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To the Addressee:

Enclosed is a pamphlet, dated February 1976, entitled Questions and Answers Illustrating Application of Regulation U, published by the Board of Governors of the Federal Reserve System. The pamphlet has been prepared primarily for the benefit and guidance of banks subject to the Board of Governors' Regulation U, "Credit By Banks for the Purpose of Purchasing or Carrying Margin Stocks", and for prospective borrowers who may be subject to the regulation by reason of liabilities created under Regulation X, "Rules Governing Borrowers Who Obtain Securities Credit."

At this Bank margin regulation matters are administered by the Securities Regulations Division of the Bank Regulations Department. Additional copies of the question and answer pamphlet or the Board regulations concerned will be furnished upon request.

FEDERAL RESERVE BANK OF NEW YORK

QUESTIONS AND ANSWERS

ILLUSTRATING APPLICATION

of

REGULATION U

CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCKS

BOARD OF GOVERNORS

of the

FEDERAL RESERVE SYSTEM

February 1976

Copies of this manual, as well as the regulations, related forms and documents referred to in this manual, can be obtained from any Federal Reserve Bank.

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QUESTIONS AND ANSWERS ILLUSTRATING

APPLICATION OF REGULATION U

Preface

The following Questions and Answers have been prepared primarily for the benefit and guidance of banks subject to the regulation. They should, however, also be useful to prospective borrowers who may be subject to the regulation by reason of liabilities created under Regulation X, "Rules Governing Borrowers Who Obtain Securities Credit." Of course, the Questions and Answers cannot be expected to cover in detail all aspects of the regulation. References to specific sections of the regulations are provided on a selective basis. In any given case the answer to a particular question must necessarily depend on the specific facts and circumstances involved. Therefore, the following Questions and Answers 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. Further questions concerning the regulation should be raised with staff of the nearest Federal Reserve Bank.

General Features of Regulation U

Persons Regulated

1. Question.--Who is governed by Regulation U?

Answer.--All banks, including mutual savings banks and banks that are not members of the Federal Reserve System (except banks which are members of a national securities exchange and therefore subject to Regulation T).

Threshold Considerations--Form U-1

2. Question.--Under Regulation U, what is the first step a bank must take before extending credit secured directly or indirectly by any stock? (See answer to question 10 for definition of "stock.")

Answer.--The bank must obtain a properly completed statement on Form U-1 (sometimes referred to as a "purpose statement") setting forth the borrower's purpose in obtaining the credit.

3. Question.--Must a Form U-1 statement be obtained if a loan is not secured, directly or indirectly, by stock? (Form U-1 is discussed further in answers to questions 35, 36 and 37 under "Procedural Requirements.")

Answer.--No.

"Purpose" Credit

4. Question.--Why is the borrower's purpose important?

Answer.--If the borrower's purpose is to purchase or carry any "margin stock," the loan is a "purpose credit." If purpose credit is stock-secured, it becomes subject to the credit limitations and other restrictions of Regulation U. (Details of these limitations and restrictions are discussed below under the caption "Nature of Credit Restrictions and Other Limitations of Regulation U." The term "margin stock" is defined in the answer to question 11.)

5. Question.--Do any of the Regulation U restrictions and limitations apply to stock-secured credit if the borrower's purpose is not the purchasing or carrying of margin stock?

Answer.--No. In that case, the only requirement is to obtain the borrower's Form U-1 statement. However, it is important to note that the borrower's statement to that effect cannot be accepted at face value if there are any indications to the contrary, since the bank's acceptance of a purpose statement must be in "good faith." For example, further inquiry should be made if the borrower instructs the bank to make payment to a named broker-dealer upon delivery of margin stock.

Secured "Indirectly"

6. Question.--Must a Form U-1 statement be obtained from a borrower if the bank's credit to the borrower is "indirectly" secured by stock?

Answer.--Yes.

7. Question.--Under what circumstances is credit indirectly secured by stock?

Answer.--Resolution of this question must necessarily depend on the facts and circumstances of each case. In general, credit is indirectly secured by stock if there is an understanding between the borrower and the bank (1) which is designed to make the stock more available to the bank in case of default than to the borrower's other creditors, or (2) which limits the borrower from exercising full dominion over the stock to sell, pledge, or donate it, or determining where it shall be placed physically. However, in the absence of any such restrictions or arrangements with the borrower, the mere fact that the bank holds the stock as custodian or trustee does not in and of itself render the credit indirectly secured. If there is any question as to whether a particular credit is to be "indirectly" secured, further advice should be solicited.

Some examples of "indirectly" secured loans follow:

A. At a time when the bank is the custodian of the securities portfolio of an investment company, the bank makes an ostensibly unsecured loan to the company upon the condition that, until the loan is fully paid, the bank will retain its custodianship and no part of the stock will be pledged or otherwise encumbered except with the bank. The additional arrangement would render the credit indirectly secured by the stock in the securities portfolio.

B. A bank loans money allegedly on an unsecured basis. However, the borrower signs a pledge not to sell or encumber his assets, which consist primarily of stocks, during the life of the loan. This arrangement commonly known as a "negative pledge" would render the credit indirectly secured.

