

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 6347]
June 6, 1969

Amendments to Margin Regulations G, T, and U
to Implement the "Over-the-Counter Margin Act"

Effective July 8, 1969

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

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System and released for publication June 9:

The Board of Governors of the Federal Reserve System announced today the criteria to be employed in selecting "over-the-counter" (OTC) stocks that will become subject to its margin regulations under an Act (P. L. 90-437) adopted by Congress last year.

A number of changes in the regulations were also adopted to implement the legislation. These changes are based upon proposals which were published for comment on February 10, 1969. Interested persons were asked to submit their comments in writing by March 17, 1969, and the proposals have been revised in the light of the comments received.

Margin regulations generally limit the amount of credit a person or firm may obtain to buy securities. In the past these regulations applied to stocks that were registered on the national securities exchanges. In announcing the amendments to its Regulations G, T, and U, the Board said the initial list of over-the-counter stocks subject to margin will be published on July 8, 1969, the date the amendments become effective.

Regulation G applies to credit provided by persons other than banks, brokers, or dealers to purchase or carry equity securities, Regulation T concerns credit by brokers, dealers, and members of national securities exchanges for the same purpose, while Regulation U applies to credit by banks.

The amendments also:

— Exempt from margin regulation bank loans to broker-dealers against inventory positions in OTC stocks when such credit is used to make a bona fide market in those stocks. A similar exemption is already available to specialists making a market in stocks registered on exchanges.

— Broaden the definition of "creditor" in Regulation T to cover all brokers and dealers and thus bring under the new margin requirements all brokers and dealers who now handle OTC accounts exclusively.

— Limit the exemption from margin regulation available through a special omnibus account to members of national stock exchanges and brokers and dealers registered with the Securities and Exchange Commission.

— Clarify the application of Regulations G and U to loans on mutual funds. Regulation T prohibits loans on mutual fund shares.

Under the criteria announced today OTC stocks subject to margin requirements would have characteristics similar to stocks registered on national exchanges. This would include a degree of national investor interest, a depth and breadth of market, availability of information respecting individual stocks, and the character and permanence of the issuers.

Margin requirements will apply only to loans made after the amendments become effective to purchase or carry OTC stocks on the Federal Reserve list or debt securities convertible into such stocks.

Criteria used to determine which broker-dealers are entitled to the market-maker exemption are designed to ensure, as far as possible, that the firm does in fact make a market in the stock, stands ready at all times (within reason) to buy or sell the stock, and does not unjustifiably "back away" from the market. Banks lending to such market-makers would have to obtain a statement on a new form, F.R. U-2, that the credit was in fact being used to carry out the market-making function. The bank could rely on the statement, if accepted in good faith.

Any registered broker-dealer will be eligible for designation as an "OTC market maker" if he meets the standards set forth in Regulation U, files with the Securities and Exchange Commission a notice of his intent to begin or continue such market-making activity and continues to file such other reports as are required pursuant to a rule to be adopted by the SEC respecting market makers in OTC margin stocks. To

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provide continuous market operations, without an interruption in credit, the amendments provide for an additional 30 days after publication of the OTC margin list within which those dealers wishing to qualify for the exemption may file with the SEC. During the 30-day period, margin requirements will not apply to bank credit extended on the OTC margin stocks to brokers and dealers registered with the SEC.

Special Omnibus Account

After the effective date of the amendments, credit not subject to margin requirements will be available through a special omnibus account only to members of national stock exchanges and brokers and dealers registered with the SEC. Under the present Regulation T, this type of credit can be extended to persons, including foreign firms, who merely certify that they observe the regulation even though they are not subject to it.

By use of a special omnibus account, a member of an exchange may make wholesale transactions for other brokers without regard to margin requirements. These transactions involve securities on which margin requirements have already been imposed at the retail level.

Under the amendments, the privilege of using the special omnibus account will no longer be available to organizations, including foreign financial institutions and others, that prefer to remain unregistered. Most firms borrowing in special omnibus accounts will not be affected by the amendments. In the case of accounts of unregistered persons, no further substitutions of collateral will be permitted after 90 days from the effective date of the amendments. Credit extended in such accounts will have to be brought up to margin requirements within a year.

Last December, the Department of Justice and the SEC presented to the House Banking and Currency Committee evidence of abuses whereby special omnibus accounts had been used by some foreign financial institutions to avoid U.S. margin requirements.

Loans on Mutual Funds

As part of the amendments, the Board incorporated a provision originally proposed last December to clarify the applicability of Regulations G and U to loans on mutual funds. Under present regulations, loans by banks and Regulation G lenders for purchasing or

carrying mutual fund shares are subject to margin requirements only if the fund's portfolio "customarily includes" securities that would themselves be subject to margin requirements. It has been found that this criterion, especially when the OTC margin stocks are added, embraces virtually all mutual funds. Under the new provision, the margin regulations will apply to loans to purchase or carry all mutual funds, unless 95 per cent of the assets are invested in "exempted securities" — largely Government issues. Because the new test can be applied objectively and includes the vast majority of mutual funds, the Board will cease publication of its list of securities subject to margin regulations.

A number of other conforming changes of a technical nature are also made throughout the regulations as necessary or appropriate.

Unrelated Changes

Clarifying changes unrelated to implementing P.L. 90-437 were made in one section of Regulation G regarding stock option and employee stock purchase plans. These changes:

— Make it clear that "plan-lenders" under such plans must be both wholly owned and controlled by the corporation involved. The only exceptions are for a trustee or a credit union, or a plan-lender formed prior to February 1, 1968, the date when the Board announced adoption of Regulation G in final form.

— Exempt from margin requirements credit extended by a plan-lender to finance the exercise of "qualified" or "restricted" option rights granted prior to February 1, 1968.

— Make clear that the credit arrangements for such plans need not be part of the plan itself.

— State that an increase in the current market value of stock used as collateral for a loan may be taken into account in determining whether the stock may be sold, withdrawn or otherwise disposed of.

In other unrelated changes, the time for retaining Federal Reserve Forms G-3 and U-1 (the "purpose statements" required by Regulations G and U) would be reduced from six to three years to ease the burden of retaining records, and a new Federal Reserve Form T-4 will be substituted for the written statements now obtained by brokers and dealers in connection with "non-purpose" extensions of credit when regulated securities are used as collateral.

The Board's margin Regulations G, T, and U will be reprinted in their entirety in the near future. The reprinted regulations, which will reflect the amendments referred to in the above statement, will be sent to you as soon as they become available.

ALFRED HAYES,
President.