FEDERAL RESERVE SYSTEM
12 CFR Parts 207, 220, 221, 224 and 265
[Regulations G, T, U and X; Docket Nos. R-0905, R-0923 and R-0944]
Securities Credit Transactions; Borrowing by Brokers and Dealers

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is adopting final amendments to Regulations G, T and U. These amendments are based on proposed amendments issued for comment by the Board in December 1995 (Docket R-0905), April 1996 (Docket R-0923) and November 1996 (Docket R-0944). The amendments reduce regulatory distinctions between broker-dealers, banks, and other lenders and implement changes to the Board's securities credit regulations to reflect changes to the Board's statutory authority under the Securities Exchange Act of 1934, as amended by the National Securities Markets Improvement Act of 1996.

DATES: Effective Date: April 1, 1998.
Compliance Date: Compliance with Regulation T is optional until July 1, 1998.

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SUPPLEMENTARY INFORMATION: Discussed below are final amendments to the Board's securities credit regulations based on three requests for comment issued in 1995 and 1996. The December 1995 request (Docket R-0905; 60 FR 63660) covered only Regulation U and dealt with mixed collateral loans and the financing of purchases effected on a delivery-versus-payment basis. The April 1996 request (Docket R-0923; 61 FR 20399) dealt primarily with credit extended to customers by broker-dealers and other lenders, such as loan value for securities under Regulations G, T and U and the account structure of Regulation T. The November 1996 request (Docket R-0944; 61 FR 60168) was issued in response to the changes in the Board's margin authority contained in the National Securities Markets Improvement Act of 1996 (NSMIA) and dealt primarily with borrowing by broker-dealers from any lender and the borrowing and lending of securities by broker-dealers.

The statutory changes from NSMIA regarding borrowing by broker-dealers require parallel amendments to the Board's various margin regulations and are discussed first. The second section deals with amendments to Regulation T and the third section with amendments to Regulations G and U. The final section describes a conforming change to Regulation X.

In a separate document published elsewhere in today's Federal Register the Board is issuing an advance notice of proposed rulemaking to solicit views on any further amendments to its margin regulations that should be proposed to complete the Board's periodic review of these regulations.

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I. Borrowing By Broker-Dealers

A. All Regulations: Implementation of NSMIA

The National Securities Markets Improvement Act of 1996 ("NSMIA")[1/] repealed section 8(a) of the Securities Exchange Act of 1934 (the "'34 Act") and exempted the extension of credit to certain broker-dealers from the Board's margin regulations. Section 8(a) of the '34 Act had required broker-dealers obtaining credit against the collateral of exchange-traded equity securities to borrow from only other broker-dealers, banks that were members of the Federal Reserve System, or banks that agreed to abide by certain restrictions applicable to member banks. After the enactment of NSMIA, the Board proposed to delete § 220.15 of Regulation T and § 221.4 of Regulation U, the regulatory sections that implemented section 8(a) of the '34 Act. No adverse comments were received, and the Board is deleting the sections as proposed. The Board is also deleting the definition of nonmember bank from § 220.2 of Regulation T because the term was used only in § 220.15 of Regulation T. Finally, the Board is deleting its delegation of authority to the Reserve Banks to accept agreements filed under section 8(a) of the '34 Act.

NSMIA amended section 7 of the '34 Act to grant a transactional exemption for credit extended to a broker-dealer "to finance its activities as a market maker or an underwriter." NSMIA also granted a status exemption for all borrowing by broker-dealers "a substantial portion of whose business consists of transactions with persons other than brokers or dealers." These statutory exemptions apply to borrowers, although the Board's margin regulations generally apply to lenders. It is therefore necessary for the Board to amend Regulations G, T and U to provide uniform treatment for broker-dealers whose borrowings are exempted from the Board rules under NSMIA.

[1/] Pub. L. 104-290, 110 Stat. 3416.

1. Scope section vs. the definition of <u>customer</u>

The Board sought comment on whether broker-dealers who qualify for an exemption from the Board's margin regulations when borrowing ("exempted borrowers") should be excluded from the scope provisions in the first section of each regulation or the definition of <u>customer</u> in the second section of each regulation. All but two of the responsive commenters preferred the use of the scope section. The Board is amending the scope section to exclude loans to an "exempted borrower" and adding a definition of "exempted borrower" to cover those broker-dealers who have a substantial portion of their business conducted with persons other than broker-dealers (when they borrow for any purpose). The Board is also excluding an "exempted borrower" from the definition of "customer" in each regulation.

2. Appropriateness of adopting a "substantial" test

The Board sought comment on whether it needs to provide a test to identify exempted borrowers. Only one commenter expressed its belief that a "substantial" test was not needed. The Board is adopting several safe harbor tests to provide guidance to lenders as to those broker-dealers who qualify under NSMIA for exempted borrower status.

One commenter stated that once the Board has decided on an appropriate test, but before it is implemented, the self regulatory organizations (SROs)[2/] should survey their member firms to ascertain how many would be qualified. The Board is not adopting this suggestion as the Board believes that it would delay unnecessarily the ability of some exempted borrowers to take advantage of the Board's implementation of the NSMIA.

3. Test for determining "substantial" customer business

a. Description of test

The Board is adopting three alternative tests for broker-dealers to qualify as exempted borrowers. Exempted borrowers are being defined to include registered brokers or dealers or members of a national securities exchange who have at least: (1) 1000 active accounts for persons other than brokers, dealers, or persons associated with a broker or dealer; or (2) $10 million in annual gross revenues from transactions with such persons; or (3) 10 percent of their annual gross revenues derived from transactions with such persons. These tests will be included in the definition of "exempted borrower" in §§ 220.2 of Regulation T and 221.2 of Regulation U. The Board believes that these tests should not be excessively onerous to satisfy or monitor, but they should exceed the levels that an entity is likely to be willing or able to achieve artificially merely to obtain exempt credit. The first test provides a straightforward mechanism for large, customer-oriented firms to determine that they meet the substantial customer business requirement. The second test covers large firms that have made a substantial commitment to transacting business with persons other than broker-dealers, but do not have a large number of customer accounts. The third test compares the relative size of a broker-dealer's customer-related securities business to its overall securities business.

[2/] All SEC-registered broker-dealers belong to one or more SRO, such as the New York Stock Exchange, Chicago Board Options Exchange, or the National Association of Securities Dealers. If a broker-dealer belongs to more than one SRO, one of the SROs is designated as its examining authority and becomes its primary regulator at the SRO level. "Examining authority" is defined in § 220.2 of Regulation T.

The Board believes these tests meet the statutory standard that a substantial portion of an exempted borrower's business consist of transactions with persons other than brokers or dealers. The Board believes that 10 percent of gross revenues is a substantial portion of a broker-dealer's business. Similarly, the Board believes that 1000 customer accounts is a substantial number of accounts, and therefore broker-dealers with this many customer accounts have a substantial portion of their business with persons other than broker-dealers. Finally, the Board believes that having $10 million in gross customer revenues is a substantial amount of revenue, and therefore these broker-dealers have a substantial portion of their business with customers.

Two of the three tests adopted by the Board today refer to "revenue." Two commenters suggested that the Board adopt its own definition of "revenue," although one of these commenters suggested that the Board build upon the definition of "gross revenues from the securities business" in section 16(9) of the Securities Investor Protection Act of 1970. The Board believes it would be more appropriate for broker-dealers to determine "revenue" in accordance with generally accepted accounting principles (GAAP). This should be easier than a new standard because broker-dealers are required under SEC rules to file annual reports that have been audited by an independent public accountant[3/] and these reports are prepared according to GAAP. Although the Board is not specifying a methodology for comparing customer revenues to gross revenues, it expects that broker-dealers will develop appropriate methods for doing so and apply them consistently over time.

The Board believes that the statutory requirement that a substantial portion of an exempted borrower's business must consist of transactions with persons other than "brokers or dealers" should be interpreted to require that these transactions also be effected with persons other than "persons associated with a broker or dealer" as defined in the '34 Act.[4/] This exclusion is included in the Board's definition of "exempted borrower" and will prevent a firm from qualifying as an exempted borrower by engaging in transactions only with related persons and corporate entities.

Several commenters responding to the Board's request for appropriate tests to identify exempted borrowers focused on the appropriate period of time over which to measure whether a broker-dealer has a substantial customer business. Some commenters suggested a broker-dealer should be deemed to have a substantial customer business if it meets one of the Board’s tests on an annual basis while others suggested using a six month period. The Board believes an annual test is appropriate. Therefore, to meet any one of the tests, a broker-dealer must have met the test on average for a 12 month period. However, the Board will permit a newly registered broker-dealer to qualify as an exempted borrower if it meets one of the Board’s tests after six months.[5/]

[3/] SEC Rule 17a-5(d); 17 CFR 240.17a-5(d).

[4/] Section 3(a)(18) of the '34 Act, 15 U.S.C. 78c(a)(18).

[5/] See Section 220.3(j) of the revised Regulation T and § 221.3(e) of the revised Regulation U.

The Board believes that broker-dealers with exempt borrowing status should reevaluate their status on an annual basis. If a broker-dealer determines that it is no longer an exempted borrower, it should notify its lenders before obtaining additional credit. Once a broker-dealer ceases to be an exempted borrower, credit obtained in reliance on the exempted borrower exception cannot be rolled over or renewed and the lines of credit should be adjusted appropriately as positions are liquidated. If the borrowing broker-dealer maintains its positions, the lender can continue to maintain the credit extended on an exempt basis. Once a borrowing broker-dealer is no longer an exempted borrower any new securities transactions requiring financing must be effected in conformity with the provisions of the Board's margin regulations other than the exempted borrower exception.[6/]

b. "Safe harbor" status of test

The term exempted borrower will be defined to "include" the three tests described above. Each of the three alternatives therefore will be a non-exclusive safe harbor. This will allow broker-dealers who meet any one of the three tests to borrow on an exempt basis, but will not preclude the possibility of demonstrating a substantial customer business in other ways.

c. Burden of proof for exempted borrower status

A commenter stated that a lender should be able to rely on a borrowing broker-dealer's representation of its exempted status "irrespective of what additional facts are known by the lender." Two other commenters recommended that lenders be able to use a "good faith" standard in accepting a borrowing broker-dealer's representation of its exempted status. The Board believes lenders should be required to apply a "good faith" standard in determining whether the Board's margin regulations apply to borrowings by specific broker-dealers. Under former Regulations G and U, "good faith" in accepting a representation required a lender to be "alert to the circumstances surrounding the credit, and if in possession of information that would cause a prudent person not to accept the notice or certification without inquiry, investigates and is satisfied that it is truthful."[7/] The Board believes that in certain situations a lender may be able to determine whether a broker-dealer qualifies as an exempted borrower without requiring a statement from the borrower. Therefore, the Board is modifying the definition of good faith in § 221.2 of Regulation U (which will also cover lenders formerly subject to Regulation G) in a way that will allow lenders to use their judgment as to whether a statement is necessary. The Board is adopting the same definition of good faith in § 220.2 of Regulation T so that all lenders will be subject to a uniform standard.

