BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

R-741

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

December 7, 1940

Dear Sir:

Enclosed for your consideration and comment is a proposed amendment to Regulation U, "Loans by Banks for the Purpose of Purchasing or Carrying Stocks Registered on a National Securities Exchange", which has been prepared by the staff but not yet acted on by the Board. The proposed amendment grows in large part out of certain rules recently issued by the Securities and Exchange Commission relating to the hypothecation of customers' securities by brokers and dealers, a copy of which is also enclosed.

The first section of the proposed amendment, section 3, would supply a mechanism by which the bank, without impounding any collateral needlessly and without waiving liens or cross liens by means of complex loan agreements, can observe the collateral requirements of the regulation with respect to a loan subject to section 1, particularly when the borrower has also a loan not so subject. It will be noted that the requirement of proposed section 3(b) concerning the collateral which must be required in certain cases when making a loan does not require the bank, after the loan is once made, to obtain additional collateral because of declines in market values or credit ratings.

Section 4 of the proposed amendment grows altogether out of the Commission's new hypothecation rules.

In preparing this amendment, the staff has had the benefit of discussion with and suggestions from legal and other representatives of some of the large banks that will be most affected by it.

In view of the fact that the Commission's new hypothecation rules become effective on February 17, 1941, and that the banks need plenty of time in advance of that date to revise their loan agreements and adjust their operations, the Board wishes to make the necessary changes in Regulation U as promptly as possible. It will be appreciated, therefore, if you will consider the proposed amendment

at your early convenience, using your own judgment as to whether to consult persons outside your Bank and if so to what extent, and let the Board have the benefit of any suggestions that you may wish to offer within perhaps a week, or at most within two weeks, after receipt of this letter.

Very truly yours,

Chester Morrill

Chester Morrill,
Secretary.

Enclosures 2

(Securities and Exchange Commission press release sent only with addressed copies of letter.)

TO PRESIDENTS OF ALL FEDERAL RESERVE BANKS

R-741-a

Proposed Amendment to Regulation U - November 29, 1940

(Occasioned by SEC rules issued November 15, 1940, concerning hypothecation of customers' securities.)

Regulation U and the Supplement thereto are hereby amended in the following respects, and such amendments shall become effective February 17, 1941, but any bank may, at its option, conduct its operations in accordance with such amendments at any time prior to such date:

1. The following sections are added after section 2 of Regulation U, and the succeeding section is renumbered accordingly:

Section 3. Identification of Collateral

(a) (1) With respect to any loan subject to section 1--i.e., a loan that is secured directly or indirectly by any stock, is for the purpose specified in section 1, and is not excepted by section 2--the bank shall identify all collateral used to meet the collateral requirements of section 1 and shall not cancel the identification except in circumstances that would permit the withdrawal of the collateral.

(2) Only collateral so identified shall have loan value for purposes of section 1 or be subject to the restrictions therein specified with respect to withdrawals and substitutions.

(b) (1) Any indebtedness of the same borrower that is not subject to section 1 shall at all times be secured by at least as much collateral not so identified as the bank acting in good faith would require if the bank held neither the loan subject to section 1 nor the identified collateral, except that this requirement shall not apply to any loan described in section 2(d), (f), (g) or (h).

(2) Notwithstanding the preceding paragraph, declines in market values or credit ratings shall (A) not require the bank to call or reduce any loan or demand any additional collateral therefor, (B) not prevent the bank from permitting withdrawals of collateral against equivalent deposits of collateral or equivalent reductions in the loan, and (C) not prevent the bank from increasing any loan on the basis of equivalent additional collateral.

(c) (1) With respect to any indebtedness outstanding on February 17, 1941, the bank need not make any identification of collateral until immediately before it permits the borrower to increase his indebtedness or to withdraw or substitute collateral, except that such identification shall be made in any event not later than August 15, 1941.

(2) When making such original identification with respect to outstanding indebtedness, the bank shall then place under identification such collateral as would then have been under identification if the requirement therefor had been in effect throughout the life of the loan, and if there is in consequence any deficiency in the collateral not so identified the bank may treat such deficiency as if it were due to declines in market values or credit ratings.

Section 4. Customers' Securities Pledged by Broker or Dealer

(a) In case any broker or dealer has with the bank any indebtedness subject to section 1, and the bank accepts in good faith from the broker or dealer information in writing that such indebtedness is secured by securities that are carried for the account of any customer, the following rules shall apply for the purposes of this regulation:

(1) such indebtedness so secured shall not be combined with any other indebtedness of the broker or dealer that is subject to section 1 and such securities shall not be combined with collateral which secures any such other indebtedness; and

(2) all such indebtedness so secured shall be considered a single loan and all such securities shall be considered in connection therewith, except that a given part of such indebtedness that is secured by any such security or any group of such securities may be treated as a separate loan if such security or group of securities secures only the part that is to be treated as a separate loan and only such security or group of securities is given loan value for such separate loan.

(b) Securities "carried for the account of any customer" by a broker or dealer shall not include securities carried for the account of any general or special partner or any director or officer of such broker or dealer, or any participant, as such, in any joint, group or syndicate account with such broker or dealer or with any partner, officer or director thereof.

2. The second paragraph of the Supplement to Regulation U is amended to read as follows:

Loans to brokers and dealers. Notwithstanding the foregoing, a stock, if registered on a national securities exchange shall have a

special maximum loan value of 75 per cent of its current market value, as determined by any reasonable method, in the case of a loan to a broker or dealer from whom the bank accepts in good faith (1) a signed statement to the effect that he is subject to the provisions of Regulation T (or that he does not extend or maintain credit to or for customers except in accordance therewith as if he were subject thereto), and (2) information in writing that the stock is carried for the account of any customer as specified in section 4(b) of Regulation U.