrained (except to the limited extent covered in section 3(q)) 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.

As a related point it may be noted, as shown in the Answer to Question (2), that any collateral securing any portion of a borrower's purpose loan at a bank automatically secures all such indebtedness of the borrower at the bank. Hence, it is not possible for a borrower to have both "unsecured" and secured purpose loans at the bank.

(6) **Question.**—What is included within the term "stock" as used in the regulation?

Answer.—The term "stock" includes any security commonly known as a stock, including preferred stock, any voting trust certificate or other instrument representing such a security, and any warrant or right to subscribe to or purchase such a security. [Sec. 3(1)] It does not, under the present regulation, include any bond, including a bond convertible into stock, or a bond carrying stock purchase warrants. But, where the immediate purpose is to obtain the stock, a loan to purchase a bond convertible into, or carrying warrants to acquire the stock, should be considered a loan to purchase the stock. See also section 3(r) regarding loans for the purchase of convertible securities.

(7) **Question.**—How may one determine whether a particular

stock is registered on a national securities exchange or whether a security is a "redeemable security" of an open-end investment company?

Answer.—The bank may rely upon any reasonably current record of such stocks and securities published or specified in a publication of the Board of Governors. [Sec. 3(c)] Such a record is published by the Board from time to time in the form of a "List of Stocks Registered on National Securities Exchanges and of Redeemable Securities of Certain Investment Companies." Copies of the current list or Supplements thereto may be obtained from the Federal Reserve Bank of the District. Frequently, it is not possible to keep this list completely current on newly organized mutual funds or new listings on exchanges. Sound practice would require that a bank take account of any such late developments known to it, and that it keep itself informed, so far as is practical, of such developments.

(8) **Question.**—In determining whether a loan for the purpose of purchasing or carrying a particular stock is currently a purpose loan, is the status of registration of the stock at the present time or at the time of making the loan the determining factor?

Answer.—Whether a loan is a purpose loan at a particular time depends on the status of the stock at that time.

A loan initially made for the purpose of purchasing or carrying a particular stock is a purpose loan if that particular stock is now registered, and this would be true even if the stock were not registered at the time the loan was originally made. A bank ordinarily is not required to reduce an outstanding secured loan or obtain additional collateral when the stock becomes registered, but the indebtedness must thereafter be treated as a regulated loan. An exception to this concerns the purchase of a convertible security which is not a registered stock. In this case, the loan becomes regulated at the time any registered stock obtained through conversion of the securities originally purchased, is substituted as collateral for the loan. If the loan would be undermargined at this time, the borrower has 30 days within which either to reduce the loan or to deposit additional collateral in order to bring the loan up to margin.

Conversely, if stock becomes unregistered, a loan which had

been made for the purpose of purchasing or carrying that stock ceases to be a purpose loan.

MAXIMUM LOAN VALUE:

(9) **Question.**—What limit is placed on the amount of a regulated loan?

Answer.—The *maximum loan value* of a stock is a percentage of its market value, specified in the current Supplement to the regulation, but varying from time to time as the Supplement is amended. The amount of the loan must not exceed the *maximum loan value* of the collateral *at the time the loan is made.* [Sec. 1(a)] The single exception to this occurs in the case of convertible securities, in which case the maximum loan value of the collateral is determined *at the time Regulation U becomes applicable,* that is, at the time of the conversion and the substitution as collateral of the registered stocks obtained upon conversion. [Sec. 3(r)]

(10) **Question.**—What is the present maximum loan value of collateral securing a regulated loan?

Answer.—(a) Except as noted in paragraph (b) of this Answer, the maximum loan value of *any stock,* whether registered or unregistered, *at this time* is 50 per cent of its current market value as determined by any reasonable method. [Supplement to regulation, effective July 10, 1962] In the case of mixed collateral (e.g., stocks and bonds), stocks have the present maximum loan value just indicated, i.e., 50 per cent, and bonds or other nonstock collateral have loan value as determined by the bank in good faith. [Sec. 1(a)]

(b) However, if the loan is to enable the borrower to exercise a stock subscription right which is evidenced by a *warrant or certificate issued to stockholders and expiring within 90 days of issuance,* a maximum loan value of 75 per cent of the current market value of the stock so acquired as determined by any reasonable method is permissible, provided the transaction is treated as indicated below in connection with Question (11). In no event could the loan exceed 100 per cent of the subscription price, since a loan in excess of that price would not be for the requisite purpose. [Sec. 3(p)]

(11) **Question.**—Does the regulation provide any special or preferential maximum loan values for stocks in certain circumstances?