4. Borrowing exemption for other broker-dealers

CBOE requested the creation of a borrowing exception in Regulations G and U for broker-dealers whose business consists of financing and carrying the accounts of registered

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[6/] See Section 220.3(j) of the revised Regulation T and § 221.3(e) of the revised Regulation U.

[7/] This language was found in the definitional section of each regulation (§ 207.2 of Regulation G and § 221.2 of Regulation U).

market makers.[8/] CBOE noted that while some broker-dealers that carry the accounts of market makers also engage in a general customer business and may qualify for the exempted borrower exception created under NSMIA, there are a few clearing firms virtually all of whose business consists of carrying the accounts of options market makers. CBOE explained that it has encouraged these firms to refrain from carrying the accounts of public customers so that such firms would not be subject to liquidation proceedings under SIPA, which CBOE believes would make the transfer of market maker accounts to other clearing firms more difficult. CBOE stated its belief that failure of these firms to obtain an exempt borrowing status under Regulations G and U will have negative consequences for the safety and liquidity of the options markets.

The Board is adopting an exception from certain of its margin rules for broker-dealers whose nonproprietary business is limited to transactions with market makers and specialists. This exemption will be found in § 221.5(c)(6) of Regulation U (which is being amended to cover all lenders other than brokers and dealers) and not in Regulation T. This means that broker-dealers who qualify for the exception will not be limited by the Board's margin regulations if they borrow from a lender other than another broker-dealer, but borrowings from broker-dealers will be subject to the provisions of Regulation T. CBOE did not request an exemption in Regulation T for loans to market maker clearing firms and the Board's authority to grant exemptions under Regulations G and U is greater than its ability to grant exemptions under Regulation T. NSMIA amended section 7(d) of the '34 Act (the section which applies to lenders other than broker-dealers and under which the Board has adopted Regulations G and U) to allow the Board to exempt such credit "as it may deem necessary or appropriate in the public interest or for the protection of investors." The Board believes that establishing a Regulation U borrowing exception for broker-dealers actively engaged in clearing and carrying the accounts of market makers is appropriate in the public interest by enhancing market liquidity and protecting that liquidity in times of market volatility.

B. Regulations G and U

1. Need for separate regulations

The Board noted last year that the current structure of its margin regulations is based in part on the requirements of recently repealed section 8(a) of the '34 Act. Section 8(a) mandated a distinction between bank and nonbank lenders with respect to loans to broker-dealers. In light of the repeal of section 8(a), the Board sought comment on whether it is still appropriate to distinguish between Regulation G and Regulation U lenders and whether the regulations should be combined. No commenters believed there is a need for differing substantive regulation of banks and Regulation G lenders. The Board is merging Regulation G into Regulation U. Except as otherwise noted, substantive provisions of Regulation G have been incorporated into Regulation U.

On a technical level, the title of Regulation U is being changed to reflect its coverage of persons other than banks, brokers and dealers. Entities that were known as "lenders" under Regulation G will be known as "nonbank lenders" under Regulation U and the term "lender" will be used in Regulation U to refer to banks and former Regulation G lenders collectively. Similar

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[8/] Although CBOE refers to these member firms as "market makers," the firms qualify as "specialists" under the '34 Act.

but not identical provisions, such as the definition of "affiliate" in § 221.2 and the requirements for obtaining a purpose statement in § 221.3(c), have been left with their differences intact. The Board is soliciting comment via an advance notice of proposed rulemaking published elsewhere in today's Federal Register to determine whether and how to harmonize further the treatment of bank and nonbank lenders. The Board is also amending its rules regarding delegation of authority to eliminate references to Regulation G.

2. Special purpose loans to broker-dealers

Regulation U has always included an exemption for loans to broker-dealers in specific circumstances.[9/] In response to the Board's request for appropriate amendments to Regulation U to reflect the broader exemption for broker-dealer borrowing contained in the NSMIA, two commenters stated their belief that the following special purpose loans to brokers and dealers found in § 221.5(c) of Regulation U no longer need to be listed separately: loans to specialists, OTC market makers, third market makers, block positioners, and odd-lot dealers; and distribution loans.[10/] The Board is deleting these provisions as unnecessarily detailed in light of the NSMIA amendments to section 7 of the '34 Act and replacing them with a general exclusion for market makers, specialists and underwriters in §§ 221.5(c)(6) and 221.5(c)(7) of Regulation U based on the language of NSMIA. Lenders formerly subject to Regulation G will also be able to extend special-purpose loans to broker-dealers under all of the exemptions contained in § 221.5(c) of Regulation U. As proposed, the Board is adding the definition of examining authority currently found only in Regulation T to § 221.2 of Regulation U because the term appears in § 221.5(c)(9) of Regulation U.

3. Board Interpretations

Before its merger into Regulation U, Regulation G contained 14 Board interpretations codified as 12 CFR 207.101-114. Seven of these interpretations[11/] were already codified in Regulations T or U as well and will be unaffected by the elimination of Regulation G. The interpretation concerning credit extended to purchase mutual shares before July 8, 1969, which has been codified at 12 CFR 207.107 (and 12 CFR 221.119), is being deleted as obsolete. The remaining six Regulation G interpretations are being moved to Regulation U.

The Board has reviewed the 25 interpretations in Regulation U (at 12 CFR 221.101-125) and decided to delete six of them. As noted in the previous paragraph, the interpretation at 12 CFR 221.119 is being deleted as obsolete. The same is true of the interpretation at 12 CFR 221.111, which deals with "retention requirements" eliminated by the Board the last time the margin regulations were comprehensively revised. The interpretations at 12 CFR 221.102 and 221.121 are being deleted because they have been superceded by NSMIA. Deletion of the interpretation at 12 CFR 221.123 (also codified in Regulation T at 12 CFR 220.126) is discussed

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[9/] See Section 221.5(c) of Regulation U.

[10/] These loans were described in paragraphs (c)(6), (7), (10), (11), (12) and (13) of former § 221.5 of Regulation U.

[11/] The Regulation G citations for these interpretations were 12 CFR 207.102, 103, 106, 108, 110, 113, and 114.

below in the Regulation T section on the use of options in short sales and arbitrage transactions (See section II. B. 3). The interpretation at 12 CFR 221.124 ("Application of the single-credit rule to loan participations") is being deleted because the Board amended the single-credit rule (§ 221.3(d) of Regulation U) in 1996 to incorporate this interpretation. The six remaining Regulation G interpretations will replace the six Regulation U interpretations being deleted today.

C. Regulation T

1. Broker-dealer accounts

The former Regulation T required that all financial relations between a broker-dealer and its customer (which may include another broker-dealer) be recorded in one of the eight accounts described in the regulation. The Board requested comment on whether the NSMIA eliminated the need for the following Regulation T accounts that were generally limited to broker-dealers: omnibus account (former § 220.10), broker-dealer credit account (former § 220.11), and the market functions account (former § 220.12). Most commenters requested retention of the omnibus account, which allows financing of a broker-dealer's customers' positions, for broker-dealers who do not have a "substantial" customer business but nevertheless finance some customer transactions. Most commenters also requested retention of the broker-dealer credit account, which permits certain extensions of credit to SEC-registered broker-dealers and allows certain other transactions to be effected without regard to the "90-day freeze" provision contained in the cash account.[12/] In support of their request to retain the broker-dealer credit account, commenters cited the provisions of the account that may be used by persons who are not SEC-registered broker-dealers (and therefore not affected by the NSMIA) and stated their belief that the Board should not eliminate the ability of these persons to avail themselves of the account. These provisions allow foreign broker-dealers to buy and sell securities on a delivery-versus-payment (DVP) basis[13/] and allow the use of this account for "prime-broker" customers.[14/] Most commenters recommended repeal of the market functions account, which permits good faith credit to be extended to broker-dealers who perform a market function such as acting as a specialist, as long as the Board indicates that its action is based on its belief that the NSMIA exemptions covers all transactions previously recorded in this account.

The Board is eliminating the market functions account because the transactions previously permitted therein have been exempted from Board regulation by the NSMIA, with one exception.[15/] The Board is also deleting the definitions of in or at the money, in the money,

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[12/] Section 220.8(c) of Regulation T.

[13/] Former § 220.11(a)(1) of Regulation T.

[14/] For a description of "prime-broker" arrangements, see SEC no-action letter of January 25, 1994, reprinted in CCH Fed. Sec. L Rptr ¶ 76,819.

[15/] Section 220.12(b)(2)(ii) of former Regulation T provided that the margin for the purchase or short sale of a security that does not qualify as a specialist or permitted offset position shall be the margin required by the Supplement. Purchases on credit and short sales of such securities by specialists will henceforth be required to be effected in the margin or good faith account.

overlying option, permitted offset, and specialist joint account from § 220.2 of Regulation T because the terms were used only in the market functions account. Consistent with its action regarding customer accounts,[16] the Board believes that additional flexibility for broker-dealers can be achieved by merging the omnibus account into the broker-dealer credit account. The different types of credit are described in separate paragraphs; the SEC and/or the SROs may require that broker-dealers keep separate records within this account, for example to segregate omnibus credit (for customers) from other types of (proprietary) broker-dealer credit. The provision allowing certain "prime broker" transactions to be effected in the broker-dealer credit account will be moved to the new good faith account to reflect the fact that these transactions are effected on behalf of non-broker-dealer customers. Former § 220.11(b), which defined the term affiliated corporation, is being moved to the definitional section of the regulation (§ 220.2).

A commenter recommended that the Board allow foreign broker-dealers to open omnibus accounts at U.S. broker-dealers. This practice was permitted under Regulation T until 1969, as long as the foreign broker-dealer certified that it made its customers margin their transactions in conformity with the requirements of Regulation T. The Board then amended Regulation T to require that the broker-dealer obtaining omnibus credit be registered with the SEC and therefore subject to the jurisdiction of the SEC and SROs to ensure Regulation T compliance for customer margin transactions. The Board believes that it is extremely difficult to ensure that an unregulated entity complies with its regulations and does not believe it is appropriate to impose Regulation T on foreign broker-dealers' transactions with customers. Therefore, the Board is not amending the omnibus account at this time.

In response to the Board's request for comment on appropriate amendments to Regulation T to reflect the changes contained in the NSMIA, one commenter recommended incorporation of § 221.5 of Regulation U ("Special purpose loans to brokers and dealers") into Regulation T, so that broker-dealers may make loans to other broker-dealers on the same basis as other lenders. The Board is adding those portions of § 221.5 of Regulation U that are not already in Regulation T to the broker-dealer credit account. These provisions allow the following types of credit without regard to other Regulation T requirements: credit to finance the purchase or sale of securities for prompt delivery or to finance securities in transit, if the credit is to be repaid upon completion of the transaction, and intraday credit. The broker-dealer credit account is also being amended to allow its use for loans to exempted borrowers for those broker-dealers who wish to record such credit in a Regulation T account.

2. Borrowing and lending of securities

The Board has regulated the borrowing and lending of securities to prevent a customer from evading the margin requirements by recharacterizing a margin loan from the broker-dealer to the customer (which requires a deposit of 50 percent of the stock's value by the customer) as the lending of securities by the customer to the broker-dealer (in return for which the customer can receive 100 percent of the stock's value in cash from the broker-dealer). With the exception of

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[16] See the discussion in section II. A. 2. d of the Supplementary Information.