8. Question.--If an extension of credit is indirectly secured by stock, how is this to be reflected in the Form U-1 purpose statement?

Answer.--Where an extension of credit is indirectly secured by stock, the collateral should be listed on Part II with a brief description, by footnote or otherwise, of the agreement or arrangement pursuant to which the securities are held.

"Regulated" Credit

9. Question.--What is "regulated" credit?

Answer.--"Regulated" credit is the term used in this pamphlet (but not in the regulation) with respect to purpose credit which is subject to the Regulation U credit restrictions and other limitations. It includes:

A. Credit obtained by a borrower from a bank for the purpose of purchasing or carrying margin stock if the credit is directly or indirectly secured by any stock, whether or not by margin stock. (See answer to question 12 on defintion of "carrying" margin stock.)

B. Credit extended by a bank to a borrower not subject to Regulation T (the regulation which applies only to brokers and dealers) or to Regulation U, if the borrower's business in important part includes the extending of credit to other persons for the purpose of purchasing or carrying margin stocks. A borrower receiving such credit is sometimes referred to as a "collateral lender" and may be subject to the Board's Regulation G, "Securities Credit by Persons Other Than Banks, Brokers, or Dealers." The credits are deemed to be for the purpose of purchasing or carrying margin stocks and may not be extended without collateral, unless the credit and its purpose are unmistakably separated and disassociated from any purpose credit. Credits secured by other than stock must be secured to the same extent as would be required if they were secured by stock and, therefore, may not exceed the maximum loan value of such non-stock collateral as determined by the bank in "good faith." Such credits are subject to all of the other provisions of the regulation including those relating to withdrawal and substitution of collateral. (See also answer to question 15.)

C. Stock-secured credit initially extended to purchase nonmargin securities would subsequently become regulated credit if those securities (by becoming registered on a national securities exchange or by being included in the OTC margin stock list) become margin stock. In such a case, the bank need do nothing except to require the borrower to adhere to applicable retention requirements in the event of substitution or withdrawal of collateral. (See Retention Requirements--Substitutions and Withdrawals below.) Conversely, if the credit was given to purchase margin stock, the credit would no longer be regulated if such stock were no longer margin stock, as where, for example, it is removed from the OTC list. (See the answer to question 11 defining "margin stock.")

Definition of "Stock"

10. Question.--What is "stock"?

Answer.--The term "stock" generally means any security commonly known as stock. Other instruments encompassed by the term "stock" include (1) any voting trust certificate or other instrument representing stock, (2) any security convertible at any time and on any terms into such a security, certificate or instrument, (3) any security carrying a warrant or right to subscribe to or purchase such security, (4) any such warrant or right and (5) any put, call or similar option giving the holder the right to purchase or sell stock. In addition, the term "stock" could include an instrument which entitles the holder to share or participate in any profits of the issuing company, such as a limited partnership interest. Counsel's opinion should be obtained when there is a question as to when an instrument is an "investment contract" and, therefore, "stock."

"Margin" Stock

11. Question.--What is "margin" stock? (See answer to question 10 for definition of "stock.")

Answer.--"Margin" stock includes:

A. Stock registered (listed) on any national securities exchange.

B. OTC margin stock--that is--stock not traded on a national securities exchange but which the Board has determined to have characteristics generally similar to a listed stock. The Board publishes a list of OTC margin stocks which is generally available to all interested persons. This list is revised periodically and is available from the Board or any Reserve Bank.

C. Securities convertible into a margin stock, or carrying any warrant or right to subscribe to or purchase a margin stock, or any such warrant or right.

D. Margin stock also includes any security issued by an investment company registered with the Securities and Exchange Commission unless the investment company is licensed under the Small Business Investment Company Act, in which case, its securities are not margin stock. (One other exception covers securities issued by an investment company, 95 percent or more of whose portfolio consists of exempted securities, such as U. S. Government, agency, State and municipal obligations.)

"Carrying" Margin Stock

12. Question.--What is meant by the term "carrying" margin stock?

Answer.--The only example of "carrying" specified in the regulation is that of credit to enable a borrower to reduce or retire indebtedness originally incurred to purchase margin stock.

Nature of Credit Restrictions and Other Limitations of Regulation U

Credit Restrictions

Extension of Credit

13. Question.--What are the limitations of Regulation U on extending regulated credit? (See answer to question 9 for definition of "regulated" credit.)

Answer.--At the time when regulated credit is extended, the amount of such credit may not exceed the "maximum loan value" of the collateral securing the credit. If the maximum loan value of stock collateralizing purpose credit should later exceed the amount of the credit (for whatever reason) at the time when more credit is sought, the bank may increase the credit to equal the maximum loan value of the collateral.

Maximum Loan Values

Maximum Loan Value of Stock

14. Question.--What is the "maximum loan value" of "stock" (as defined in section 221.3(l) and generally described in the answer to question 10) used to collateralize regulated credit?

