

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. 10829  
January 17 1996 ]

**SECURITIES CREDIT TRANSACTIONS**

**Proposed Amendments to Regulation U**

*Comments Invited by February 15*

*To All Banks, Brokers and Dealers, and Persons Extending  
Securities Credit in the Second Federal Reserve District,  
and Others Concerned:*

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued for public comment proposed amendments to its Regulation U, Credit for Banks for the Purpose of Purchasing or Carrying Margin Stocks. Comment is requested by February 15, 1996.

The proposed amendments call for:

- explicit guidance for banks financing margin stock that has been purchased by their customers through a broker-dealer on a delivery-versus-payment (C.O.D.) basis.
- greater flexibility for withdrawals and substitutions of collateral when margin stock is pledged along with cash equivalents and other securities by treating the entire credit as a single loan.

In addition, the proposed amendments would conform Regulation U to changes recently proposed for Regulation T about increased loan value for exchange-traded options and money market funds.

Printed on the following pages is the text of the proposal, which has been published in the *Federal Register*. Comments thereon should be submitted by February 15, 1996, and may be sent to the Board of Governors, as specified in the Board's notice, or to our Compliance Examinations Department.

**WILLIAM J. McDONOUGH,**  
*President.*



# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## FEDERAL RESERVE SYSTEM

### 12 CFR Part 221

[Regulation U; Docket No. R-0905]

RIN 7100-AB65

#### Securities Credit Transactions; Review of Regulation U, "Credit by Banks for the Purpose of Purchasing or Carrying Margin Stocks"

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed rule.

**SUMMARY:** The Board is proposing amendments to Regulation U, the regulation that covers extensions of credit by banks that are secured in whole or in part by those publicly traded securities defined as "margin stock". These amendments are being proposed as part of the Board's program to periodically review its regulations as well as to fulfill the requirements of section 303 of the Riegle Community Redevelopment and Regulatory Improvement Act of 1994. Two of the most important effects of the proposed amendments would be to provide: Explicit guidance for banks financing margin stock purchased by their customers through a broker-dealer on a delivery-versus-payment (or C.O.D.) basis; and greater flexibility for withdrawals and substitutions of collateral when margin stock is pledged along with cash equivalents and other securities by treating the entire credit as a single loan. In addition, amendments would conform Regulation U to changes recently proposed for Regulation T regarding increased loan value for exchange-traded options and money market mutual funds. Technical amendments would update the regulation to reflect a 1991 Board interpretation allowing lead banks to apply Regulation U to syndicated loans independent of other credit extended by syndicate banks and restore language indicating that the exemption for temporary financing of customer

securities transactions does not apply to securities purchased at a broker-dealer.

**DATES:** Comments should be received on or before February 15, 1996.

**ADDRESSES:** Comments should refer to Docket No. R-0905, and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Comments also may be delivered to Room B-222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, NW. (between Constitution Avenue and C Street, NW.) at any time. Comments received will be available for inspection in Room MP-500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding availability of information.

**FOR FURTHER INFORMATION CONTACT:** Scott Holz, Senior Attorney, or Angela Desmond, Senior Counsel, Division of Banking Supervision and Regulation, (202) 452-2781. For users of Telecommunications Device for the Deaf (TDD), please contact Dorothea Thompson, (202) 452-3544.

**SUPPLEMENTARY INFORMATION:** The Board is proposing amendments to Regulation U (12 CFR part 221), "Credit by Banks for the Purpose of Purchasing or Carrying Margin Stocks," as part of its program to periodically review its regulations and to satisfy requirements under section 303 of the Riegle Community Redevelopment and Regulatory Improvement Act of 1994. The proposed amendments include coverage of bank financing of securities purchased by customers through a broker-dealer on a cash basis and treatment of mixed-collateral loans (loans secured in part by margin stock and in part by other collateral) as a single loan if all collateral consists of securities and cash equivalents. Conforming amendments are proposed in light of the recently published amendments to Regulation T (12 CFR part 220), "Credit by Brokers and Dealers" (see 60 FR 33763; June 29, 1995) that would increase the loan value of exchange-traded options and money market mutual funds. Two technical amendments are discussed below.

In addition to the amendments described in this proposal, comment is invited on all areas of Regulation U,

including (but not limited to) whether the regulation can be eliminated, simplified, or the burdens imposed thereunder eased.