U.S. government securities,[17] former Regulation T on its face applied to any loan of securities in which a creditor was either borrowing or lending. The Regulation T provision that covers borrowing and lending securities (formerly § 220.16; now § 220.10) has traditionally contained collateral requirements (the "collateral test") and limited the situations for which securities may be borrowed or lent (the "purpose test"). With the adoption of the good faith account, Regulation T restrictions on the borrowing and lending of securities will only apply to those securities not entitled to good faith loan value.

a. Collateral test

Regulation T has reflected industry practice by requiring 100 percent collateral against a borrowing of securities, with the collateral limited to cash and cash equivalents. Although the Board believes requiring 100 percent liquid collateral is consistent with prudent securities lending practices, it sought comment on whether the existing collateral requirements are necessary for Regulation T purposes and proposed three alternatives. Two of the alternatives would retain the 100 percent collateral requirement. Of those two alternatives, one would allow any security as collateral as long as it was valued at its regulatory loan value[18] and the other would allow any collateral without specifying limits as to how the collateral is to be valued. The third alternative would eliminate the collateral requirements in their entirety.

No commenter opposed an expansion of the types of collateral permitted for borrowing and lending securities. Two commenters supported allowing all securities at their regulatory loan value and three commenters supported allowing all collateral. Total elimination of collateral requirements in connection with the borrowing and lending of securities was explicitly supported by four commenters (including two who also supported one of the other alternatives) and specifically opposed by two commenters. One of the opposing commenters gave no reason for its opposition, while the other expressed dissatisfaction with the purpose test and suggested that the collateral test was necessary to make up this deficiency. Commenters supporting elimination of the collateral requirements stated that the purpose test adequately limits circumvention of the margin requirements by limiting the situations in which securities may be lent. The commenters stated that the current collateral requirement of 100 is at odds with the 50 percent requirement for margin loans on equity securities. Commenters also noted that the SEC's customer protection rule specifies acceptable collateral for securities lending transactions conducted by broker-dealers with customers. The Board notes that in addition to the SEC's customer protection rules and the reasons cited above, the SROs may choose to impose safety and soundness requirements on the borrowing and lending of securities by their member firms. The Board is eliminating the collateral requirements for borrowing and lending securities.

b. Purpose test

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[17] Borrowing and lending of government (exempted) securities has been permitted in the government securities account without regard to the borrowing and lending of securities provision of Regulation T.

[18] The regulatory loan value of a security is the difference between 100 percent and the margin required by the Supplement to Regulation T (formerly § 220.18, now § 220.12).

In addition to the collateral test, Regulation T also contains a "purpose test" generally limiting the borrowing or lending of securities by broker-dealers to situations involving short sales or "fails" to receive securities needed for delivery. Although the Board did not specifically propose to amend the purpose test, several commenters recommended modifications to the purpose test. These recommendations included: (1) broadening the exception added last year for foreign securities to cover those that trade in the United States, (2) broadening the exception added last year to permit borrowing of securities before a short sale has occurred to cover fail transactions and to allow more time to borrow foreign securities, and (3) expanding the purpose test to cover dividend reinvestment plans.

(1) Foreign securities exception

Last year the Board created an exception to its general rule regarding the borrowing and lending of securities for certain foreign securities. Under former § 220.16(b) of Regulation T, foreign securities that are not publicly traded in the United States could be lent to foreign persons without regard to the purpose test and on any collateral.[19/] Although several commenters responding to the Board's proposal of this exception in 1995 objected to the fact that it did not cover foreign securities listed on a U.S. securities exchange or the Nasdaq Stock Market, other commenters, including U.S. securities exchanges, stressed the importance of equal treatment in this area for all securities that are publicly traded in the United States. One commenter responding to last year's request for public comment repeated its earlier comment requesting that the Board eliminate this limitation on the foreign security exception and added an alternative request that the Board narrow this limitation to U.S. traded foreign securities being lent for short sales effected in the United States. The commenter pointed out that (1) the foreign securities exception only applies to securities lent to foreign persons and therefore "equal treatment" for all U.S. traded securities is already assured for securities lent to U.S. persons; (2) denying the foreign securities exception to U.S. traded foreign securities could create a disincentive to foreign companies considering a dual listing arrangement in the United States; and (3) U.S. broker-dealers are disadvantaged vis-a-vis foreign broker-dealers if their ability to lend foreign securities is curtailed once those securities are listed for trading in the United States. In light of these considerations, the Board is amending the foreign securities exception from the purpose test to cover all foreign securities without regard to whether the securities are traded in the United States.

(**2) "Pre-borrowing"**

Last year the Board also amended Regulation T to allow the borrowing of a security up to one standard settlement cycle[20/] in advance of the trade date of a short sale. Two commenters

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[19/] When the foreign securities exception was adopted, it permitted the use of any legal collateral, but required that the collateral's value be at all times at least equal to the value of the securities being lent. The requirement for 100 percent collateral against a loan of these securities is being eliminated in conjunction with the Board's elimination of the collateral test for all securities lending transactions.

[20/] The phrase "standard settlement cycle" refers to SEC Rule 15c6-1 (17 CFR 240.17c6-1) which currently sets this period at three business days.

requested that the Board allow creditors to borrow securities three days before the trade date of a transaction they reasonably anticipate will result in a fail to deliver. The Board sees no reason to maintain a different time frame for borrowings to accommodate fails versus short sales, as long as the fail is not intended to evade the requirements of Regulation T. The last sentence of § 220.10(a) of Regulation T (former § 220.16(a)) is therefore being amended to cover fails as well as short sales.

Three commenters also requested that the Board allow creditors to borrow foreign securities with extended settlement periods (i.e., more than three business days) up to one foreign settlement period in advance of the trade date of a short sale or fail to deliver transaction. The Board is not adopting such an amendment. The three day period adopted by the Board last year was an attempt to balance the need to complete short sales and fail transactions while guarding against the potential for manipulative transactions such as squeezes. The Board does not believe there is a compelling reason to treat foreign securities differently.

3. Dividend reinvestment and purchase plans

Last year, the Board declined to adopt a suggestion by commenters that the purpose test for borrowing and lending securities be expanded to allow creditors to borrow securities in order to take advantage of dividend reinvestment programs. Three commenters in this docket repeated the suggestion. The Board continues to believe that allowing a broker-dealer to borrow customer securities to take advantage of a dividend reinvestment and purchase plan could allow customers to obtain greater credit than could be obtained via a conventional margin loan and unlike borrowing to cover a short sale or fail is not necessary for efficient functioning and clearing of transactions in the securities market. Therefore, the Board is not amending Regulation T to accommodate dividend reinvestment and purchase plans.

c. Exempted borrowers

In its request for comment on appropriate amendments to implement the changes contained in the NSMIA, the Board stated that it appeared that Regulation T's requirements for borrowing and lending securities no longer applied to the borrowing and lending of securities between two exempted borrowers. The Board requested comment on how to amend the rules regarding borrowing and lending of securities to reflect the NSMIA. Although the SROs that commented responded by stating their belief that borrowing and lending of securities by brokers and dealers should still be subject to a “purpose test,” all other responsive commenters supported the Board's view that Regulation T no longer appears to apply to securities lending transactions between exempt broker-dealers. Three commenters suggested that Regulation T also should not apply when only one party to the securities lending transaction is an exempt broker-dealer; however, the commenters were not in agreement as to how this principal should be applied. Following the Board's stated logic that Regulation T has covered the borrowing and lending of securities to prevent a customer from lending securities against 100 percent cash in order to evade the 50 percent maximum otherwise allowed, the Board is amending Regulation T by adding a new paragraph (c) to the section entitled “Borrowing and lending securities” (§ 220.10) to exclude a broker-dealer that is an exempted borrower from the restrictions of Regulation T if it is lending securities, but not if it is borrowing securities. In order to prevent circumvention of the Board's margin rules for nonexempted equity securities, a broker-dealer that is an exempted borrower and is therefore entitled to lend securities without regard to Regulation T will not be permitted to borrow securities from a customer or a broker-dealer that is not an exempted borrower in order to relend them unless the relending is for a permitted purpose such as a short sale or fail transaction.

II. Regulation T

A. Debt Securities and Portfolio Margining

1. Loan value

Debt securities listed on a national securities exchange have always had loan value under Regulation T.[21] Beginning in 1978, the Board created the concept of an "OTC (over-the-counter) margin bond" to allow loan value for unlisted debt securities that meet Board established criteria. These criteria have been expanded over the years. Nevertheless, not all OTC debt securities qualify as "OTC margin bonds." Debt securities that are neither exchange-listed nor OTC margin bonds have no loan value in a margin account.

a. Good faith loan value for all non-equity securities

Last year, the Board amended Regulation T to include all investment- grade debt securities under the definition of OTC margin bond and therefore ensured good faith loan value for these securities.[22] At the same time, the Board proposed to grant good faith loan value to all non-equity securities.[23] The Board noted that banks and other lenders are not subject to the Board's margin requirements when extending credit on non-equity securities.

The Board's proposal was supported by all responsive commenters except for one commenter. This commenter argued that broker-dealers have a "salesman's stake" not shared by non-broker-dealer lenders and this difference justifies the continuation of denying loan value to certain non-investment-grade debt securities. On the other hand, another commenter stated that there is no policy justification for distinguishing between broker-dealers and other U.S. lenders and several commenters noted that allowing good faith loan value for non-equity securities would increase the ability of U.S. broker-dealers to compete with other domestic and foreign lenders.

The Board is amending Regulation T as proposed to permit broker-dealers to extend good faith credit against all non-equity securities. Broker-dealers should be no less competent to determine the loan value of non-investment- grade debt securities than a bank or other lender would be. In addition, self regulatory organizations (SROs) such as the New York Stock Exchange will still be able to set margin requirements for non-equity security transactions effected by their member brokerage firms. To implement this change, the Board is amending § 220.2 of

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[21] From 1934 until 1968, exchange-listed debt securities were subject to the same margin requirements as exchange-listed equity securities. Since 1968, marginable debt securities have been subject to a good faith margin requirement.

[22] Many investment-grade debt securities were already covered under the existing definition of "OTC margin bond." However, some classes of debt securities, such as domestic debt securities exempt from SEC registration, were unable to qualify under the existing definition.

[23] Formerly, debt securities met the definition of margin security and were entitled to good faith loan value only if they were registered on a national securities exchange, rated investment-grade, or otherwise qualified as OTC margin bonds.

Regulation T by deleting the definition of OTC margin bond, replacing paragraph (3) of the definition of margin security (currently "any OTC margin bond") with "any non-equity security" and changing the Supplement[24/] that provides good faith loan value for these securities to refer to any "non-equity security" where the regulation currently specifies "registered nonconvertible debt security or OTC margin bond." The Board is also adding the word "equity" to paragraph (e) of the Supplement to make clear that the only securities that have no loan value under Regulation T are nonmargin nonexempted equity securities.

b. "Equity-linked" and preferred securities

The Board proposed to define non-equity security as "a security that is not an equity security."[25/] Under the proposed definition, debt securities that are equity-linked securities still would be afforded good faith loan value. The Board also sought comment on whether it should modify this proposed definition to exclude "equity-linked securities," and if so, what securities should be excluded. Modification of the proposed definition of non-equity security to exclude "equity-linked" securities would result in their being treated as equity securities and therefore subject to either a 50 percent or 100 percent margin requirement.