Answer.--The maximum loan value of stock is a percentage of current market value, which the credit may not exceed at the time the credit is extended. Percentages are fixed by the Board from time to time and are set forth in a Supplement to Regulation U. Currently (as of February 1, 1976) the maximum loan values of the various categories of stock are as follows:

A. For stock in general the maximum loan value is 50 percent of their current market value.

B. The maximum loan value of debt securities convertible into stock is 50 percent of the current market value of such securities. Special provisions that apply to loans on convertible debt securities are set forth in section 221.3(t) of the regulation.

C. Puts, calls or combinations thereof have no loan value, even though they may be registered on a national securities exchange and are therefore margin stock.

D. If the credit is to enable the borrower to exercise a stock subscription right, expiring within 90 days of issuance, a maximum loan value of 75 percent of the current market value of the stock to be acquired is permissible, provided the additional conditions set forth in section 221.3(p) are met.

E. Insurance premium funding credits (as described in section 221.3(x)) cannot exceed the amount necessary to pay the insurance premium plus any applicable interest, and in any event, cannot exceed 40 percent of the current market value of the securities pledged as collateral, as set forth in section 221.3(x). Further information on this type of credit is contained in a separate set of questions and answers available through the Reserve Banks.

F. Although all stock of a given class is eligible for the maximum loan value permitted by the regulation, a bank should be alert to determine whether stock received as collateral is "restricted stock." If such is the case the bank may have difficulty in realizing on it should sale be required and, in fact, may be unable to do so without violation of the Federal securities laws. Further advice should be solicited when there is suspicion that the stock to be pledged may be "restricted." In general, "restricted stock" can be classified as (1) stock owned by any person who directly or indirectly controls the issuer or (2) stock received from an issuer, or controlling person of the issuer, in a nonpublic transaction and which may or may not bear a legend advising that it has not been registered pursuant to the Securities Act of 1933.

Maximum Loan Value of Other Collateral

15. Question.--If a bank extends credit to a borrower for the purpose of purchasing or carrying margin stocks on collateral which does not include any security identified in the answer to question 14, what is the maximum loan value of such collateral?

Answer.--The maximum loan value of such collateral is determined by the bank in "good faith." This procedure applies as well to "collateral lender" credit (see answer B to question 9).

Market Value of Securities

16. Question.--How is the current market value of securities ascertained?

Answer.--The current market value of securities may be ascertained by any reasonable method. For example:

A. In the case of a security registered on a national securities exchange, the current market value would be (1) the actual current purchase or sale price of such security or (2) in the absence of such current purchase or sale, the last closing sale price.

B. If the security is not registered on such an exchange, the current market value would be (1) the actual current purchase or sale price of such security as ascertained by any reasonable method or (2) in the absence of information on such current purchase or sale, the current prevailing bid quotations as reflected in the NASDAQ system or, in the absence of a NASDAQ quotation, in any other recognized inter-dealer quotation service.

"Single Credit" Rule

17. Question.--Is the maximum loan value of stock, except convertible debt securities, deposited with the bank to collateralize a regulated loan affected by the fact that the borrower has an existing outstanding unsecured purpose loan?

Answer.--No. However, several additional rules apply. The regulation provides that all "purpose" credit to the same borrower shall be deemed a "single credit." Accordingly, all stock, except convertible debt securities, used to collateralize the subsequent purpose credit is deemed to collateralize both that credit as well as the previously unsecured purpose credit. (The regulation provides a separate single credit rule for "purpose" credit to the same borrower that is secured by convertible debt securities.) These principles may be illustrated by the following example:

Assume a bank has extended a $5,000 purpose credit on an unsecured basis to a borrower in good faith. Subsequently, the bank extends a $5,000 stock-secured purpose credit to the same borrower.

A. If the stock collateral has a current market value of $10,000 sufficient to carry the second credit of $5,000, this collateral would be sufficient for the extension of the second credit.

B. However, the borrower's account would then be undermargined--that is, under the "single credit" rule the $10,000 of stock is deemed not only to collateralize the $5,000 second credit but the previously unsecured purpose credit of $5,000 as well.

C. Because both credits were properly extended on their respective occasions, the regulation does not require the bank to demand more than the $10,000 stock collateral for the second $5,000 credit. However, since the account is undermargined, it is governed by the limitations of the "retention requirements" in the event the borrower seeks to substitute or withdraw any collateral. (See Retention Requirements--Substitutions and Withdrawals below.)

18. Question.--If a bank has extended a regulated loan to a borrower, may it then extend an unsecured purpose loan to the same borrower?

Answer.--No. Under the single credit rule, stock collateral for any purpose credit is collateral for all purpose credit extended to the same customer. The effect of the single credit rule is to make the second loan secured. Additional collateral would be required in an amount sufficient to meet the margin requirement on the new credit.

Segregation of Collateral

19. Question.--If a borrower has a purpose loan secured by stock, how much other collateral (whether stock or non-stock) must be deposited by the borrower to secure a nonregulated loan?

Answer.--The regulation requires a bank which has other collateral from the same borrower securing a nonpurpose loan to maintain collateral for the nonpurpose loan at a level which it would in good faith require for that loan in the absence of the purpose credit.