Answer.—The only special or preferential maximum loan value for stocks is described under Question (10) above, i.e., the 75 per cent maximum loan value in the case of a loan to enable the borrower to exercise a stock subscription right which is evidenced by a warrant or certificate issued to stockholders and expiring within 90 days of issuance. However, the 75 per cent maximum loan value in such a case is permissible *only if* (1) the transaction is handled by the bank on a segregated basis; (2) the bank prohibits any withdrawal or substitution of the stock used to make the loan until the amount of the loan is reduced to an amount not exceeding the regular maximum loan value specified in the current Supplement to the regulation, at which time the loan need no longer be segregated; and (3) there is no other subscription right loan to the borrower which has been outstanding at the bank more than nine months without being reduced to the amount indicated in clause (2) above. [Sec. 3(p)]

In particular, no preferential maximum loan value is provided for a registered stock acquired under an officers' or employees' stock purchase plan. However, the loan value may be computed against its current market value as indicated on the exchange where it is listed, rather than against the borrower's cost if the latter is lower.

EXCEPTED LOANS:

(12) **Question.**—What loans, even though they have the characteristics of a regulated loan, are excepted from the regulation?

Answer.—(a) Any loan to a bank or to a foreign banking institution. [Sec. 2(a)] The term "bank" does not include a bank which is a member of a national securities exchange and therefore subject to Regulation T. [Sec. 3(k)]

(b) Any loan made prior to July 16, 1945 to any person whose total indebtedness to the bank at the date of and including such loan did not exceed $1,000. [Sec. 2(b)] The term "total indebtedness" means total indebtedness for all purposes and is not restricted to total indebtedness for the purpose of purchasing or carrying registered stocks or "redeemable securities."

(c) Any loan to a dealer, or two or more dealers, to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange. [Sec. 2(c)] In general, this exception covers the underwriting and distributing of

new issues; it should not be regarded as excepting, for example, a loan to finance the ordinary activities of an over-the-counter dealer, nor the disposition through salesmen of securities purchased on an exchange.

(d) Any loan to a broker or dealer that is made in exceptional circumstances in good faith to meet his emergency needs. [Sec. 2(d)] The bank, however, should obtain and preserve adequate evidence of the details in order to support excepting the loan.

(e) Any loan to a broker or dealer secured by any securities which, according to written notice received by the bank from the broker or dealer pursuant to the rules of the Securities and Exchange Commission concerning the hypothecation of customers' securities, are *securities carried for the account of one or more customers,* provided the bank accepts in good faith from the borrower a signed statement that he is subject to Regulation T or that all credit extended or maintained by him for customers complies with Regulation T. [Sec. 2(e)]

(f) Any temporary advance to finance the purchase or sale of securities for prompt delivery which is to be repaid in the ordinary course of business upon completion of the transaction. [Sec. 2(f)] This exception is intended to facilitate the financing of bona fide *cash transactions* such as, for example, (1) the purchase of a security by a bank as agent for the account of a customer who intends to make payment promptly upon receipt of the security, or (2) an advance to a customer who has sold his security pending delivery to and payment by the buyer. The exception *does not* apply to a temporary loan which is to be repaid from the proceeds of a new regulated loan. Nor does this exception, or the exceptions described under (g) or (h), below, apply to a loan to a person described in the Answer to Question (3), above, or to a loan to a borrower to pay for securities purchased in a "special cash account" with a broker or dealer unless the borrower himself is a broker or dealer.

(g) Any loan against securities in transit or surrendered for transfer, which is payable in the ordinary course of business upon completion of the transaction. [Sec. 2 (f)] In general, this exception is designed to cover the cashing of sight drafts with securities attached. However, note the qualification under (f) above.

(h) Any loan which is to be repaid on the calendar day on which

it is made. [Sec. 2(h)] This exception would cover so-called "day" loans but *not* "overnight" loans. Also, note the qualification under (f) above.

(i) A loan made outside the 50 States of the United States and the District of Columbia. [Sec. 2(i)] The exception would apply, for example, to the usual loan by the foreign branch office of an American bank.