Comment on the appropriate treatment of equity-linked securities was mixed. Several commenters stated that equity-linked securities trade like equity securities and are often priced in reliance on equity securities and therefore should be subject to the same margin requirements as equity securities.[26/] Other commenters stated that it was unnecessary for the Board to exclude equity-linked securities from its proposed definition of non-equity security in light of the SEC's authority to elaborate on the definition of "equity security" under the '34 Act to address questions that may arise regarding novel or hybrid products whose status might otherwise be unclear. Staff of the SEC commented that equity-linked securities, because they present many of the same type of risks as equity securities, should be treated as equity securities for purposes of the Board's margin regulations. SEC staff further commented that they view a equity-linked security as one under which any part of the issuer's obligations is contingent upon, or requires the delivery on an optional or forward basis of, an equity security or group or index of equity securities. The Board is adopting the definition of the term non-equity security that was proposed, with the result that equity-linked securities which do not meet the '34 Act definition of equity security will be entitled

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[24/] The Supplement, which contains the margin requirements for various securities transactions, is the last section of each of the Board's margin regulations. The Supplement was formerly § 220.18; the Supplement under the revised Regulation T adopted today is § 220.12.

[25/] The term equity security is defined in section 3(a)(11) of the Securities Exchange Act of 1934 (15 U.S.C. 78(c)(a)(11)).

[26/] Some of these commenters included convertible debt securities in their discussion of the types of "equity-linked" securities they believe should be subject to equity margin requirements. The Board has always treated convertible debt securities as equity securities because section 3(a)(11) of the Securities Exchange Act of 1934 defines "equity security" to include a security convertible into an equity security.

to good faith loan value. The Board will defer to the SEC on the appropriate definition of equity security.

One commenter suggested that preferred stock be margined at a good faith level because its dividend rate is generally tied to current interest rates. Another commenter sought confirmation that the term non-equity security would include all mortgage and other asset-backed securities, including debt instruments, trust certificates, or partnership/participation interests. As noted above, the Board is deferring to the SEC on the exact parameters of the definition of equity security.

2. Good faith account

a. Appropriateness

In addition to proposing good faith loan value for all non-equity securities, the Board proposed creating an account separate from the margin account described in §220.4 of Regulation T to effect transactions involving these securities. The new account would allow purchases and sales of non-equity securities on a credit or cash basis, repurchase and reverse repurchase agreements on non-equity securities and the purchase or sale of options on non-equity securities. All commenters supporting good faith loan value for all debt securities supported creation of a new account. The Board is adopting its proposal for a non-equity account and, as discussed below, is merging it with the government securities account and other accounts and naming it the "good faith account." The good faith account replaces the government securities account formerly found in § 220.6 of Regulation T.

b. Prohibition on transactions causing a deficit

The Board has generally viewed section 7 of the ’34 Act as prohibiting broker-dealers from extending purpose credit[27/] that is either unsecured or secured by collateral other than securities. In proposing to create a new non-equity account, the Board included a prohibition on transactions that would cause the account to liquidate to a deficit (i.e., cause the market value of the collateral to fall below the customer's debit balance). This proposed provision was included to prevent broker-dealers from extending unsecured purpose credit, which might be an evasion of the good faith margin requirement. Commenters generally opposed the proposal to prohibit transactions that would cause the account to liquidate to a deficit, stating that the restriction would seriously undermine the usefulness of the proposed account for transactions in fixed-income securities because it would present substantial uncertainty with respect to bilateral extensions of credit such as reverse repurchase agreements, which may liquidate to a deficit, and would continue to place broker-dealers at a disadvantage vis-a-vis banks and other lenders.

Several commenters argued that section 7(c)(1)(B)(ii) of the '34 Act does not prohibit unsecured credit if the credit is either "not for the purpose of purchasing or carrying securities" or not extended for the purpose of "evading or circumventing" the Board's rules regarding credit secured by securities. This reading of the statute allows broker-dealers to extend unsecured purpose credit if the Board concludes that such credit is not for the purpose of evading or circumventing its rules regarding secured credit. The Board believes that this interpretation is consistent with the statute and therefore is eliminating the proposed "liquidate to a deficit"

[27/] "Purpose credit" is defined as credit for the purpose of buying, carrying, or trading in securities.

prohibition for the good faith account. The Board believes that permitting transactions in a non-equity securities account to liquidate to a deficit is not necessarily an evasion or circumvention of the rules permitting good faith loan credit for these securities as a lender extending good faith credit may consider factors other than the immediate liquidation value of the collateral.

c. Money market and other financial instruments

In commenting on the Board's proposal to grant good faith loan value to non-equity securities, many commenters sought good faith loan value for money market and other financial instruments such as bankers acceptances, certificates of deposit, and commercial paper when used in a margin account.[28/] In effect, commenters argued that broker-dealers should be able to consider the collateral value of these financial instruments in extending good faith credit on non-equity securities. The Board believes section 7 of the '34 Act permits the extension of unsecured purpose credit if the Board concludes that such credit is not for the purpose of evading or circumventing its rules regarding credit collateralized by securities. This reasoning also applies to purpose credit secured by collateral that may not meet the definition of a "security" in the '34 Act. The Board believes that allowing good faith loan value for all assets other than equity securities in the new good faith account does not evade or circumvent its rules requiring good faith margin for transactions involving non-equity securities. The Board therefore is expressly allowing the inclusion of such assets in the good faith account described below.

d. Merging non-equity account into other accounts

The Board sought comment on merging the non-equity account into the government securities account (former § 220.6) and/or the nonsecurities credit account (former § 220.9). Several commenters supported merging the proposed non-equity account into the government securities account. One commenter opposed merging the new account into any existing account because it believes transactions in the proposed non-equity account should be subject to a requirement for timely payment, a requirement not imposed for the other two accounts suggested by the Board. A second commenter opposed allowing purpose and non-purpose credit in the same account, although another commenter noted that purpose and nonpurpose credit could be segregated within the account.

In order to provide maximum flexibility, the Board is merging all three accounts for purposes of Regulation T. The new account will be called the "good faith account" and will be described in § 220.6 of the revised Regulation T. Creditors may keep separate records for each type of credit extended within the account. In addition, the Board is amending Regulation T to allow other customer transactions for which the Board does not specify margin or payment requirements to be effected in the good faith account. These include all transactions currently effected in the arbitrage account[29/] and those transactions effected in the broker-dealer credit

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[28/] Money market and other financial instruments that may not meet the definition of "security" in the '34 Act are currently valued at good faith when used as collateral for nonpurpose credit in the nonsecurities credit account. These instruments currently have no loan value when used in a margin account.

[29/] The arbitrage account was formerly found in § 220.7 of Regulation T.

account pursuant to a "prime brokerage" arrangement.[30/] This merger of accounts will leave most customers with three possible accounts: a cash account, a margin account (with the possibility of a linked special memorandum account) and a good faith account.[31/] The good faith account could be used for transactions involving securities entitled to good faith margin (including the borrowing and lending thereof), as well as nonpurpose credit, bona fide arbitrage,[32/] and prime broker transactions. Rules of the SROs and individual brokerage firms may require separation of specific types of credit within the new account for their own administrative or regulatory purposes, but this would not be required by Regulation T. All credit extended by a broker-dealer to a non-broker-dealer customer that is either subject to good faith margin or not specifically subject to any Regulation T margin requirement could be recorded in the new account. Transactions formerly effected in the margin account could continue to be effected there, and the restrictions contained in the margin account, such as the requirement for timely deposit of payment or margin, would continue to apply to transactions conducted in that account.

3. Portfolio margining

Regulation T prescribes margin requirements for each security held in a margin account. Certain positions involving more than one security, such as a long position in a convertible bond coupled with a short position in the underlying security, are defined as a single position and given lower margin requirements than would be required individually. Any combination of securities not specifically identified in Regulation T must be margined without regard to any possible offsetting positions. The Board noted last year that commenters have requested greater flexibility to engage in cross-margining (using financial futures to offset securities margin requirements) and

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[30/] This provision was formerly found in § 220.11(a)(5) of Regulation T. "Prime brokerage" is an arrangement involving a customer and at least two broker-dealers, one of whom is the "prime broker." Transactions on behalf of the customer are effected by the non-prime broker-dealer (known as an "executing broker") and immediately sent to the prime broker. The prime broker enforces Regulation T vis-a-vis the customer for all transactions, wherever executed. The broker-dealer credit account is used by the executing broker to record the customers transactions because recordkeeping requirements are less onerous than if the transaction were recorded in a cash or margin account. The new good faith account will eliminate the need to record these customer transactions in the broker-dealer credit account.

[31/] Customers who are broker-dealers will be able to have a fourth possible account if they take advantage of the broker-dealer credit account.

[32/] The Board is not modifying the scope of transactions that may be effected as "bona fide arbitrage." One commenter suggested permitting margin-free arbitrage that is not based on locking in a profit from a current disparity in the prices of the two securities, and lesser or no margin on transactions that would qualify as arbitrage if they had been effected simultaneously. The Board is not adopting these two suggestions, as they do not comport with the underlying policy of the arbitrage account of allowing special credit for transactions that perform a market function by eliminating real-time disparities in pricing between identical or closely related securities.

more broadly "portfolio" or "risk-based" margining of customer assets. The Board identified several provisions in Regulation T that are impediments to the possible adoption of a portfolio margining system. These include: the definition of good faith margin, the requirement that items in one account not be considered in meeting requirements in another account (see § 220.3(b), "Separation of accounts"), and the special memorandum account (SMA).

a. Portfolio margining as an alternative to Regulation T

The Board sought comment on any implementation problems that might arise with a partial or complete move to portfolio margining, including the need for delaying the effective date of any final rule in order to allow the SROs time to amend their rules. A commenter suggested an amendment to Regulation T that would permit a creditor, in lieu of compliance with Regulation T, to comply with any portfolio margining system permitted by an SRO under SEC-approved rules. This would not require a delay between Board action and SRO implementation. The Board is amending the scope provision of Regulation T[33/] to allow portfolio margining to be developed by the industry and approved by the SEC as an alternative to compliance with Regulation T by broker-dealers.

b. Definition of good faith margin

The Board stated that a revised definition of good faith margin[34/] is a necessary prerequisite to eventual implementation of a portfolio margining system. The Board requested comment on a proposed amendment that would modify the definition of good faith margin by deleting references to a specific security and eliminating the requirement that the credit be extended without regard to the customer's other assets.[35/] This change would facilitate portfolio margining on good faith basis. Almost all of the responsive commenters supported this proposal. One commenter suggested that the Board determine what type of portfolio margining systems should be adopted before modifying the definition of good faith. The Board believes that broker-dealers will be afforded greater flexibility by changing the definition of good faith at this time while permitting portfolio margining to be developed and implemented at a later date when agreed upon by the SEC and SROs. The Board therefore is adopting a definition of “good faith with respect to margin” in § 220.2 of Regulation T that substantially follows the proposal.