20. Question.--May a bank extend to the same customer a nonpurpose loan secured by stock and a purpose loan either unsecured or secured by collateral consisting of other than stock?

Answer.--For Regulation U purposes, whenever a bank extends two loans to the same customer, one a purpose loan and the other nonpurpose, any stock collateral would first be identified with the purpose loan. Any excess collateral, whether stock or non-stock, not so identified with the purpose loan could be utilized for the collateral requirement as to the nonpurpose loan, if deemed necessary by the bank.

Mixed Collateral

21. Question.--Is it possible for a bank to make a purpose loan secured in part by stock collateral and in part by non-stock collateral?

Answer.--A bank may make a loan on mixed collateral providing the transaction is treated for Regulation U purposes as if it were two separate and distinct loans, even if a single loan instrument is used. The stock collateral portion can be given no greater loan value than the current margin requirements permit. The non-stock portion of the collateral may be assigned no more than good faith loan value. The records of the bank must be maintained so that each portion of the credit and the collateral underlying it are irrevocably identified for the purpose of compliance with the substitution and withdrawal provisions of the regulation.

Shrinkage of Loan Value of Stocks

22. Question.--If the stock securing a purpose credit had appropriate maximum loan value when the credit was extended, does the regulation require the bank to take any steps if the market value of the stock has declined to a point where the prescribed maximum loan value becomes less than the outstanding amount of the credit or if the Board has taken action subsequently to reduce the maximum loan value while the credit is outstanding?

Answer.--For Regulation U purposes, the bank is not required to take any action in these circumstances. However, the credit is subject to retention requirements if the borrower wishes to substitute or withdraw collateral.

Renewals and Extensions

23. Question.--How does the regulation apply if the borrower wishes a renewal or extension of maturity in connection with a regulated credit?

Answer.--The regulation does not require the bank to treat the renewal or extension of maturity of a credit as a new extension of credit if the amount is not increased except by the addition of related interest or service charges and transactional taxes. The renewal or extension of maturity may be made even though the market value of the stock collateral may have declined to a point where the prescribed maximum loan value becomes less than the outstanding amount of the credit or the Board has taken action to reduce the maximum loan value while the credit is outstanding.

Retention Requirements--Substitutions and Withdrawals

24. Question.--What are retention requirements and how do they apply to a loan in an "undermargined" status where the current maximum loan value of the collateral is less than the balance of the loan?

Answer.--Retention requirements refer to the amount by which a loan balance must be reduced when there is a substitution or withdrawal of collateral from an account. The retention requirement is computed on the basis of a percentage of the current market value of the collateral as set by the Board and shown in the supplement to the regulation. The following examples show how this provision applies to a loan in an "undermargined" status under the current 70 percent retention requirement:

A. The balance of the loan is $15,000, and the collateral consists of stock with a current market value of $25,000, at a time when the maximum loan value of securities is 50 percent of the market price. In such a case the maximum loan value of the collateral is only $12,500, and the credit of $15,000 is therefore undermargined by $2,500. In that posture, if the borrower wishes to withdraw $5,000 of securities he must reduce the credit by the retention requirement (which currently is 70 percent of the current market value of the withdrawn security), namely by $3,500 ($5,000 x 70% = $3,500), leaving a loan balance of $11,500.

B. As in the previous example, the loan balance is $15,000 and the current market value of the stock is $25,000, with the credit being undermargined by $2,500. The borrower desires to withdraw $7,000 of securities and deposit other securities in the amount of $5,000. The retention requirement (of 70 percent) as to the $7,000 withdrawn securities is $4,900, and the securities deposited have a maximum loan value of only $2,500. In this case, the maximum loan value of the substituted securities is $2,400 less than the retention requirement of the withdrawn securities. Accordingly, the credit must be reduced by $2,400, with a resultant loan balance of $12,600.

C. Again, the loan balance is $15,000 and the current market value of the collateral is $25,000, with the credit being undermargined by $2,500. The borrower desires to withdraw $5,000 of securities and deposit others in the amount of $6,000. The retention requirement (of 70 percent) as to the $5,000 withdrawn is $3,500, and the securities deposited have a maximum loan value of $3,000. The maximum loan value of the substituted securities is $500 less than the retention requirement of the withdrawn securities. Accordingly, the loan must be reduced by $500, with a resultant balance of $14,500.

25. Question.--To what extent, if any, would retention requirement provisions apply in the case of a substitution or withdrawal in an account that is not in an "undermargined" status; that is, the current maximum loan value of the collateral in the account equals or exceeds the balance of the loan?

Answer.--The retention requirement would apply only if the substitution or withdrawal would result in reducing the current maximum loan value of the residual collateral below the balance of the loan. Some examples follow:

A. Current market value of collateral is $10,000, the current maximum loan value is $5,000 and the balance of the loan is $5,000. The borrower wishes to withdraw $2,000 of collateral. The status of the loan account is currently right on margin. Therefore, the balance of the loan must be reduced by an amount equal to the current maximum loan value (currently 50 percent) or $1,000. The current market value of collateral would then be $8,000, the current maximum loan value would be $4,000 and the balance of the loan would be $4,000.