(j) Any loan to a member of a national securities exchange for the purpose of financing his or his customers' bona fide arbitrage transactions in securities. [Sec. 2(j)] In general, "arbitrage" is defined to mean (1) the purchase or sale of a security in one market together with an offsetting sale or purchase of the *same security* in a different market at as nearly the same time as practicable for the purpose of taking advantage of a difference in prices in the two markets (e.g., the purchase in London of 100 shares of stock of the X company and the immediate sale of a like amount of the same security in New York); or (2) the purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within 90 days following the date of its purchase into a *second security* together with an offsetting sale at or about the same time of such second security, for the purpose of taking advantage of a disparity in the price of the two securities (e.g., the purchase of a bond of X company and the immediate sale of the stock into which the bond is convertible without any restriction). The purchase of issued securities and sale of unissued securities which are to be issued to holders of the issued security under a tentative plan of reorganization or merger which has not been finally approved by the stockholders, the court, or other necessary authority, should *not* be considered a bona fide arbitrage.

(k) Any loan to a member of a national securities exchange for the purpose of financing such member's transactions as an *odd-lot dealer* (including transactions as a combined *odd-lot dealer* and *specialist*) in securities with respect to which he is registered on such exchange as an odd-lot dealer. The separate function of the specialist on the NYSE, where the two are separate, may be similarly financed under a "good faith" loan value. [Secs. 2(k), 3(o)]

MAKING OF REGULATED LOANS:

(13) **Question.**—If the maximum loan value of the collateral securing an outstanding regulated loan exceeds the total amount of

the loan, may the bank make another regulated loan without the deposit of additional collateral?

Answer.—Yes. The bank may make an additional regulated loan equal to the amount of the excess loan value of the collateral. This is permissible regardless of the cause of the excess, whether it results from an increase in the market value of the collateral, a decrease in the amount of the original loan, or a subsequent increase by the Board in the permissible maximum loan value.

(14) **Question.**—May a bank make a new regulated loan in case the outstanding regulated loan has a deficiency in collateral?

Answer.—Yes. The new loan, however, must be secured by additional collateral having a maximum loan value at least equal to the amount of the new loan. Thereafter both loans must be considered a single loan for the purposes of substitutions or withdrawals of collateral. *An increase of an existing loan* must be considered a new loan, except insofar as the increase may be due solely to the addition of interest or service charges, or of taxes on transactions in connection with the loan. [Sec. 3(d)] See also Question (1)(d) of these Questions and Answers and section 3(r) of Regulation U relating to conversion of convertible securities.

(15) **Question.**—If a bank has outstanding a purpose loan which is *not* a regulated loan because it is not secured directly or indirectly by any stock, may the bank, without regard to the status of the outstanding loan, make the same customer another loan which *is* a regulated loan?

Answer.—Yes, but the outstanding loan thereupon becomes a regulated loan and thereafter both loans must be considered, by reason of their purpose, to be a single loan. [Sec. 1(b)] However, the bank need not obtain additional collateral to cover the outstanding loan, even if the combined single loan is now undermargined. [See also Answers to Questions (16), (24) and (25).]

(16) **Question.**—May a bank make a nonpurpose loan in reliance on the collateral used to meet the requirements for a regulated loan?

Answer.—In general, no. In the case of *any regulated loan,* the bank is *required* to identify all the collateral used to meet the maximum loan value limitation of the regulation, and only the collateral so identified has loan value for the purpose of the regula-

tion and is subject to the restrictions of the regulation applicable to collateral for a regulated loan. For any nonregulated indebtedness of the same borrower (other than loans excepted by sections 2(d), (f), (g), or (h)), the bank shall require in good faith as much collateral (if any) not so identified as it would require if it did not hold the regulated loan. However, this does not require the bank to waive or forego any lien. It also does not apply to a loan to meet emergency expenses not reasonably foreseeable, provided the circumstances are suitably documented. [Sec. 3(n)]

It should be noted that the nonregulated indebtedness referred to here is necessarily a nonpurpose indebtedness, since it is not possible for the same borrower to have at the same bank both "unsecured" and secured *purpose* loans. See Answer to Question (2).

(17) **Question.**—Does the regulation require that a bank obtain a *statement of purpose* for every stock-secured loan which is not a regulated loan?

Answer.—While there is no requirement in the present regulation that such a statement be obtained, a bank should do so in any case in which the bank's records do not otherwise indicate satisfactorily the actual purpose of the loan. There is no need for a statement of purpose with respect to a loan which the bank treats as a regulated loan. A bank may rely upon a statement with respect to the purpose of the loan, if it is (1) signed by the borrower, (2) accepted by the bank in good faith and signed by an officer as having been so accepted, and (3) if it merely states what is not the purpose of the loan, it is supported by a memorandum of the lending officer describing the purpose of the loan. [Sec. 3(a)] Unless such a statement is on file, the bank should be able to demonstrate the purpose of a loan which is secured by stocks.

