INTERPRETATION OF LAW OR REGULATION

(Copies to be sent to all Federal Reserve banks)

August 16, 1938

Mr. _____, Vice President,
Federal Reserve Bank of _____,
_____, _____.

Dear Mr. _____:

Reference is made to your letter of August 6, 1938, regarding two questions under Regulation U.

The first question relates to a situation in which a bank makes a loan to a broker or dealer who is a member of a national securities exchange, or who transacts business through the medium of such a member, for the purpose of enabling such broker or dealer to purchase certain registered stocks directly from individual or other investors. It is understood that such securities would be purchased directly from the owners, who are neither members of a national securities exchange nor brokers or dealers who transact a business in securities through the medium of any such member. In other words, such sellers are of the general public and there is no question of their having any direct or indirect connection with any member, broker or dealer.

It is the view of the Board that a loan by a bank to enable the borrower to purchase stocks in the circumstances described would be exempt from Regulation U under section 2(e) of the regulation which exempts:

> "Any loan for the purpose of purchasing a stock from or through a person who is not a member of a national securities exchange and is not a broker or dealer who transacts a business in securities through the medium of any such member, or for the purpose of carrying a stock so purchased;"

For your confidential information it should be added that the Board recognizes that this exemption, like certain other provisions of the regulation, contains possibilities of abuse which might in time require appropriate amendments; and any information of this nature that may develop from time to time naturally is of interest to the Board.

While the answer to the first question would not depend upon whether or not the security purchased had been called for retirement,

in the second case this is an important consideration. In this case a broker or dealer purchases certain shares of a registered preferred stock after the stock has been called for retirement. A bank, acting for the broker or dealer, takes up the stocks, pays for them, and delivers them to the issuer for retirement. The question is whether an advance made for the broker or dealer by the bank in taking up the securities would be covered by section 2(f) which exempts:

> "Any temporary advance to finance the purchase or sale of securities for prompt delivery which is to be repaid in the ordinary course of business upon completion of the transaction;"

The Board is of the opinion that if the call for retirement has already been issued when the securities are purchased, and in addition the securities are promptly delivered to the issuer for such retirement, a loan of the type described would come within the exemption. On the other hand, if the stocks have not been called for retirement when they are purchased, or if they are not promptly delivered to the issuer for retirement, the exemption would not apply, unless, of course, the transaction qualifies as an ordinary cash purchase under the conditions described in section 2(f).

It does not appear that any other exception specified in section 2 would apply to the facts stated in your letter although, as you indicate, the loans detailed on the page accompanying your letter may have involved a "mistake made in good faith" as described in section 3(h).

It is to be noted that in connection with the exemptions mentioned above, as at other points in the regulation, it is necessary to distinguish between the purpose of a loan and the collateral for a loan. The exceptions in section 2(e) and 2(f) relate to purpose. Thus they exempt loans of the types described, but they do not increase the loan value to which securities of the type described are entitled when they are collateral for a loan that is subject to the regulation.

Very truly yours,

(Signed) S. R. Carpenter

S. R. Carpenter,
Assistant Secretary.