B. Current market value of collateral is $11,000, the current maximum loan value is $5,500 and the loan balance is $5,000. The borrower withdraws $2,000 of collateral. The loan balance must be reduced by $500 so that it will not exceed the current maximum loan value of the collateral after the withdrawal. The current market value of the collateral would then be $9,000, the current maximum loan value would be $4,500 and the balance of the loan would be $4,500.

C. Current market value of the collateral is $12,000, the current maximum loan value is $6,000 and the loan balance is $5,000. The borrower withdraws $2,000 of collateral. The loan balance need not be reduced because it will not exceed the current maximum loan value of the collateral after the withdrawal. The current market value of the collateral would then be $10,000, the current maximum loan value would be $5,000 and the loan balance would be $5,000.

Same-Day Transactions--Equity Ratio

26. Question.--What are the limits on substitutions and withdrawals of collateral when they result from purchases and sales on the same business day?

Answer.--In certain situations as explained below, if specific conditions are met, a borrower may without limit effect withdrawals and substitutions of collateral by reason of purchases and sales if all of them are executed within the same day, and if there is no net diminution of the loan value of the collateral. However, before this may be permitted, the "equity ratio" of the credit must be ascertained, since the borrower cannot avail himself of the same-day substitution privilege unless the equity ratio is equal to or greater than the "minimum equity ratio" which the Board fixes from time to time. Currently (as of February 1, 1976), as set forth in a Supplement to Regulation U, the minimum equity ratio of a credit is 30 percent. The examples furnished below cover not only situations where the purchase and sale amounts balance out, but also those where the amount of the one exceeds that of the other:

A. The minimum equity ratio of the credit is 30 percent at the time. The credit is $17,500, the current market value of the collateral is $25,000, and the difference (or equity) is therefore $7,500. This equals the minimum equity ratio of 30 percent of the collateral value of $25,000. In these circumstances, the borrower is free to engage in any number of "same-day" transactions in equal offsetting amounts.

B. Assuming the same facts as the foregoing, if the proceeds of sales of withdrawn securities exceed the total cost of the purchases of substituted securities, the credit must be reduced in accordance with a formula which works out this way. If the retention requirement (currently 70 percent of market value) of $7,000 of securities withdrawn is $4,900, and the retention requirment for the $5,000 of securities substituted is $3,500, the $17,500 credit must be reduced by the difference, namely $1,400, leaving a net balance in the credit of $16,100.

C. If the total cost of purchases is $7,000 and the total proceeds of sales are $5,000, the amount of the credit may be increased upon the following computation. The maximum loan value (at 50 percent) of the securities purchased (substituted) is $3,500, and the maximum loan value of the securities sold (withdrawn) is $2,500. The difference of $1,000 may be added to the $17,500 credit, with the remaining $1,000 being supplied by the borrower. The result is that the credit has been increased only to the extent that the maximum loan value of the collateral has been increased. This is permissible.

Reorganizations and Recapitalizations

27. Question.--Are there any exceptions to the substitution and withdrawal restrictions which apply to an undermargined account?

Answer.--In the case of the reorganization or recapitalization of a company which was the issuer of securities deposited by the borrower as collateral for the credit, the borrower may withdraw such securities as he must surrender in order to receive new securities in lieu thereof as part of the reorganization or recapitalization. In such an event, the borrower must deposit the new securities in place of the securities withdrawn.

Transfers of Credit

From Bank to Bank

28. Question.--Under what circumstances may a bank, at the instance of a borrower, take over the borrower's undermargined regulated credit from another bank?

Answer.--If satisfied that the borrower's request for the transfer is not a means for evading Regulation U requirements and that the other bank's extension of credit was in compliance with the regulation, the transferee bank may take over the other bank's credit by paying the other bank the existing balance of the credit and receiving the collateral securing that credit. Despite the fact that the credit is undermargined, the transferee bank is under no obligation to take any affirmative steps with respect to the credit or collateral which the other bank did not have to take. However, being undermargined, the credit would continue to be subject to the retention requirement provisions governing substitutions and withdrawals.

It should be emphasized that, in extending the credit to the borrower in connection with the transfer, the transferee bank must make payment of the credit directly to the other bank. The privilege to the borrower of transferring his obligation to the transferee bank does not apply if the payment to reduce or retire his indebtedness to the other bank is made directly to the borrower. In such a case, the transaction is a new extension of credit which would be limited to the maximum loan value of the collateral.

Among the other conditions to be complied with is that the transferee bank must satisfy itself that, when originally extended by the other bank, the credit was in compliance with the regulation, and it must examine the borrower's purpose statement to ascertain whether an officer of the bank signed that statement as having been accepted in good faith. In addition, the transferee bank may not increase the credit and must take the same collateral which the other bank had. If only part of the credit is transferred, then a pro rata portion of the collateral must be taken. (Note that this provision is limited to interbank transfers.)