(18) **Question.**—Would the mere acceptance by a bank of a nonpurpose statement protect the bank?

Answer.—No. Under section 3(a) as amended effective June 15, 1959, if a statement of the borrower merely states what is not the purpose of the loan, it must be supported by a memorandum or notation of the lending officer describing the purpose of the loan. In addition, no statement of the borrower may be relied upon unless it is accepted "in good faith" and signed by an officer of the bank as having been so accepted. A bank could not, of course, rely "in good faith" upon a statement which it knew to be false or if, in the

circumstances, it had reason to question the correctness or completeness of the statement. The requirement of "good faith" is of vital importance; and to fulfill such requirement the bank must be alert to circumstances surrounding the loan and the borrower. For example, if the bank had reason to suspect that a loan was obtained with the idea of purchasing unregistered stock or bonds merely as a temporary expedient and shortly thereafter selling the unregistered stock or bonds and purchasing registered stocks, the loan should be considered to be a purpose loan; and the bank, in such a case, would not be justified in relying on the borrower's statement without full investigation. Special vigilance would be necessary also where, on more than one occasion, a borrower substituted registered stock for other collateral securing a loan. In addition, a bank could not accept a statement in "good faith" without obtaining a reliable and satisfactory explanation where, for example, a loan is made to a customer who is not a broker or dealer, but a broker or dealer is to deliver registered stock to secure the loan or is to receive the proceeds of the loan. There usually would be reasonable grounds for questioning reliance upon a statement if an unsecured loan should become secured by registered stock shortly after disbursement of the loan. In any case, "good faith" would require the exercise of special diligence where the borrower is not personally known to the bank or to the officer who processes the loan. See also the Answer to Question (31) below, as to transfers of loans.

(19) **Question.**—If a bank holds stock under a bona fide trust agreement established by a borrower and does not rely upon such stock in any way in making a purpose loan, does the purpose loan become a regulated loan by virtue of the stock held under the trust?

Answer.—No. A loan need not be treated as collateralled by securities which are held by the bank only in the capacity of custodian, depositary 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. Such reliance, however, ordinarily must be inferred if holding the securities serves in some way to protect the interests of the bank in connection with the loan. [Sec. 3(f)]

WITHDRAWALS AND SUBSTITUTIONS OF COLLATERAL:

(20) **Question.**—May a bank permit the substitution or withdrawal of collateral securing a regulated loan which is *fully* mar-

gined in accordance with the maximum loan value specified in the current Supplement to the regulation?

Answer.—Yes, if the substitution or withdrawal would not cause the maximum loan value of the remaining collateral at such time to be less than the amount of the loan. If the withdrawal or substitution would result in a deficiency, then it would be permitted only on the terms applicable to withdrawals or substitutions in undermargined accounts, as described in the Answer to Question (21). [Sec. 1(c)]

(21) **Question.**—May a bank permit the substitution or withdrawal of collateral securing a regulated loan which is *undermargined,* i.e., which has insufficient collateral to satisfy the maximum loan value specified in the current Supplement to the regulation?

Answer.—Substitution or withdrawal, unless it results from a purchase and sale executed on the same day, is permissible in an undermargined account only if (1) the loan would not exceed the maximum loan value of the collateral after such withdrawal or substitution, or (2) the loan is reduced by an amount at least equal to the "retention requirement" of the collateral withdrawn minus the maximum loan value of the collateral deposited. [Sec. 1(c)]

The "retention requirement" of nonstock collateral is the same as its maximum loan value, and the "retention requirement" of stock collateral is prescribed from time to time in the Supplement to the regulation. Effective June 15, 1959, the "retention requirement" of a stock, whether or not registered on a national securities exchange, was set in the Supplement at 50 per cent of market value.

At the present time (March 1963) the maximum loan value of stocks is 50 per cent and the retention requirement is also 50 per cent. In the following example, because the maximum loan value was assumed to be less than the retention requirement, reduction of the loan was necessary; this would not be necessary at present. The example is included here in this form, however, because of its significance at times when the maximum loan value is less than 50 per cent.

Example: if $1,000 market value of stock X were withdrawn from an undermargined account in a situation other than a same-day-purchase-and-sale, and $1,000 market value of stock Y were deposited, the loan must be reduced by an amount determined as follows: the retention requirement of collateral withdrawn (i.e., 50 per cent

of $1,000, or $500) less the maximum loan value of the collateral deposited (e.g., if the maximum loan value specified at the time were 10 per cent, this would be $100) equals the required reduction (i.e., $400). Thus, the loan in this example must be reduced by $400. Of course, if some smaller reduction would reduce the loan to the maximum loan value of the collateral, then the smaller reduction would be sufficient.