#### 1. Financing of Securities Purchased on a DVP Basis

Banks often act as custodians for their customers' securities. These securities are generally purchased via a registered broker-dealer in a cash account and sent to the bank on a delivery-versus-payment (DVP) basis.<sup>1</sup> Banks traditionally have not accepted securities in a DVP transaction if the customer does not have the funds to make full payment on hand at the bank. Accepting securities without having the customer's full payment on hand involves a credit relationship similar to a customer using a margin account at a broker-dealer.

In the past few years, System examiners and staff of the Securities and Exchange Commission have alleged that certain banks were financing these DVP purchases without documentation and in excess of margin requirements contained in Regulation U. The banks were found in violation of Regulation U or settled charges without admitting or denying their culpability.<sup>2</sup>

Provided customers have sufficient collateral, Board staff believes financing of securities purchases can be accommodated within the existing provision for revolving-credit agreements found in § 221.3(c) of Regulation U, with the addition of some clarifying language.<sup>3</sup> However, it should be noted that this will not result in exactly equal regulation between banks and broker-dealers because the combination of Board, SEC, and SRO rules applicable to broker-dealers in this area cannot be recreated in Regulation

<sup>1</sup> Customers purchase securities at a broker-dealer on either a cash or margin basis, using either a cash or margin account. When a customer purchases a security on a cash basis, he either deposits the full purchase price in the cash account or asks to have the security sent to his agent (usually a custodial bank) against full payment of the purchase price. This latter method is described in section 220.2(e) of Regulation T as a *delivery against payment, payment against delivery, or C.O.D. transaction* and is generally referred to by the industry as a DVP transaction.

<sup>2</sup> See, e.g., *SEC v. Hansen*, 726 F. Supp. 74 (S.D.N.Y. 1989).

<sup>3</sup> Applying the section on revolving-credit agreements will ensure that banks financing such purchases establish credit limits for their customers, including limits on intraday trading.



U.4 Board staff believes that the supervisory structure for banking institutions and the requirement that banks establish credit agreements before financing these transactions will lead banks to impose some additional limitations themselves, but because the additional requirements applicable to broker-dealers are not contained in Regulation T, they cannot be imposed by Regulation U.

## 2. Mixed-Collateral Loans

Regulation U does not apply to extensions of securities credit that are not secured at least in part by margin stock. Loans secured in part by margin stock and in part by other collateral are known as "mixed-collateral" loans and Regulation U has always required some kind of separation for these types of loans. Although a single credit agreement may be used,<sup>5</sup> § 221.3(e) of Regulation U states that a loan secured in part by margin stock and in part by other collateral "shall be treated as two separate loans." This separation requirement has been the subject of numerous inquiries since the last revision of Regulation U and has led to this proposal for a relaxation of the regulation in this area.<sup>6</sup>

The section on mixed-collateral loans does not present a problem when first applied at the time the loan commitment is made, as it merely requires a bank to determine the loan value of margin stock collateral and then verify that the other collateral has a good faith loan value sufficient to make up the difference between the loan value of the margin stock and the amount of credit being extended and to

<sup>4</sup> Although the Board does not have a maintenance margin in its regulations, broker-dealers are required to monitor extensions of securities credit under SRO rules, call for additional collateral when market values fall below a specified percentage, and sell some of the customer's securities if the additional collateral is not received. In addition, SRO rules require customers opening margin accounts to deposit a minimum amount of equity in cash or securities (generally \$2000).

<sup>5</sup> The ability of a bank to use a single credit agreement was a reform instituted in 1983. Before that time, separate credit agreements were required for the stock collateral and the nonstock collateral.

<sup>6</sup> Before 1983, Regulation U covered loans secured by any stock. A "mixed-collateral" loan was one secured in part by stock and in part by other collateral. Now that the regulation's scope has been reduced to cover only loans secured by margin stock, a "mixed-collateral" loan is one secured in part by margin stock and in part by other collateral. "Other collateral" may include stock that would have been covered under the previous version of Regulation U and therefore not subject to the provisions covering mixed-collateral loans. This reduction in the scope of the regulation had the unintended effect of reducing the flexibility for withdrawals and substitutions of collateral for mixed-collateral loans.

allocate the credit secured by each tranche.

There have been, however, a number of inquiries concerning the interplay of § 221.3(e) (mixed-collateral loans) and § 221.3(f) (withdrawals and substitutions) of Regulation U. As an example, suppose the value of a customer's nonmargin stock collateral has increased over time but the value of the margin stock has not. In spite of the fact that the overall value of the collateral has increased, the customer cannot withdraw margin stock because this "separate" loan does not have sufficient loan value to permit the withdrawal. In other words, changes in collateral value in one tranche have no effect on the other tranche. This separation requirement makes collateral management extremely difficult.