From Borrower to Borrower

29. Question.--May a bank transfer undermargined regulated credit from one of its borrowers to others?

Answer.--Yes, provided the transaction is not designed to enable the transferee borrower to avoid depositing the amount of collateral which would be required for an initial extension of credit to him. The bank must receive a statement by the transferor describing the circumstances giving rise to the transfer and negating any intention of avoiding the maximum loan value requirement of the regulation. That statement must be signed by an officer of the bank in good faith and kept with each transferee account.

Exempt Credit

30. Question.--What kind of securities and transactions are exempt from Regulation U margin requirements?

Answer.--Stock-secured credit is exempt from the margin requirements if extended to purchase or carry exempted securities or nonmargin stocks; however, it should be noted that a Form U-1 purpose statement must be obtained. Other examples of exempt credit are (1) certain transactions with broker-dealers (see answer to question 42 on "Exempt Transactions with and for Broker-Dealers") and (2) some other specified kinds of miscellaneous transactions (see answer to question 32 on "Exceptions to the General Rule").

Exempted Securities

31. Question.--What is an exempted security?

Answer.--The general categories of exempted securities are as follows:

A. Direct obligations of, or obligations guaranteed as to principal and interest by, (1) the United States, (2) any State, (3) any agency or instrumentality of a State, (4) any political subdivision of a State or of a State agency or instrumentality or (5) any municipal corporate instrumentality of one or more States.

B. Securities issued or guaranteed by corporations in which the United States has a direct or indirect interest and which the Secretary of the Treasury has designated as exempted securities.

C. Securities designated by rule or regulation of the Securities and Exchange Commission to be "exempted securities" for the purpose of the provisions of Section 7(d) of the Securities Exchange Act of 1934.

D. (1) Limited kinds of industrial development bonds meeting specified requirements of the Internal Revenue Code, (2) interests in common trust funds administered by banks in certain fiduciary capacities and (3) interests in specified limited "separate accounts," maintained by insurance companies which are issued in connection with designated kinds of stock bonus, pension, profit sharing or annuity plans meeting specified requirements of the Internal Revenue Code.

Exceptions to the General Rule

32. Question.--What transactions are exempt from Regulation U other than certain transactions with broker-dealers? (For transactions with broker-dealers, see answer to question 42.)

Answer.--The following examples represent some of these miscellaneous exempt transactions:

A. Credit extended outside the States of the United States and the District of Columbia is exempt credit. The borrower, if a U.S. citizen, must, however, conform to the provisions of the Board's Regulation X "Rules Governing Borrowers Who Obtain Securities Credit."

B. Credit is exempt credit if extended to a bank or a foreign banking institution. A special provision of Regulation U provides that the term "bank" does not include one which is a member of a national securities exchange.

C. Exempt credit may be extended by a bank to a "plan-lender" to finance stock option and employee stock purchase plans to officers and employees of a corporation, its subsidiaries or affiliates, under plans which comply with section 207.4(a) of Regulation G; with the proviso that the bank shall have no recourse to any stock purchased under such a plan.

Prohibition Against Arranging for More Favorable Terms

33. Question.--Can a bank arrange with others (e.g., unregulated individuals, foreign banking or other unregulated companies and institutions or lenders subject to Regulation G) to extend credit to any persons to purchase or carry margin stocks on terms more generous than Regulation U permits?

Answer.--No. The rule contains an absolute prohibition against such activity. In addition, Regulation X generally prohibits a domestic borrower from receiving credit on terms more lenient than those allowed by the Board's margin regulations. Further, a bank which arranged such credit might be liable for aiding and abetting a violation of Regulation X.

34. Question.--What kinds of activity are encompassed by the term "arranging"?

Answer.--For the purpose of the rule, prohibited "arranging" embraces activity which may fall short of actual negotiations to procure credit for the borrower from the other person. For example, arranging would include any act on the part of a bank, such as an introduction, leading to an extension of credit from a third person. Further, a bank cannot refer a borrower or potential borrower to another lender not subject to Regulation U, such as the bank's parent holding company or an affiliated finance company, for a purpose loan secured by nonmargin stock in an amount greater than is permitted by Regulation U. However, the prohibition against arranging would not preclude a bank from furnishing credit information concerning a customer in accordance with its general business practice.

Procedural Requirements

35. Question.--Must a bank obtain a statement on Form U-1 from every borrower to whom it extends stock-secured credit?

Answer.--Yes. However, an exception to this requirement relates to good faith credit extended to broker-dealers without reference to margin requirements. (See answer to question 42.)

36. Question.--What other extensions of purpose credit do not require a Form U-1?

Answer.--A Form U-1 would not be required in connection with credit extended pursuant to section 221.2, except for credit extended to a person who is not a broker or dealer in connection with "Day Loans," "Prompt Delivery Clearance" or "Securities in Transit or Transfer" as described in section 221.2(f), (g) and (h).

37. Question.--Under what circumstances would a borrower who wishes to substitute stock collateral on an existing loan be required to execute a new Form U-1 purpose statement?