In the case of a substitution resulting from a purchase and sale occurring on the same day, the substitution is permissible in an undermargined loan without additional collateral or reduction in the loan if the excess of the loan over the maximum loan value of the securities is not thereby increased. The bank must reasonably ascertain and have evidence in its records that the purchase and sale orders were both executed on the same day. The controlling events which must occur on the same day are the executions of the purchase and sale orders, and not the bank's receipt or release of stock certificates. For example, if $2,000 market value of stock A were sold in an undermargined loan, and $2,000 market value of stock B were purchased in the loan, both orders being executed on the same day, the substitution could be effected in the account without any deposit of additional collateral or any reduction in the loan.

(22) **Question.**—How much collateral may a bank release by reason of a reduction in the amount of a regulated loan which is *undermargined* on the basis of the maximum loan value specified in the current Supplement to the regulation?

Answer.—A reduction in the amount of an undermargined loan permits the bank to release collateral having a "retention requirement" as large as the reduction in the loan. [Sec. 1(c)]

For example, under present retention requirements of 50 per cent for stock collateral, if an undermargined loan were reduced by $1,000, stock collateral with a market value of $2,000 could be withdrawn.

(23) **Question.**—Are there any exceptions to the provisions explained above regarding substitutions or withdrawals of collateral?

Answer.—(a) Yes, substitutions and withdrawals are permitted, without regard to the above provisions, to enable a borrower to participate in a reorganization. [Sec. 3(g)] In any such case the bank would normally be expected to obtain as promptly as possible such other securities as are to be issued in connection therewith.

(b) Withdrawals or substitutions are *prohibited in the case of subscription right loans* as indicated in the Answer to Question (11) above, except as may be permissible under section 3(g).

(24) **Question.**—If a bank has outstanding a loan either secured or unsecured, *the purpose of which is not known,* and then, subsequently, makes a regulated loan to the same borrower, may the bank permit withdrawals or substitutions of collateral to either loan without ascertaining the purpose of the first loan?

Answer.—Not if the maximum loan value of the remaining collateral is, or would thereupon become, less than the combined indebtedness. Since all the borrower's purpose loans at the bank must be considered a single loan, and all collateral therefor must be considered as a unit, the bank cannot exclude from this total indebtedness a previously outstanding loan unless the bank has satisfied itself that the loan is not a purpose loan. See Questions (17) and (18) regarding the purpose of a loan.

(25) **Question.**—Are the provisions of Regulation U applicable to the withdrawal or substitution of collateral to a loan that is not for the purpose of purchasing or carrying a registered stock?

Answer.—No. Under so-called "overlap" agreements which are frequently used by banks, collateral which secures one loan of a borrower at a bank also secures all other indebtedness of the borrower to the bank. As a result of such "overlap" agreements, collateral securing a nonpurpose loan may also secure a purpose loan. Before the June 15, 1959 amendment to section 3(n), collateral which secured a nonpurpose loan might in that way become subject to limitations on withdrawals and substitutions. Since that date, however, the limitations apply only to collateral that has been used to meet the requirements of the regulation, rather than to all collateral available to secure a purpose loan.

MAINTENANCE OF A REGULATED LOAN:

(26) **Question.**—If there is a decline in the market value of the collateral securing a regulated loan or a decrease in the maximum loan value prescribed by the Board which causes the maximum loan value of the collateral to be less than the amount of the loan, is the bank required by the regulation to demand additional collateral equal to the deficiency or to require liquidation or payment of the loan?

Answer.—No. The regulation does not require the bank to obtain additional collateral nor to liquidate or reduce any regulated loan by reason of such a decline or decrease. But see section 3(r) concerning loans for the purchase of convertible securities. (It should be noted that brokers or securities exchanges may impose requirements as to margins to be *maintained* and that these requirements operate in quite a different way from the *initial* margin requirements prescribed under Regulation U.)

TRANSFER OF LOANS:

(27) **Question.**—What procedure should a bank follow in accepting the transfer of a loan from another bank, as permitted by section 3(e)?

Answer.—The transferee bank should pay off the transferor bank against the receipt of the collateral. A loan to enable a borrower to reduce or retire existing indebtedness at another bank or to replace funds which the borrower has used for such purpose does not constitute a transfer of the loan within the meaning of section 3(e). See the Answer to Question (31) below, for transfers of loans from one borrower to another, or to others.