The Board also sought comment on whether an amended definition of good faith should be limited to the proposed non-equity account or made applicable for all accounts. All of the commenters expressing an opinion supported modifying the definition of good faith for all accounts. The new definition of “good faith with respect to margin” in § 220.2 of Regulation T will cover transactions recorded in the good faith account. The Board is retaining the

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[33/] Section 220.1(b) of Regulation T.

[34/] Margin is the amount of equity a customer must have against a given position and the complement of the security's loan value. A margin requirement of 60 percent for a security is the same as assigning it a loan value of 40 percent. In determining good faith margin, a broker-dealer is assigning a "good faith" loan value to a specific non-equity security.

[35/] The Board proposed to modify the current definition to read as follows: "good faith margin means the amount of margin which a creditor would require in exercising sound credit judgment."

requirements of the former definition of good faith margin for transactions recorded in the margin account by adding a new paragraph, "sound credit judgment" (§ 220.4(b)(8)), to the provisions concerning the margin account. Allowing a broker-dealer to determine margin requirements by taking into account the customer's other unrelated assets or securities positions is inconsistent with limiting the loan value of equity securities to 50 percent of its current market value. Therefore, securities entitled to "good faith" margin treatment, if used in a margin account, must be valued without regard to the customer's other assets and securities positions held in connection with unrelated transactions.

c. Separation of accounts

Section 220.3(b) of Regulation T, "Separation of accounts," generally provides that requirements for an account may not be met by considering items in any other account.[36/] Consistent with its action last year to allow financial futures to serve in lieu of margin for securities options pursuant to SRO rules, the Board proposed to modify the separation of accounts provision to allow commodities and foreign exchange positions in the nonsecurities credit account to be considered in calculating margin for any securities transaction in the proposed good faith account for non-equity securities transactions or the margin account for any securities transaction. Responsive commenters supported the Board's proposal. The Board is adopting the amendment to § 220.3(b) of Regulation T as proposed.

The Board also invited comment on whether it should modify further the separation of accounts provision in §220.3(b) of Regulation T to facilitate portfolio margining. Several commenters pointed out that the separation of accounts provision will have to be relaxed if portfolio margining is made part of Regulation T. One commenter supported complete elimination of the separation of accounts provision, while two other commenters did not believe broker-dealers should be required to link accounts, but should be permitted to do so if they wish. The Board is not taking any additional action with respect to § 220.3(b) of Regulation T at this time, as the development of portfolio margining systems can be accommodated as an alternative to compliance with the account-based system contained within Regulation T, as is provided in § 220.1(b)(3)(i) of the revised regulation. Further, the Board notes that the reduction in the number of customer accounts resulting from combining the proposed good faith account with the arbitrage, government securities, nonsecurities credit and prime brokerage portion of the broker-dealer credit account will result in fewer situations in which the separation of accounts provision of Regulation T will apply.

d. Retention of the special memorandum account

Section 220.5 of Regulation T provides that a broker-dealer may maintain a special memorandum account (SMA) for a customer in conjunction with the customer's margin account and use the SMA to hold customer moneys not required to be maintained in the margin account. The Board sought comment on eliminating the SMA in conjunction with adoption of a portfolio margining system. Several commenters expressed support for retaining the SMA and one commenter noted that the SMA could be recreated by use of the cash account, which it believes would be less efficient. This commenter also pointed out that the concept of the SMA would not

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[36/] An exception is provided for maintaining a special memorandum account (SMA) with a margin account.

be necessary under a portfolio margining system because initial and maintenance margin requirements would be the same. Another commenter wanted broker-dealers to be able to establish multiple margin accounts for the same person in cases other than those identified in Regulation T [37] and operate separate SMAs for each account.

The Board is not making any changes to the SMA at this time. The SMA will continue to be available for use in conjunction with a margin account, but will not be available for use in conjunction with a good faith account. The concept of locking in "buying power" from the appreciated value of securities held in an account or monies not required by Regulation T is inconsistent with the revised definition of "good faith with respect to margin" which is based on the creditor's judgment of the customer's creditworthiness and collateral at a given time. The issue of using an SMA in connection with adoption of portfolio margining systems may be addressed by the SEC, SROs and securities industry.

B. Equity Securities and Options

1. Domestic stocks

Prior to the adoption of today's amendments, the following United States traded stocks[38] were subject to the Board's 50 percent margin requirement:[39] (1) stocks traded on a national

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[37] The Board allows multiple margin accounts for a single customer under conditions found in § 220.4(a)(2) of Regulation T. These margin accounts may be operated with separate SMAs.

[38] Stocks that are not traded in the United States are subject to Regulation T (although they are not covered by Regulations G and U) and their margin status is discussed in section II.B.2 of the Supplementary Information.

[39] Although section 7 of the '34 Act instructs the Board to limit the amount of credit that can be extended against nonexempted securities, it does not require the Board to make individualized determinations for every security.

Section 7 originally mandated that the Board prescribe rules with respect to the amount of credit that may be extended on "any security (other than an exempted security) registered on a national securities exchange." The Board originally subjected all securities registered on a national securities exchange to the same margin requirement. It later established different margin requirements for convertible and nonconvertible debt securities, but at no time denied loan value (i.e., required 100 percent margin) to exchange-listed securities (with the exception of options).

In 1968, Congress amended section 7 of the '34 Act to delete the reference to exchange securities exchange, (2) stocks in the National Market tier of the Nasdaq Stock Market ("NMS" securities), and (3) stocks in the Small Capitalization ("SmallCap" securities) tier of the Nasdaq Stock Market that are identified by the Board as "OTC margin stocks." These stocks were subject to the same margin requirements regardless of whether the lender is a broker-dealer, bank, or other lender.[40/]

In its request for comment issued last year, the Board noted that although the definition and treatment of domestic margin stocks is currently the same in Regulations G, T and U, nonmargin stocks are treated differently at broker-dealers (where they have no loan value) than at banks and other lenders (where the Board's margin rules do not limit their value). The Board sought comment on the possibility of expanding the types of securities with loan value at broker-dealers by amending the definition of margin security in § 220.2 of Regulation T to cover all domestic equity securities that have a "ready market" for purposes of the SEC's net capital rule.[41/] This would cover all Nasdaq SmallCap stocks[42/] and thousands of additional over-the-counter ("OTC") stocks not traded on Nasdaq. In light of the disparate treatment of nonmargin stock at broker-dealers versus other lenders, the Board also sought comment on the appropriate definition of margin stock under Regulations G and U and on possible solutions to the current structure of its margin regulations that results in an increase in burden for lenders other than broker-dealers whenever burden is reduced for broker-dealers. The Board suggested its regulations might be amended to cover more securities for broker-dealers and fewer securities for banks and other lenders.

The proposal to make all domestic "ready market" stocks marginable under Regulation T was supported by four commenters and opposed by four commenters, while another commenter

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listed securities so that the Board is now instructed to prescribe rules with respect to the amount of credit that may be extended on "any security (other than an exempted security)." The Board chose to implement this authority to establish margin requirements for securities not traded on a national securities exchange by subjecting every over-the-counter stock to a set of Board-established criteria and publishing a list of those OTC securities which meet these criteria. However, in 1983 the Board deferred to the listing requirements of Nasdaq's National Market tier as an additional method of qualifying as a margin security. Thereafter, domestic stocks that were not listed on a national securities exchange qualified for margin treatment either by being listed on Nasdaq's National Market tier or by appearing on the Board's List of Marginable OTC Stocks after meeting the Board's criteria formerly found in § 220.17 of Regulation T.

[40/] Lenders other than broker-dealers and banks are responsible for applying Federal Reserve margin requirements only after they have extended margin stock secured credit in an amount that surpasses one of two dollar thresholds: $200,000 in credit extended in one calendar quarter or $500,000 in credit outstanding at any time.

[41/] 17 CFR 240.15c3-1, "Net capital requirements for brokers or dealers."

[42/] The SmallCap tier of the Nasdaq Stock Market contains over 1800 stocks, of which approximately 442 are currently marginable at broker-dealers.

stated its belief that further clarification is needed before such an amendment could be adopted. Three commenters suggested expanding the definition of OTC margin stock at least to cover all stocks listed on the Nasdaq Stock Market.

Regulation T has always included all securities (other than options) registered on any national securities exchange as margin securities.[43/] In allowing loan value for certain over-the-counter securities, the Board has attempted through its criteria to ensure similar levels of liquidity and transparency.[44/] The NASD has recently raised listing requirements for both the National Market and SmallCap tiers of the Nasdaq Stock Market.[45/] The minimum standards for listing on Nasdaq (i.e., the SmallCap tier) generally equal or exceed those of the American, Boston, Chicago, Pacific, and Philadelphia Stock Exchanges. The Board believes that Nasdaq SmallCap issues, which meet or exceed many national securities exchange requirements, should not be denied margin status solely because they are not traded on an "exchange." Therefore the Board is including all Nasdaq listed issues in its definition of margin security.[46/] The Board's quarterly OTC List will no longer be necessary for broker-dealers because the Board will no longer choose which Nasdaq stocks are marginable, but will instead rely on Nasdaq listing standards to the same extent it relies on the listing standards of U.S. securities exchanges.

SEC staff have asked for a delay in the effective date of the amendment giving 50 percent loan value to all Nasdaq securities to address possible sales practice issues. The Board is delaying

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43/ Although the term "national securities exchange" is not defined in the Board's margin regulations or section 3(a) of the '34 Act (whence terms are incorporated by reference into the Board's margin regulations), the Board has always understood the term to mean a securities exchange registered with the SEC under section 6 of the '34 Act ("National securities exchanges," 15 U.S.C. 78f). In a separate document published elsewhere in today's Federal Register, the Board is requesting comment on whether it should propose to incorporate this definition into its margin regulations.

44/ The Board definition of OTC margin stock in the second (definitional) section of Regulations G, T and U referred to stock "that the Board has determined has the degree of national investor interest, the depth and breadth of market, the availability of information respecting the security and its issuer, and the character and permanence of the issuer to warrant being treated like an equity security traded on a national securities exchange."

45/ SEC approval was received on August 22, 1997.

46/ The definition of margin security formerly included "any OTC security designated as qualified for trading in the national market system under a designation plan approved by the Securities and Exchange Commission (NMS security)" as well as "any OTC margin stock." The former referred to Nasdaq listed stocks trading in the National Market tier, while the latter referred to those Nasdaq listed stocks trading in the SmallCap tier that the Board identified on a quarterly basis as meeting the requirements found in § 207.6 of Regulation G, § 220.17 of Regulation T, and § 221.7 of Regulation U. These two paragraphs have been replaced with a reference to "any security listed on the Nasdaq Stock Market."

the effectiveness of this provision until January 1, 1999 and will cease publication of its quarterly OTC List for U.S. traded securities after publication of the November 1998 list.[47] The Board may revisit the issue of allowing credit on other equity securities at a later date.

