

S-11
Reg. U-16INTERPRETATION OF LAW OR REGULATION

(Copies to be sent to all Federal reserve banks)

June 25, 1937.

Mr. _____,

_____.

Dear Mr. _____:

Reference is made to your letter of April 26, 1937, regarding the inquiry of _____ National Bank, _____, _____, as to the possible effect under Regulation U of the substitution of registered stocks as collateral for a loan originally supposed to have been made for the purpose of purchasing unregistered stocks. The question is presented in the following excerpt which you quote from the bank's letter:

"Another point has been raised by one of our officers in connection with a substantial loan which was made for the purpose of purchasing unlisted stocks which are pledged as security with an additional margin of unlisted stocks. The borrower subsequently withdrew on trust receipt part of the unlisted stocks, sold the same and purchased listed stocks which were substituted as part of the collateral. The original loan of course was not interpreted as being subject to Regulation U, and the question now arises as to whether this substitution of listed stocks for unlisted stocks, without any change in the amount of the principal of the loan, creates a situation which involves Regulation U in any manner."

This question was considered when Regulation U was being prepared, and it was realized that there would be some possibility of evasion of the regulation if the original purpose of the loan was made the determining factor. However, this possibility did not seem to be so great as to justify the increased difficulties which would be caused banks in operating under the regulation if a different rule were followed; and, accordingly, the regulation was drafted so that, at least for the present, the original purpose of the loan is controlling.

It should be borne in mind in this connection, however, that the original purpose of the loan should not be determined upon a

narrow analysis of the immediate use to which the proceeds of the loan are put. Instead, the fundamental purpose of the loan should be considered to be controlling. As you state in your letter:

"* * * it might be established that the purpose of the borrower from the outset was the purchase of registered stocks. In this case, the regulation would probably apply if the bank were aware of the intention. At any rate, it might be concluded that any repetition of the practice would overcome the presumption of the bank that the purpose was correctly stated by the borrower. The bank might not be considered as acting 'in good faith' if it accepted a statement by the borrower that the loan was not subject to the regulation."

In the case presented by _____ National Bank the question of whether the loan was originally subject to Regulation U would depend upon the intention of the borrower when the loan was obtained. If the loan was obtained with the idea of purchasing the unregistered stocks merely as a temporary expedient and shortly thereafter selling the unregistered stocks and purchasing registered stocks, the loan should be considered to be a loan for the purpose of purchasing or carrying registered stocks. The circumstances related would seem to raise at least some question as to whether the loan was not of this type.

Of course, a bank would not be responsible for misrepresentations made to it by its borrowers if the bank operates diligently and in entire good faith; but a bank should carefully scrutinize cases in which there is any indication that the borrower is concealing the true purpose of the loan and, as you suggest, there would be reason for special vigilance if registered stocks are substituted for unregistered stocks soon after the loan is made, or on more than one occasion.

Very truly yours,

(Signed) Chester Morrill

Chester Morrill,
Secretary.