Board staff has tried to respond to inquiries in this area through interpretation of the existing regulation.<sup>7</sup> However, in light of the growth of revolving credit agreements secured by more than just margin stock, it appears that the current rule is unnecessarily burdensome to effectuate the statutory scheme of regulation.<sup>8</sup>

The proposed amendment to the section on mixed collateral loans would still require the regulatory segregation of collateral, but would expand the types of collateral that could be securing loans that currently can only be secured by margin stock to include all financial instruments (stocks, bonds, and cash equivalents).<sup>9</sup> Acting in good faith, a bank would be able to value all financial instruments in accordance with the margin requirements in the Supplement to Regulation U (§ 221.8) and permit substitutions within this group in conformity with the section on withdrawals and substitutions, meaning the aggregate loan value of the substituted collateral must at least equal the aggregate loan value of the collateral withdrawn. Under the proposed amendment, credit secured by

<sup>7</sup> See, e.g., *Federal Reserve Regulatory Service* 5-923.2, 5-923.41, and 5-923.42.

<sup>8</sup> Many customers who have securities to pledge as collateral have more than just margin stock (they often have debt securities as well). The section on mixed-collateral loans presumes there will be no change in the collateral once it has been pledged. The number of inquiries in this area is an indication that this is often not the case.

<sup>9</sup> One of the goals of the section on mixed-collateral loans is to ensure that a lender does not inflate the loan value of nonmargin collateral to offset the fact that the margin regulations limit the value of margin stock to 50 percent of its current market value. Most financial instruments have readily available prices, lessening the possibility for evasion of the margin requirements. Other collateral, such as real estate, boats and automobiles, is more likely to have a less well agreed upon market value.

nonfinancial collateral, such as real estate, would continue to be treated as a separate loan. Comment is invited on the continuing need for separation of collateral between financial instruments and other collateral.

## 3. Conforming Amendments

Although the Board's margin regulations provide a level playing field for lenders extending purpose credit secured by margin stock, statutory and other considerations have always made the scope of Regulations G and U less broad than that of Regulation T.<sup>10</sup> Two of the proposed amendments to Regulation T would make it less restrictive than Regulation U, leading the Board to propose conforming amendments. The two amendments would allow 50 percent margin for exchange-traded options (currently given no loan value) and good faith loan value for money market mutual funds (currently given 50 percent loan value). In addition, the definitions of "cash equivalent" and "examining authority" would be added from the Regulation T proposal to the definitional section of Regulation U.

## 4. Technical Amendments

Two technical amendments are proposed. The first would add a sentence to the "single-credit rule" to reflect a 1991 Board interpretation allowing the lead bank to perform Regulation U compliance for syndicated loans. The other would reinsert language inadvertently deleted in 1983 from one of the Regulation U exemptions for credit extended to persons other than broker-dealers.<sup>11</sup>

## 5. Section-by-Section Explanation of Proposed Changes to Regulation U

### Section 221.1 Authority, Purpose and Scope.

No substantive changes.

### Section 221.2 Definitions.

(1) Eliminate letter designations for definitions in § 221.2 and references thereto in §§ 221.1(b), 221.3(a) and 221.7(c)(2).

(2) Add definitions (from Regulation T) for *cash equivalent* and *examining authority* (referred to in § 221.5(c)(9)(ii)).

<sup>10</sup> For example, although the Securities Exchange Act of 1934 requires the Board to set margins for all purchases of securities, it specifically excludes bank loans on nonconvertible debt securities.

<sup>11</sup> The exemption for credit to a customer to temporarily finance the purchase or sale of securities for prompt delivery contained a restriction prohibiting its use for securities purchased at a broker-dealer. This restriction was inadvertently dropped in 1983 and it is being reinserted.



(3) Exclude money market funds from definition of *margin stock* so as to give allow them good faith loan value.

(4) Edit statement in definition of *maximum loan value* that “[p]uts, calls and combinations thereof have no loan value” to reflect loan value for exchange-traded options.

**Section 221.3 General Requirements**

**221.3(a)—General Rule**

(1) Edit statement in general rule that collateral other than margin stock has good faith loan value to reflect fact that puts and calls that do not qualify as margin stock have no loan value.

**221.3(c)—Revolving-Credit or Multiple-Draw Agreements**

(2) Expand subsection to cover financing of securities purchased on a payment-against-delivery (or DVP) basis.