2. Foreign stocks

The Board has been identifying those foreign equity securities that are eligible for margin at broker-dealers since 1990 by publishing a List of Foreign Margin Stocks ("Foreign List") on a quarterly basis. As in the case of OTC margin stocks, the Board has based its decisions on criteria aimed at ensuring liquidity and price transparency for all margin securities. Last year, the Board amended its criteria for foreign margin stocks to encompass foreign stocks deemed to have a "ready market" under the SEC's net capital rule.[48] This action allowed the inclusion of hundreds of additional foreign stocks on the Foreign List, based on a "no action" position from the SEC that effectively treats all stocks on the Financial Times/Standard & Poor's World Actuaries Indices ("FT/S&P Indices") as having a "ready market" for capital purposes.[49] Although there was considerable overlap between stocks on the FT/S&P Indices and the Board's Foreign List, there were also a significant number of foreign stocks that appeared on the Foreign List but not the FT/S&P Indices. The Board sought comment on whether it should phase out its original criteria and Foreign List and rely exclusively on the SEC's "ready market" test.

Most commenters opposed the idea of phasing out the Board's original eligibility requirements for foreign margin stocks in favor of reliance on the FT/S&P Indices or the SEC's "ready market" concept because they did not want to eliminate the marginability of stocks that appear on the Board's Foreign List but that may not meet the other tests. The Board therefore is retaining its Foreign List to identify those foreign stocks that have been found to meet the Board's original eligibility and continued listing requirements and amending the definition of foreign margin stock in § 220.2 of Regulation T to include both securities on the Board's Foreign List and those deemed to have a "ready market" for capital purposes, as determined by the SEC. This will allow a stock appearing on the FT/S&P Indices to qualify as a margin security without the need to be included on the Board's Foreign List, a request made by several commenters. Several other commenters also requested the ability to have broker-dealers make their own determination that a specific foreign stock has a "ready market" and should therefore be a margin security. The Board views the process of increasing the coverage of its definition of margin security as an incremental one and believes it is appropriate at this time to limit the margin status of foreign stocks to those that either meet the Board's original criteria for foreign margin stock and therefore appear on the

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[47] For a discussion of the effect of the elimination of the OTC List for lenders other than broker-dealers, see section III. A. 1. In the Supplementary Information.

[48] 17 CFR 240.15c3-1.

[49] See, 58 FR 44310; August 20, 1993.

Board's Foreign List or are deemed by the SEC to have a "ready market" for purposes of their net capital rule.[50/]

3. Options: short sales and arbitrage transactions

When options first began trading on a national securities exchange in 1973, the Board issued an interpretation concluding that options may not be considered securities "exchangeable or convertible into other securities, within 90 calendar days, without restriction other than the payment of money."[51/] The quoted language appears in the bona fide arbitrage provision of the good faith account (§ 220.6(b) of Regulation T, formerly the arbitrage account in § 220.7) and in the Supplement (§ 220.12 of Regulation T, formerly § 220.18) under the margin required for short sales. The effect of the interpretation was to preclude the possibility of effecting “bona fide arbitrage” (which requires no margin under Regulation T) between options and their underlying securities and to preclude the use of an option in lieu of the 50 percent margin required for short sales in addition to the short sale proceeds. Last year, the Board proposed to rescind the 1973 interpretation. A majority of commenters supported this proposal, although the Treasury Department commented that this may have merit for certain options but is premature until an approach is more fully developed.

The Board is rescinding its interpretation that options are not convertible securities and amending the Supplement of Regulation T to allow a listed call option to serve as partial margin for short sales of the underlying security. To ensure that a call option adequately covers a customer's obligation in a short sale, the Supplement of Regulation T requires that a call option serving in lieu of part of the required margin is an American style option[52/] issued by a registered clearing corporation and traded on a national securities exchange with an exercise (strike) price that is not greater than the price at which the underlying security was sold short. This will ensure that the short sale proceeds and option can be used to cover the short position in the underlying security if necessary. In addition, rescission of the Board interpretation will allow "bona fide" arbitrage between options and their underlying securities to be effected without further regulatory changes in the good faith account on the same basis as other convertible securities such as convertible bonds.

In response to the Board's request for comment on using long calls to offset some of the required margin for a short sale, several commenters also suggested that the Board should not require margin for the long purchase of a security if the customer has a long put on that security. The Board believes the use of a put option in lieu of margin for the purchase of a security may be

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[50/] In this regard, the Board is confirming that broker-dealers may rely on written "no action" or interpretative letters issued by the SEC or its staff regarding its "ready market" criteria.

[51/] 12 CFR 220.126 and 12 CFR 221.123, reprinted in the Federal Reserve Regulatory Service at 5-488.

[52/] American style options are exercisable on any business day until expiration. European style options may be exercised only at expiration.

appropriate in the context of a future portfolio margining system, which is permitted as an alternative to Regulation T.[53/]

When the Board adopted amendments to Regulation T in 1996, it made several provisions of the regulation concerning options effective only until June 1, 1997.[54/] These provisions have been replaced with SRO rules and the Board is deleting the provisions from the revised Regulation T.

C. Miscellaneous Issues

1. Foreign Issues

a. Credit by foreign branches of U.S. broker-dealers

The Board proposed to amend Regulation T to exempt credit extended by foreign branches of U.S. broker-dealers if the credit is extended to foreign persons against foreign securities. This proposal was supported by all responsive commenters, although one commenter expressed concern about foreign securities whose principal trading market is in the United States and another commenter suggested exempting all credit extended by U.S. broker-dealers outside the United States. The Board is adopting its proposal and amending the scope section of Regulation T to exclude financial relations between a foreign branch of a U.S. broker-dealer and a foreign person involving foreign securities.[55/] This will remove restrictions from foreign branches of U.S. broker-dealers that are not imposed on foreign branches of U.S. banks or foreign affiliates of U.S. lenders.

b. Foreign currency

The Board is moving former § 220.4(b)(8) of Regulation T, which permits a creditor to extend credit in a margin account denominated in any freely convertible foreign currency, to the general provisions section of the regulation (specifically, § 220.3(i)). This will make clear that creditors may also extend credit denominated in any freely convertible currency in the good faith account and the broker-dealer credit account.

2. Technical amendments

There were no negative comments on the first two technical amendments described below, which were proposed by the Board in April 1996. The third amendment is also technical in nature and was suggested by a commenter.

a. Definition of <u>covered option transaction</u>

The Board proposed to amend the definition of <u>covered option transaction</u> in § 220.2 of Regulation T to shorten the list of permissible options transactions in the cash account by referring to SRO rules generically. These rules were most recently amended in June of this year and the Board's action should result in a shorter and simpler Regulation T without having a substantive effect for broker-dealers. The Board is adopting the amendment as proposed.

[53/] <u>See</u> Section 220.1(b)(3)(i) of the revised Regulation T.

[54/] <u>See,</u> e.g., §§ 220.4(b)(9) and 220.12(b)(6) of the former Regulation T.

[55/] <u>See</u> Section 220.1(b)(3)(iv) of the revised Regulation T.

b. Definition of margin equity security

The Board proposed to add a definition of the term margin equity security, which appears in the Supplement to Regulation T. No adverse comments were received. The definition, which is being adopted as proposed, states that a margin equity security means a margin security (as defined in Regulation T) that is an equity security (as defined in section 3(a) of the '34 Act, whence definitions are incorporated into the Board's margin regulations if not otherwise defined by the Board).

c. Definition of current market value

Regulations G and U each contained a definition of the phrase “current market value” used to determine the loan value of margin securities. Regulation T did not contain a definition of current market value but addressed the same issue in former § 220.3(g), “Valuing securities.” One commenter noted that while Regulation T contains several references to a security's "current market value," it does not contain a definition of this term as do Regulations G and U. The Board is adding a definition of current market value to § 220.2 of Regulation T that is the equivalent of former § 220.3(g) and is deleting former § 220.3(g) from Regulation T. This action will have no substantive effect, but will make the structure of the Board's margin regulations more consistent.

3. Cash account: 90-day freeze

Customers who do not have sufficient funds in their cash account to pay for a security on trade date must agree to pay for the security before selling it. According to § 220.8(c)(1) of Regulation T, if a nonexempted security "is sold or delivered to another broker or dealer without having been previously paid for in full by the customer, the privilege of delaying payment beyond the trade date shall be withdrawn for 90 calendar days." This is known as a "90-day freeze." However, § 220.8(c)(2) says the freeze "shall not apply" if full payment is received within the required payment period and the proceeds from the sale are not withdrawn before payment is received. In response to requests for clarification from commenters, the Board is of the view that when a customer sells or delivers out securities that have not been paid for, the 90-day freeze contained in § 220.8(c) of Regulation T need not be applied until the permissible payment period has passed.

4. Board interpretations

The Board is reviewing its interpretations of Regulation T as part of its periodic review. In 1996, the Board deleted eleven interpretations that had either been incorporated directly into the regulation or had become moot due to subsequent amendments. As discussed above in section II.B.3, the Board is deleting an additional interpretation today that prevented the use of options as margin for short sales of the underlying security and prevented the use of the bona fide arbitrage provision for transactions involving options and their underlying securities.

In an advance notice of proposed rulemaking published elsewhere in today's Federal Register, the Board is also specifically soliciting comment on whether it should propose amendments to incorporate and broaden two additional interpretations: a 1962 interpretation[56/]

[56/] 12 CFR 220.119, reprinted in the FRRS at 5-490.

regarding the retirement of stock by an issuer and a 1990 interpretation[57/] regarding the application of the arranging provision[58/] to broker-dealer activities under SEC Rule 144A.

III. Regulations G and U

A. Loan Value

1. Over-the-counter stocks

Prior to the adoption of today's amendments, all of the Board's securities credit regulations permitted 50 percent loan value for: (1) stocks traded on a national securities exchange, (2) stocks in the National Market tier of the Nasdaq Stock Market ("NMS" securities), and (3) stocks in the Small Capitalization ("SmallCap" securities) tier of the Nasdaq Stock Market that are identified by the Board as "OTC margin stocks."

In its request for comment issued last year, the Board noted that although the definition and treatment of domestic margin stocks is currently the same in Regulations G, T and U, nonmargin stocks are treated differently at broker-dealers (where they have no loan value) than at banks and other lenders (where the Board's margin rules do not limit their value). In light of the disparate treatment of nonmargin stock at broker-dealers versus other lenders, the Board sought comment on the appropriate definition of margin stock under Regulations G and U and on possible solutions to the current structure of its margin regulations. This structure results in an increase in burden for lenders other than broker-dealers whenever burden is reduced for broker-dealers if the definition of margin stock in Regulations G and U is expanded whenever the definition of margin security is expanded in Regulation T. The Board suggested its regulations might be amended to cover more securities for broker-dealers and fewer securities for banks and other lenders.

Although three commenters argued for uniform coverage of equity securities under the Board's margin regulations, most commenters opposed increasing the coverage of Regulations G and U if Regulation T is amended to permit broker-dealers to extend credit against more securities. Because banks and other lenders already have experience in valuing smaller issues, the Board believes that definition of margin stock in Regulation U (which incorporates Regulation G) can be amended to exclude stocks trading in the SmallCap tier of the Nasdaq Stock Market.[59/] The Board's quarterly OTC List will no longer be required for banks and other nonbroker lenders because the Board will no longer choose which Nasdaq stocks qualify as a margin stock for purposes of Regulation U. These lenders can determine whether an OTC stock is in Nasdaq's

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[57/] 12 CFR 220.131, reprinted in the FRRS at 5-470.1.