Answer.--A new purpose statement would be required only if the amount of the loan were increased because additional funds were advanced to the borrower. When a new purpose statement is not required, the bank may wish to record the change in collateral in its files by attaching an appropriate record to the existing Form U-1.

Miscellaneous Provisions

Mistakes in Good Faith

38. Question.--Can a bank be held accountable for noncompliance with Regulation U requirements if the noncompliance was the result of a mistake?

Answer.--Not if the mistake was in good faith. Good faith requires that the bank should be alert to the circumstances surrounding the loan. If at the time a loan is made the bank has knowledge, from any source, reasonably sufficient to put the bank on notice that a contemplated transaction would result in a violation of the regulation, it will be deemed not to have acted in good faith.

Action Taken for Bank Protection

39. Question.--Under what circumstances other than a mistake in good faith may noncompliance with Regulation U requirements be excusable?

Answer.--In circumstances under which the bank, acting in good faith, deems such action necessary for its own protection.

Liabilities for Violations

40. Question.--What are the potential liabilities of a bank or a borrower for violation of Regulation U?

Answer.--As to the bank, Section 29(b) of the Securities Exchange Act of 1934 declares contracts made in violation of regulations issued thereunder void as to the rights of the violator. The party not responsible for the violation may rescind the contract and, in a proper case, sue for damages. Further, the bank may be criminally liable under various statutes, including those cited in the Form U-1 purpose statement, and as an aider and abetter of violations of Regulation X.

A borrower may have criminal liability under various statutes, including those cited in the Form U-1 purpose statement, and under Regulation X.

Transactions by Bank as Trustee

41. Question.--If a bank extends stock-secured purpose credit in its capacity as trustee, is the transaction subject to Regulation U requirements?

Answer.--Yes. This principle can have application where, for example, the bank is the trustee of an employees' savings plan which includes stocks and which provides that any participant may borrow from the plan within certain limits and that his stocks in the plan are to serve as security.

Exempt Transactions with and for Broker-Dealers

42. Question.--What are the kinds of stock-secured purpose transactions with and for broker-dealers that are exempt from the margin restrictions of Regulation U?

Answer. --These include the following:

A. Prompt Delivery Clearance Loans. Credit is exempt if extended to finance the purchase or sale of securities for prompt delivery and if the credit is to be repaid in the ordinary course of business upon completion of the transaction. This kind of credit is extended as a temporary advance under the broker-dealer's instructions to the bank to make payment to a seller against delivery of securities, which are destined for a customer of the broker-dealer upon arrangement with the customer to make payment promptly on delivery (COD or POD). The understanding with the bank is that the broker-dealer will repay promptly as soon as the customer on a COD or POD basis takes delivery and pays for the securities. Caution: This exemption is for clearance purposes only and it may not be used by a broker-dealer if he has an inventory of securities of like kind which could be delivered to his customer or if the broker-dealer's arrangement with his customer is not on a strict COD or POD basis within section 4(c)(5) of Regulation T (12 CFR 220.4(c)(5)). If a broker-dealer makes purchases of securities for an issuer intending to retire them, the broker-dealer can receive this exempt clearance credit, provided the issuer has actually made a call for retirement, and the broker-dealer delivers the securities promptly to the issuer against payment for such purpose, upon the understanding that the bank is to be repaid in the ordinary course from the proceeds emanating from such delivery, upon completion of the transaction.

B. Securities in Transit or Transfer. This refers in the main to credit extended by a bank which has received, principally from a selling broker-dealer, securities with sight draft attached with instructions to deliver them to the purchasing broker-dealer's bank (usually out of town) against payment. The credit is extended to the selling broker-dealer for the amount of the sight draft, pending his bank's receipt of payment from the purchaser's bank; and the credit is to be repaid with the proceeds of such payment.

C. Day Loans. Credit which is to be and is repaid on the same day is exempt credit under certain circumstances. These are termed "day loans" and are made principally to enable a broker-dealer to pay for securities bought for customers on the anticipation by the broker-dealer of funds to be obtained in the ordinary course of business during the day. Repayment of the loan must be made on the same day. This would preclude repayment with the proceeds of a second (regulated) loan from the bank later the same day.

D. Temporary Financing of Distributions. Credit is exempt if extended to one or more broker-dealers engaged in the distribution of securities not through the medium of a national securities exchange. Credit is not exempt under this item if the proceeds are used to facilitate open market purchases (whether off or on an exchange) for later disposition through salesmen over-the-counter; and exempt credit is not available under this item for ordinary activities of an over-the-counter broker-dealer.

E. Arbitrage Transactions. Exempt credit can be extended to a member of a national securities exchange to finance his or his customers' bona fide arbitrage transactions. A bona fide arbitrage transaction consists of either (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 or about the same time, in order to profit from a difference in price between the two markets or (2) the purchase of a security which is (without restriction other than the payment of money) exchangeable or convertible within 90 calendar days of the date of purchase into a second security, together with an offsetting sale of the second security at or about the same time, in order to profit from the disparity in prices of the two securities. The time of exchangeability or convertibility may be 180 calendar days if the security purchased is solely a due bill or other evidence of the right to receive only the security that is sold, and if the security that is sold is trading as a when-issued security.