(3) Clarify that FR U-1 is always taken when arrangement is established and must be amended for subsequent disbursements if (i) all collateral is not pledged up front, or (ii) collateral has been withdrawn or substituted between disbursements.

**221.3(d)—Single Credit Rule**

(4) Clarify that single credit rule does not cover syndicated loans (see Board Interpretation on loan participations in section 221.124 of Regulation U).

**221.3(e)—Mixed Collateral Loans**

(5) Alter application of rule so that instead of separating margin stock collateral from nonmargin stock collateral, securities and cash equivalents are separated from other types of collateral.

**Section 221.4 Agreements of Nonmember Banks**

Editorial change reflects combining of Forms FR T-1 and FR T-2.

**Section 221.5 Special Purpose Loans to Brokers and Dealers**

No substantive changes.

**Section 221.6 Exempted Transactions**

Restore language to 221.6(f) that credit is not to be used by a customer to purchase securities from a broker-dealer.

**Section 221.7 OTC List**

No substantive changes.

**Section 221.8 Supplement**

Allow options that qualify as margin stock the same loan value as other margin stock.

**Regulatory Flexibility Act**

As noted in the summary, the proposed amendments should improve the regulation by providing explicit guidance on certain lending practices and greater flexibility in verifying compliance for certain types of loans. The Board believes there will be a beneficial economic impact if this proposal is adopted. Comments are invited on this statement.

**Paperwork Reduction Act**

In accordance with section 3506 of the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35; 5 CFR 1320 Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project (7100-0115), Washington, DC 20503, with copies of such comments to be sent to Mary M. McLaughlin, Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 97, Board of Governors of the Federal Reserve System, Washington, DC 20551.

The collection of information requirements in this proposed regulation are found in 12 CFR part 221. This information is required by Regulation U and authorized by the Securities Exchange Act of 1934 (15 U.S.C. 78g and 78w). The respondents are for-profit financial institutions. Records must be retained for three years after the credit is extinguished.

The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number. The OMB control number is 7100-0115.

No additional reporting requirements or modifications to existing recordkeeping requirements are proposed. The current estimated burden is 4 minutes per response. There are 10,637 subject respondents making an estimated average of 212 of the subject loans annually, for a total of 157,853 hours of annual burden for recordkeeping. Based on an hourly cost of \$20, the annual cost to the public is estimated to be \$3,157,060.

Because the records would be maintained at banks and the notices are not provided to the Federal Reserve, no issue of confidentiality under the Freedom of Information Act arises.

Comments are invited on: (a) Whether the proposed collection of information is necessary for the proper performance of the Federal Reserve's functions; including whether the information has

practical utility; (b) the accuracy of the Federal Reserve's estimate of the burden of the proposed information collection, including the cost of compliance; (c) ways to enhance the quality, utility, and clarity of the information to be collected; and (d) ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology.

**List of Subjects in 12 CFR Part 221**

Banks, banking, Brokers, Credit, Federal Reserve System, Margin, Margin requirements, Investment companies, Investments, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Board proposes to amend 12 CFR Part 221 as follows:

**PART 221—CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCK (REGULATION U)**

1. The authority citation for Part 221 is revised to read as follows:

**Authority:** 15 U.S.C. 78c, 78g, 78h, 78q, and 78w.

**§ 221.1 [Amended]**

2. Section 221.1(b) is amended by removing the word “§ 221.2(b)” and adding “§ 221.2” in its place.

3. Section 221.2 is amended as follows:

a. By removing the alphabetic paragraph designations from the definitions and placing the definitions in alphabetical order;

b. By removing the paragraph designation (1) in front of the definition of *Bank*, by designating the text following the work *Bank* as paragraph (1), by revising newly designated paragraph (1) introductory text and paragraph (2) introductory text;

c. By adding new definitions in alphabetical order for *Cash equivalent* and *Examining authority*;

d. By removing the period at the end of paragraph (6)(iii) and adding “; or” in its place, and by adding new paragraph (6)(iv) to the definition of *Margin stock*;

e. By revising the third sentence of the definition of *Maximum loan value*.

The additions and revisions read as follows:

**§ 221.2 Definitions.**

\* \* \* \* \*

*Bank* (1) Has the meaning given to it in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)) and includes:

\* \* \* \* \*

(2) *Bank* does not include:

\* \* \* \* \*



Cash equivalent means negotiable bank certificates of deposit, bankers acceptances issued by banking institutions in the United States and payable in the United States, and any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8) that is a money market fund in compliance with all applicable requirements of SEC Rule 2a-7 (17 CFR 270.2a-7).