[58/] As proposed in 1996, the Board is moving the arranging provision from former § 220.13 of Regulation T to the general provisions found in § 220.3.

[59/] Approximately 442 SmallCap issues qualify as "OTC margin stock" under the Board's criteria formerly found in § 221.7 of Regulation U. If today's amendments were adopted with an immediate effective date, these stocks would no longer be subject to a 50 percent loan value limitation when used as collateral for purpose loans. The number of stocks that will actually be affected when the new regulation goes into effect is likely to be somewhat smaller once the new Nasdaq listing requirements are fully phased in.

National Market tier by consulting a newspaper, contacting the NASD or SEC, or checking the NASD's web site at http://www.nasdaq.com. The Board is therefore deleting the requirements for inclusion on the OTC List formerly found in § 221.7 of Regulation U, the definition of OTC margin stock in § 221.2 of Regulation U, and the provision concerning "lack of notice of NMS security designation" formerly found in § 221.3(j) of Regulation U.

2. Options

Options, whether traded on an exchange (also known as listed options) or over-the-counter (also known as unlisted options), have traditionally had no loan value under the Board's margin regulations.[60] In 1995, the Board proposed giving listed options 50 percent loan value at broker-dealers (under Regulation T) and banks (under Regulation U).[61] Based on comments received in connection with the proposed amendments to Regulation T, the Board decided in 1996 to incorporate rules of the options exchanges (also known as self-regulatory organizations or SROs) regarding options loan value into Regulation T instead of the 50 percent requirement it had proposed. At the same time, the Board proposed to amend Regulations G and U to allow these lenders to extend credit against listed options to the extent permitted by the rules of the options exchanges. The Board sought comment on the practicality of requiring banks and others to comply with rules of SROs of which they are not members.[62] Five commenters supported uniform margin requirements for all lenders, while four other commenters opposed making lenders who are not broker-dealers, and therefore not members of a securities SRO, comply with SRO rules. The SRO margin rules for options are complex and the Board does not believe it is practical to require banks to comply with the rules of national securities exchanges of which they are not members, nor to expect bank examiners to be familiar with these rules in verifying compliance with Regulation U. The Board is therefore adopting the original 1995 Regulation U proposal and amending the Supplement to Regulation U to allow lenders other than broker-dealers to extend 50 percent loan value against listed options. Unlisted options continue to have no loan value when used as part of a mixed-collateral loan. However, banks and other lenders can extend credit against unlisted options if the loan is not subject to Regulation U. The Board is

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[60] Listed options were the only securities denied loan value by the Board under all of its securities credit regulations, in spite of the fact that they qualify as margin stock because they are listed on a national securities exchange. Although unlisted options do not qualify as margin stock and most nonmargin stock has good faith loan value under Regulation U, unlisted options have no loan value if the loan is a purpose credit secured at least in part by margin stock. Of course, Regulations G and U by their terms would not cover a loan that was solely secured by an unlisted option.

[61] The Regulation T proposal for broker-dealers was part of Docket No. R-0772 and appeared at 60 FR 33763 (June 29, 1995). The Regulation U proposal for banks was part of Docket No. R-0905 and appeared at 60 FR 63660 (December 12, 1995).

[62] The final action on Regulation T and revised proposal for Regulations G and U appeared at 61 FR 20385 (May 6, 1996).

requesting comment on the future status of unlisted options under Regulation U in an advance notice of proposed rulemaking published elsewhere in today's Federal Register.

3. Money market mutual funds

Although Regulation U treats most mutual funds as margin stock subject to 50 percent loan value, it has always allowed good faith loan value for mutual funds whose portfolios consist of exempted securities.[63] In 1995, the Board proposed to extend this treatment to all money market mutual funds under both Regulations T and U. All responsive commenters supported this proposal, which was adopted for Regulation T purposes in 1996. The Board is therefore amending the definition of margin stock in Regulation U to exclude money market mutual funds. This will have the effect of permitting good faith loan value for these securities when they are used as collateral for a purpose loan that is secured in part by margin stock.[64]

B. Financing of Securities Purchased on a DVP Basis

Banks may act as custodians for their customers' securities. These securities are often purchased at registered broker-dealers and delivered to the bank on a delivery-versus-payment (DVP) basis. In the late 1980s and early 1990s, Federal Reserve System examiners and staff of the SEC alleged that certain banks were accepting the delivery of customer margin securities without having the customer's full payment on hand, thereby extending purpose credit in excess of the Regulation U margin requirements. In many cases, payment for the customer's purchase was made in reliance on the proceeds of the sale of the same security.[65]

The purchase and same-day sale of a security without independent funds to pay for the purchase is prohibited at a broker-dealer if effected in a cash account (where it is known as "free-riding"), because the customer is obtaining intraday credit from the broker-dealer to pay for the security so it can own the security in order to sell it. This practice, however, is not prohibited at a broker-dealer if effected in a margin account, because the broker-dealer has entered into a credit relationship with the customer before extending credit to cover the purchase. In order to allow banks to extend credit in a manner similar to broker-dealers using a margin account, the Board proposed to amend the existing provision in § 221.3(c) of Regulation U for revolving credit agreements to include such credit. The Board stated its belief that applying the revolving credit provision would ensure that banks financing customer securities transactions establish credit limits for their customers, including limits on intraday trading.

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[63] Section 221.2 of Regulation U excludes from the definition of "margin stock" any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 "which has at least 95 percent of its assets continuously invested in exempted securities."

[64] Regulation T was amended last year to provide similar treatment for money market mutual funds. The Board is using the same definition used at that time, i.e., a security issued by a registered investment company that is considered a money market fund under SEC Rule 2a-7 (17 CFR 270.2a-7, "Money market funds").

[65] In response to banks who argued that they were relying on the sale proceeds of the unpaid-for security, Board staff opined that reliance on sale proceeds is tantamount to reliance on the security itself.

Ten commenters, including five Reserve Banks, supported the Board's proposal. Two bank trade associations opposed the proposal. The trade associations made similar arguments. Each acknowledged that in providing custodial services banks sometimes extend credit to pay for customer securities and this credit may be intraday or extend for a longer period of time. The trade associations stated that this credit is extended by a bank in its own discretion and not pursuant to an agreement with their customer. The trade associations stated banks do not have written agreements with their customers because they do not want to be required to extend this type of credit. The trade associations stated that custodial banks generally have a lien only on the assets in a customer's account, and they believed it would be inconsistent for a bank to demand that a customer post additional assets to cover overdraft extensions of credit. The trade associations were also concerned that the Board's proposal might be seen as superseding staff opinions in this area permitting some overdrafts when banks carefully monitor their customer's transactions.

As an alternative to the Board's proposal to cover extensions of credit used to finance a customer's purchase of securities on a DVP basis under the provision for revolving lines of credit, the trade associations suggested exempting these transactions by amending § 221.6(f) of Regulation U. Section 221.6(f) provides that a bank may extend and maintain purpose credit without regard to the requirements of Regulation U if the credit is to "temporarily finance the purchase or sale of securities for prompt delivery, if the credit is to be repaid in the ordinary course of business upon completion of the transaction." The Board proposed to amend this section to restore language inadvertently deleted in 1983 that makes clear the exception cannot be used to finance the purchase of securities at a broker-dealer (see, e.g. staff opinions at FRRS 5-884.68 and 5-942.2). The trade associations suggested that if the Board's primary concern in this area is preventing banks from aiding and abetting free-riding violations by their customers, § 221.6(f) of Regulation U should be amended not by restating that it cannot be used to finance transactions effected at a broker-dealer, but by stating that the exception is not available if the bank "knowingly" relies on the proceeds of a security's sale as a source of payment for the security.

The Board is amending the revolving credit agreement provision in § 221.3(c)(2)(iii)(B) of Regulation U as proposed to require a lender to call for additional collateral when the lender is relying on margin stock which is insufficient to cover an extension of purpose credit. This will clarify that a lender who has an agreement with its customer covering credit extended in connection with custodial or clearing services is properly secured or truly unsecured and should therefore be free from allegations of aiding and abetting customer free-riding violations. The Board is also readopting the language inadvertently dropped from § 221.6(f) of Regulation U, as proposed. The exemption in § 221.6(f) of Regulation U has never been available to cover the same-day purchase and sale of a security bought in a cash account at a broker-dealer, and the restoration of the former language will eliminate any ambiguity. Finally, the Board notes that its action is not intended to supersede the staff opinions in this area.

In the advance notice of proposed rulemaking published elsewhere in today's Federal Register, the Board is soliciting comment on proposals to address the supervisory and credit implications of free-riding.

C. Mixed Collateral Loans

Regulation U does not apply to extensions of securities credit that are not secured at least in part by margin stock. Purpose loans secured in part by margin stock and in part by other collateral are known as "mixed-collateral" loans and Regulation U has always required some kind of separation for these types of loans.[66/] Section 221.3(e) of Regulation U provided that mixed collateral loans "shall be treated as two separate loans." This was intended to prevent a bank from inflating the value of nonmargin stock collateral to make up for the 50 percent limitation for purpose loans secured by margin stock.

The provision for mixed collateral loans did not present a problem when applied at the time the loan commitment is made, as it merely required a bank to determine the loan value of margin stock collateral and then verify that the other collateral has a good faith loan value sufficient to make up the difference between the loan value of the margin stock and the amount of credit being extended and allocate the credit secured by each tranche.

The Board has received a number of inquiries about the interplay of the provision for mixed-collateral loans and § 221.3(f) of Regulation U, which covers withdrawals and substitution of collateral. For example, if the value of a customer's nonmargin stock collateral has increased since a mixed collateral loan was made, but the value of the margin stock has stayed the same, the customer cannot withdraw margin stock even though the overall value of the collateral has increased, because the "separate" loan secured by margin stock does not have excess value that would permit its withdrawal. In other words, changes in collateral value in one tranche have no effect on the other.

Noting that the separation requirement for mixed collateral loans makes collateral management extremely difficult, the Board proposed to modify the provision on mixed-collateral loans so that instead of separating margin stock from all other collateral, a bank would separate margin stock and other financial instruments such as nonmargin stock, bonds, and cash equivalents. This collateral would secure one loan and nonfinancial instruments (such as real estate), if any, would be treated as securing a "separate" loan. The Board noted that financial instruments generally have readily available prices and are therefore less susceptible to being assigned an inflated value to offset the 50 percent loan value limitation for margin stock. The Board also invited comment on the continuing need for separation of financial and nonfinancial collateral.

Ten commenters supported the Board's proposal and no commenter expressed a preference for maintaining the status quo. One commenter suggested providing additional flexibility by amending the regulation to provide that margin stock and other financial instruments may be treated as a single loan. Three commenters supported complete elimination of any separation requirements.

The Board is deleting the mixed collateral loan provision in former § 221.3(e) of Regulation U. Banks will still be required to make a good faith determination that nonmargin stock collateral, if any, has sufficient good faith loan value to make up the difference between the regulatory loan value of margin stock and the amount of credit extended for a purpose loan. Although nonfinancial instruments are often more difficult to value than securities, the Board believes the requirement of good faith on the part of the lender is sufficient to guard against

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[66/] The mixed-collateral loan provision does not apply to nonpurpose loans.

circumvention of the Board's margin requirements for equity securities. With the elimination of the requirement to separate purpose loans secured by margin stock from other purpose loans will allow a bank to release any type of collateral if the overall loan value of the pool of collateral is greater that the amount required under Regulation U.