F. Credit Extended Pursuant to Hypothecation. A bank may extend credit to a member of a national securities exchange or a broker-dealer collateralized by customers' securities. To extend the credit, the bank must receive from such member or broker-dealer a statement conforming to a rule of the Securities and Exchange Commission concerning the hypothecation of customers' securities. The amount of credit so extended is limited to the amount of debt owed by the customer of such member or broker-dealer.

G. Emergency Credit. Good faith exempt credit may be extended to a broker-dealer in exceptional circumstances to meet his emergency needs. In order to substantiate the basis for such credit, the bank's records should document the circumstances under which this kind of loan was made.

H. Specialists. A bank may in good faith without reference to margin requirements extend credit on any stock to a registered specialist of a national securities exchange exclusively to finance such broker-dealer's activities as a specialist, so long as the exchange supplies appropriate reports to the Board. Stock identified by a specialist as held for investment under an Internal Revenue rule is not eligible for exempt credit.

I. Odd-Lot Dealers. Credit extended to a registered odd-lot dealer of a national securities exchange to finance his transactions as such odd-lot dealer is exempt credit.

J. OTC Market Makers. For the purpose of this special credit provision, an OTC market maker is a broker-dealer who is a market maker for one or more OTC margin stocks which appear on a list published from time to time by the Board. An OTC market maker may be extended credit by a bank on a good faith loan value basis on any OTC margin stock without reference to margin requirements if he furnishes the bank with information on Form U-2, duly executed by the broker-dealer and accepted by the bank in good faith, to the effect that he is a market maker of the OTC margin stocks identified on that form and on Securities and Exchange Commission Form X-17A-12(1) filed with that agency. The bank must retain the Form U-2 statement among its records for at least three years after such exempt credit is terminated. Listed stocks and OTC nonmargin stocks do not qualify for good faith loan value under this provision. An OTC market maker in a nonmargin stock may, however, obtain good faith credit on any stock because the loan to finance such market making activity would be for a purpose other than to purchase or carry margin securities.

K. Third Market Makers. A third market maker is a broker-dealer who makes an over-the-counter market in securities registered on a national securities exchange. Credit may be extended to a third market maker in good faith on any stock without reference to margin requirements if required information is furnished to the bank on Form U-3. The conditions of the third market maker exemption are highly technical and further advice should be solicited before credit is extended.

The Form U-3 filings must be retained by the bank for three years after the exempt credit has been terminated.

L. Block-Positioners. To qualify for a block-positioner's exemption for credit on any margin stock acquired in the ordinary course of the activity of block-positioning, a broker-dealer must first (1) file an executed Form U-5, accepted in good faith by a duly authorized officer of the bank and (2) have filed with the Securities and Exchange Commission a notice that he will engage in that activity (which is limited by highly technical criteria). Further advice should be solicited before credit is extended in reliance on this exemption. Exempt credit on a given block must be extinguished and repaid or conformed to normal margin requirements if any portion thereof is outstanding continuously for 20 business days. This 20-day period may be extended for one or more 5-day periods in exceptional cases by a regularly constituted committee of an exchange of which the broker-dealer is a member or through which the block transaction was effected, or, if effected over-the-counter, by a committee of the NASD, upon being satisfied that the block-positioner is acting in good faith and that the circumstances warrant such an extension. All such extensions must be supported by a filing by the block-positioner and the appropriate committee with the bank on

Form U-6 setting forth the reasons for the extension. The bank must act in good faith and have no information which might contradict those representations.

The Form U-5 and U-6 filings must be retained by the bank for at least three years after the credit to which it relates has been extinguished.

M. Loans for Capital Contributions. Credit is exempt from the regulation if extended to or maintained for a person to use the proceeds (1) for making a loan or capital contribution to a broker-dealer which (under the capital requirement rules of the Securities and Exchange Commission) is subject to a "satisfactory subordination agreement" or an agreement of a partner of a broker-dealer to include the equity in his partnership account as part of the broker-dealer's capital or (2) for purchasing stock directly from a corporate broker-dealer, but not as part of a public distribution. This exemption is subject to certain conditions specified in section 221.2(m).

Exempt credit may also be extended to a broker-dealer if (1) the Securities Investor Protection Corporation certifies to the Board that such credit is appropriate in the circumstances and (2) the Board by order exempts the loan from regulation.

General Prohibitions Against Credit to Broker-Dealers by Nonmember Banks--Relief from Prohibitions

43. Question.--May a bank which is not a member of the Federal Reserve System extend credit to a broker-dealer for borrowings in his ordinary course of business?

Answer.--No, unless the bank files with the Board an undertaking to comply with the Securities Exchange Act of 1934, the Federal Reserve Act as amended, and the Banking Act of 1933, as they apply to member banks and which relate to the use of credit to finance transactions in securities, as well as with all applicable rules and regulations under those laws. Forms T-1 and T-2 of the Board are the forms to be filed by a nonmember bank to reflect such undertaking.