\* \* \* \* \*

Examining authority means:

(1) The national securities exchange or national securities association of which a broker or dealer is a member; or

(2) If a member of more than one self-regulatory organization, the organization designated by the Securities and Exchange Commission (SEC) as the examining authority for the creditor.

\* \* \* \* \*

Margin stock \* \* \*

(6) \* \* \*

(iv) A company which is a money market fund in compliance with all applicable requirements of SEC Rule 2a-7 (17 CFR 270.2a-7).

Maximum loan value \* \* \* Puts, calls and combinations thereof that do not qualify as margin stock have no loan value. \* \* \*

\* \* \* \* \*

4. Section 221.3 is amended as follows:

- a. By revising the last sentence of paragraph (a)(1);
b. By revising paragraph (c);
c. By adding a sentence to the end of paragraph (d)(1);
d. By revising paragraph (e). The revisions and additions read as follows:

§ 221.3 General requirements.

(a) \* \* \* (1) \* \* \* All other collateral, except for puts and calls, has good faith loan value, as defined in § 221.2 of this part.

\* \* \* \* \*

(c) Purpose statement for agreements involving revolving or multiple-draw credit or financing of securities purchases on a payment-against-delivery basis. (1) If a bank extends credit, secured directly or indirectly by any margin stock, in an amount exceeding \$100,000, under an agreement involving revolving or other multiple-draw credit or financing of securities purchases on a payment-against-delivery basis, Form FR U-1 must be executed at the time the credit arrangement is originally established and must be amended as described in paragraph (c)(2) of this section for each disbursement if all of the collateral for

the agreement is not pledged at the time the agreement is originally established.

(2) If a purpose statement executed at the time the credit arrangement is initially made indicates that the purpose is to purchase or carry margin stock, the credit will be deemed in compliance with this part if the maximum loan value of the collateral at least equals the aggregate amount of funds actually disbursed or at the end of any day on which credit is extended under the agreement, the bank calls for additional collateral sufficient bring the credit into compliance with § 221.8 (the Supplement). For any purpose credit disbursed under the agreement, the bank shall obtain and attach to the executed Form FR U-1 a current list of collateral which adequately supports all credit extended under the agreement.

(d) \* \* \* (1) \* \* \* Syndicated loans need not be aggregated with other unrelated purpose credit extended by the same bank.

\* \* \* \* \*

(e) Mixed collateral loans. (1) A purpose credit secured in part by margin stock and in part by collateral other than securities and cash equivalents shall be treated as two separate loans, one secured by margin stock and any other securities and cash equivalents and one by all other collateral. A bank may use a single credit agreement, if it maintains records identifying each portion of the credit and its collateral.

(2) A purpose credit secured entirely by securities and cash equivalents may be treated as a single loan.

\* \* \* \* \*

5. Section 221.4 is amended by revising the parenthetical phrase in the middle of paragraph (a) to read as follows:

§ 221.4 Agreements of nonmember banks.

(a) \* \* \* (See Form FR T-1, T-2)

\* \* \*

\* \* \* \* \*

6. Section 221.6 is amended by revising paragraph (f) to read as follows:

§ 221.6 Exempted transactions.

\* \* \* \* \*

(f) To any customer, other than a broker or dealer, to temporarily finance the purchase or sale of securities for prompt delivery, if the credit is to be repaid in the ordinary course of business upon completion of the transaction and is not extended to enable the customer to pay for securities purchased in an account subject to part 220 of this chapter;

\* \* \* \* \*

7. Section 221.7 is amended by revising paragraph (c)(2) to read as follows:

§ 221.7 Requirements for the list of OTC margin stocks.

\* \* \* \* \*

(c) \* \* \*

(2) No longer substantially meets the provisions of paragraph (b) of this section or the definition of OTC margin stock in § 221.2 of this part.

\* \* \* \* \*

8. Section 221.8 is amended by revising paragraphs (a) and (c) to read as follows:

§ 221.8 Supplement, maximum loan value of margin stock and other collateral.

(a) Maximum loan value of margin stock. The maximum loan value of any margin stock is fifty percent of its current market value.

\* \* \* \* \*

(c) Maximum loan value of options. Except for options that qualify as margin stock, puts, calls, and combinations thereof have no loan value.

By order of the Board of Governors of the Federal Reserve System, December 6, 1995.

William W. Wiles,

Secretary of the Board.

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