(28) **Question.**—May a bank accept transfer of a regulated loan from another bank if the bank knows or has reason to know that the loan when made failed to comply with the regulation?

Answer.—No. See the Answer to Question (31) below, as to the bank's duty to ascertain all relevant facts connected with the transfer of a loan.

(29) **Question.**—If a regulated loan is fully margined must there be compliance with section 3(e) in connection with the transfer of the loan to another bank?

Answer.—No. Since the transferee bank could make the loan initially because the maximum loan value of the securities equals or exceeds the loan, the transferee bank may treat the loan as a new loan and need not rely on section 3(e) permitting transfers.

(30) **Question.**—In accepting the transfer of a loan from another bank, how may the transferee bank determine whether there is any change in the amount of the loan or in the collateral thereto?

Answer.—If the transferred loan is a regulated loan, it must be accompanied by all the collateral used to meet the collateral re-

quirements of the regulation, i.e., all the collateral required to be identified under section 3(n). In the case of a transfer of a portion of such a loan, the transferred portion should be accompanied by its proper proportion of the entire collateral so that the ratio of loan value of collateral to indebtedness is the same with the transferred portion of the indebtedness and transferred portion of the collateral as with the aggregate indebtedness and aggregate collateral.

(31) **Question.**—May a bank permit the transfer of a loan from one borrower to another, or to others, under all circumstances?

Answer.—No, only as a bona fide incident to a transaction that is not undertaken for the purpose of avoiding the requirements of the regulation. In connection with any transfer of a loan between borrowers, an officer at the bank must obtain and keep with the transferee loan account a statement signed by the transferor, which the officer accepts in good faith, describing the circumstances of the transfer. In addition, of course, a bank should exercise good faith, including reasonable diligence, in ascertaining all facts relevant to any transfer of a loan. See the last sentence of section 3(a) regarding acceptance of a statement in good faith.

(32) **Question.**—May a bank accept the transfer of a loan of a borrower from another lender which is *not a bank* (e.g., a broker or dealer) without following the requirements of the regulation as to the making of the loan?

Answer.—No. Although the regulation originally permitted such a transfer, this permission was eliminated shortly after the regulation was issued. [Sec. 3(e)]

(33) **Question.**—After a transfer of a regulated loan from one bank to another, may the bank permit withdrawals and substitutions of collateral?

Answer.—Yes. The bank accepting the transfer of a regulated loan may permit withdrawals and substitutions of collateral on the same basis as if it had been the original maker of the loan. If the transferee bank already has a regulated loan to the same borrower or a loan to him which has not been a regulated loan solely because it has not been secured by any stock, the transferred loan and the outstanding loan must be combined for the purpose of the regulation in determining permissible withdrawals or substitutions of collateral.

LOANS TO OVER-THE-COUNTER-DEALERS:

(34) **Question.**—Does the regulation apply to stock-secured loans made to an over-the-counter dealer whose business consists chiefly of purchasing or carrying unregistered securities but who also, as a regular part of his business, purchases or carries registered stocks?

Answer.—Theoretically, if the different parts of the dealer's business are kept separate so that it can be demonstrated that a particular loan is not for the purpose of purchasing or carrying any registered stocks, such loan, of course, would not be subject to the regulation.

In practice, however, it would be difficult to effect any such separation. In the absence of such separation, any loan to replenish the working capital of such over-the-counter dealer cannot be said to be a nonpurpose loan and should, therefore, be considered a regulated loan.

BANK BORROWING BY BROKERS AND DEALERS ON REGISTERED SECURITIES:

Under the provisions of section 8(a) of the Securities Exchange Act of 1934 it is unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly, to borrow in the ordinary course of business as a broker or dealer on any registered security (other than an exempted security) from any bank which is not a member of the Federal Reserve System unless such nonmember bank shall have filed with the Board of Governors of the Federal Reserve System an agreement (on Federal Reserve Board Form T-1 or T-2) undertaking to comply with all the provisions of the Securities Exchange Act of 1934, the Federal Reserve Act as amended, and the Banking Act of 1933, which are applicable to member banks and which relate to the use of credit to finance transactions in securities, and with such rules and regulations as may be prescribed pursuant to such provisions of law.

In view of the foregoing, a nonmember bank should not make loans to any brokers or dealers in the circumstances specified in the Act unless such bank has filed an agreement on Federal Reserve Board Form T-1 or T-2 with the Board of Governors.