

S-215
Reg. U-28

INTERPRETATION OF LAW OR REGULATION

(Copies to Be Sent to All Federal Reserve Banks)

April 24, 1940

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

Dear Mr. _____:

Reference is made to your letter of April 8, 1940, regarding Regulation U.

You describe a case in which a borrower who has a loan subject to Regulation U has sold part of the stock securing the loan and left the proceeds with the bank as a cashier's check securing the loan. Nevertheless the amount of the loan exceeded the maximum loan value of the collateral even after the sale. Several weeks later, when the amount of the loan still exceeded the maximum loan value of the collateral, the borrower wished to repurchase the stock, using the cashier's check to make payment. The question is whether such purchase could be made without the borrower depositing additional cash or collateral.

As you indicate in your letter, the purchase would, in effect, be a substitution of the stock for the cashier's check, the replacement of collateral having 100 per cent loan value by collateral having 60 per cent loan value. This would cause a reduction in the maximum loan value of the collateral, would therefore increase the deficiency in such maximum loan value, and hence would seem to be forbidden by section 1 of the regulation.

You point out that although the purchase would increase the deficiency, the entire series of transactions would in this particular case produce a slight reduction in the deficiency. You then raise the question whether this fact would not, in such a case, dispense with the need for obtaining additional cash or collateral for the purchase.

However, the regulation does not seem to offer any practical basis for giving the purchase such a privileged status because of its relation to the sale that occurred at a considerably earlier time, and it is the view of the Board, as indicated in its letter of September 3, 1937, (S-32; Loose-Leaf Service #8163), that the purchase would not comply with the regulation unless the borrower deposited sufficient additional

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cash or collateral. This conclusion not only appears to be the correct interpretation of the regulation but also, upon further consideration and in view of all the circumstances, is believed to represent the most workable general rule for various situations. Therefore, while the Board agrees with your view that the problem should be considered by the Board in the light of the facts which you describe, it feels after such consideration that it would not be desirable to alter the requirements of the regulation on the point.

It may be noted with respect to the general problem, however, that when stocks are sold the bank may permit the borrower to withdraw a sum equal to the difference between the maximum loan value of the stocks and their market value. Under present requirements this would permit a withdrawal equal to 40 per cent of such market value. Such a withdrawal in connection with a sale would, of course, make it possible for the borrower to have the margin required for a subsequent purchase of securities at the same or any lower price. It is recognized that this procedure might be impractical in certain circumstances, but it seems that it might present a means of facilitating the transactions in some situations of the type to which you refer.

Very truly yours,

(Signed) L. P. Bethea

L. P. Bethea,
Assistant Secretary.