IV. Regulation X

Regulation X (“Borrowers of securities credit”) applies the Board's margin regulations to United States persons and related parties who obtain credit outside the United States to purchase or carry United States securities. Borrowers must conform the credit they receive with one of the Board's other margin regulations, according to the lender involved. The regulation also applies to borrowers who obtain credit within the United States to purchase or carry any security if the borrower willfully causes the credit to be extended in contravention of the Board's other margin regulations. Both of these provisions refer to Regulation G. The Board is amending Regulation X to remove the references to Regulation G. Borrowers obtaining credit outside the United States who were formerly required to conform their credit to Regulation G will now be required to conform their credit to Regulation U as it applies to nonbank lenders.

Regulatory Flexibility Act

The amendments being adopted are intended two accomplish two goals. As discussed in the preamble, some of the amendments have been developed to implement the National Securities Markets Improvement Act (Pub. L. 104-290), which reduced the scope of the Board’s statutory authority for margin regulation. The others are intended to simplify regulatory requirements and eliminate restrictions currently imposed on broker-dealers, other lenders of securities credit, and their customers. For example, smaller companies whose stock is listed on Nasdaq’s Small Capitalization market will no longer be subject to Regulation G registration and reporting requirements if they extend credit to employees secured by company stock. The Board believes the amendments will not have a substantial adverse effect on a significant number of small lenders.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the rule under the authority delegated to the Board by the Office of Management and Budget. The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, an information collection unless it displays a currently valid OMB control number. The OMB control numbers are listed below.

The collections of information that may be affected by this rulemaking are found in 12 CFR 207 and 12 CFR 221. These information collections are mandatory (15 U.S.C. §§78g and 78w). The respondents and recordkeepers are for-profit financial institutions, including banks and nonbank lenders. The Federal Reserve collects the information in order to identify lenders subject to Regulation G, to verify compliance with Regulation G, and to monitor the size of the market for margin credit. The purpose statements collect information on the amount and purpose of the loans secured by margin stock. The burden associated with the FR U-1 and the FR G-3 is recordkeeping burden. Because the records would be maintained by respondents and are not provided to the Federal Reserve, no issue of confidentiality under the Freedom of Information Act arises. The FR G-2 does not contain confidential information. The information in the FR G-1 and the FR G-4 are given confidential treatment under the Freedom of Information Act (5 U.S.C. §552 (b)(4)).

In a separate document published elsewhere in today's Federal Register, the Board is soliciting comment on the disposition of certain reporting forms currently used by Regulation G lenders, the FR G-1, FR G-2, and FR G-4, and on further amendments to Regulation U that would affect the margin credit "purpose statements," the FR G-3 and the FR U-1. Accordingly, until the Board has collected and analyzed such comments as may be forthcoming, it will extend for three years, without revision, under delegated authority by the Office of Management and Budget, the following collections of information: FR G-1 (OMB No. 7100-0011), FR G-2 (OMB No. 7100-0011), FR G-3 (OMB No. 7100-0018), FR G-4 (OMB No. 7100-0011), and FR U-1 (OMB No. 7100-0115). The Board anticipates that these information collections will be revised before the full three-year period has ended.

In proposed amendments issued for comment by the Board in December 1995 (Docket R-0905), April 1996 (Docket R-0923), and November 1996 (Docket R-0944), no comments specifically addressing the burden estimates for these information collections were received.

The estimated annual burden for these information collections is summarized in the table below.

	estimated number of respondents	*annual frequency*	*estimated average hours per response*	*estimated annual burden hours*
FR G-1	81	1	2.50	203
FR G-2	68	1	0.25	17
FR G-3	700	20	0.16	2,240
FR G-4	629	1	2.00	1,258
FR U-1	10,637	212	0.07	157,853
total				161,571

The Federal Reserve has a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20551; and to the Office of Management and Budget, Paperwork Reduction Projects (7100-0011, 7100-0018, and 7100-0115), Washington, DC 20503.

List of Subjects:

12 CFR Part 207

Banks, banking, Credit, Federal Reserve System, Reporting and recordkeeping requirements, Securities.

12 CFR Part 220

Banks, banking, Brokers, Credit, Federal Reserve System, Reporting and recordkeeping requirements, Securities.

12 CFR Part 221

Banks, banking, Brokers, Credit, Federal Reserve System, Reporting and recordkeeping requirements, Securities.

12 CFR Part 224

Banks, banking, Brokers, Credit, Federal Reserve System, Reporting and recordkeeping requirements, Securities.

12 CFR Part 265

Authority delegations (Government agencies), Banks, banking, Federal Reserve System.

For the reasons set out in the preamble, 12 CFR parts 207, 220, 221, 224, and 265 are amended as follows:

PART 207 -- SECURITIES CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS (REGULATION G)

1. The authority citation for part 207 continues to read as follows:

Authority: 12 U.S.C. 78c, 78g, 78q, and 78w.

PART 207 -- SECURITIES CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS (REGULATION G) [REMOVED]

2. Part 207 is removed.

PART 220 -- CREDIT BY BROKERS AND DEALERS (REGULATION T)

1. The authority citation for Part 220 continues to read as follows:

Authority: 15 U.S.C. 78c, 78g, 78q, and 78w.

2. Sections 220.1 through 220.12 are revised to read as follows:

PART 220--CREDIT BY BROKERS AND DEALERS (REGULATION T)

§ 220.1 Authority, purpose, and scope.

(a) Authority and purpose. Regulation T (this part) is issued by the Board of Governors of the Federal Reserve System (the Board) pursuant to the Securities Exchange Act of 1934 (the Act) (15 U.S.C.78a et seq.). Its principal purpose is to regulate extensions of credit by brokers and dealers; it also covers related transactions within the Board's authority under the Act. It imposes, among other obligations, initial margin requirements and payment rules on certain securities transactions.

(b) Scope. (1) This part provides a margin account and four special purpose accounts in which to record all financial relations between a customer and a creditor. Any transaction not specifically permitted in a special purpose account shall be recorded in a margin account.

(2) This part does not preclude any exchange, national securities association, or creditor from imposing additional requirements or taking action for its own protection.

(3) This part does not apply to:

(i) Financial relations between a customer and a creditor to the extent that they comply with a portfolio margining system under rules approved or amended by the SEC;

(ii) Credit extended by a creditor based on a good faith determination that the borrower is an exempted borrower,

(iii) Financial relations between a customer and a broker or dealer registered only under section 15C of the Act; and

(iv) Financial relations between a foreign branch of a creditor and a foreign person involving foreign securities.

§ 220.2 Definitions.

The terms used in this part have the meanings given them in section 3(a) of the Act or as defined in this section.

Affiliated corporation means a corporation of which all the common stock is owned directly or indirectly by the firm or general partners and employees of the firm, or by the corporation or holders of the controlling stock and employees of the corporation, and the affiliation has been approved by the creditor's examining authority.

Cash equivalent means securities issued or guaranteed by the United States or its agencies, negotiable bank certificates of deposit, bankers acceptances issued by banking institutions in the United States and payable in the United States, or money market mutual funds.

Covered option transaction means any transaction involving options or warrants in which the customer's risk is limited and all elements of the transaction are subject to contemporaneous exercise if:

(1) The amount at risk is held in the account in cash, cash equivalents, or via an escrow receipt; and

(2) The transaction is eligible for the cash account by the rules of the registered national securities exchange authorized to trade the option or warrant or by the rules of the creditor's examining authority in the case of an unregistered option, provided that all such rules have been approved or amended by the SEC.

Credit balance means the cash amount due the customer in a margin account after debiting amounts transferred to the special memorandum account.

Creditor means any broker or dealer (as defined in sections 3(a)(4) and 3(a)(5) of the Act), any member of a national securities exchange, or any person associated with a broker or dealer (as defined in section 3(a)(18) of the Act), except for business entities controlling or under common control with the creditor.

Current market value of:

(1) A security means:

(i) Throughout the day of the purchase or sale of a security, the security's total cost of purchase or the net proceeds of its sale including any commissions charged; or

(ii) At any other time, the closing sale price of the security on the preceding business day, as shown by any regularly published reporting or quotation service. If there is no closing sale price, the creditor may use any reasonable estimate of the market value of the security as of the close of business on the preceding business day.

(2) Any other collateral means a value determined by any reasonable method.

Customer excludes an exempted borrower and includes:

(1) Any person or persons acting jointly:

(i) To or for whom a creditor extends, arranges, or maintains any credit; or

(ii) Who would be considered a customer of the creditor according to the ordinary usage of the trade.

(2) Any partner in a firm who would be considered a customer of the firm absent the partnership relationship; and

(3) Any joint venture in which a creditor participates and which would be considered a customer of the creditor if the creditor were not a participant.

Debit balance means the cash amount owed to the creditor in a margin account after debiting amounts transferred to the special memorandum account.

Delivery against payment, Payment against delivery, or a C.O.D. transaction refers to an arrangement under which a creditor and a customer agree that the creditor will deliver to, or accept from, the customer, or the customer's agent, a security against full payment of the purchase price.

Equity means the total current market value of security positions held in the margin account plus any credit balance less the debit balance in the margin account.

Escrow agreement means any agreement issued in connection with a call or put option under which a bank or any person designated as a control location under paragraph (c) of SEC Rule 15c3-3 (17 CFR 240.15c3-3(c)), holding the underlying asset or required cash or cash equivalents, is obligated to deliver to the creditor (in the case of a call option) or accept from the creditor (in the case of a put option) the underlying asset or required cash or cash equivalent against payment of the exercise price upon exercise of the call or put.

Examining authority means:

(1) The national securities exchange or national securities association of which a creditor is a member; or

(2) If a member of more than one self-regulatory organization, the organization designated by the SEC as the examining authority for the creditor.

Exempted borrower means a member of a national securities exchange or a registered broker or dealer, a substantial portion of whose business consists of transactions with persons other than brokers or dealers, and includes a borrower who:

(1) Maintains at least 1000 active accounts on an annual basis for persons other than brokers, dealers, and persons associated with a broker or dealer;

(2) Earns at least $10 million in gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer; or

(3) Earns at least 10 percent of its gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer.

Exempted securities mutual fund means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), provided the company has at least 95 percent of its assets continuously invested in exempted securities (as defined in section 3(a)(12) of the Act).

Foreign margin stock means a foreign security that is an equity security that:

(1) Appears on the Board's periodically published List of Foreign Margin Stocks; or

(2) Is deemed to have a "ready market" under SEC Rule 15c3-1 (17 CFR 240.15c3-3) or a "no-action" position issued thereunder.

Foreign person means a person other than a United States person as defined in section 7(f) of the Act.

Foreign security means a security issued in a jurisdiction other than the United States.

Good faith with respect to:

(1) Margin means the amount of margin which a creditor would require in exercising sound credit judgment;

(2) Making a determination or accepting a statement concerning a borrower means that the creditor is alert to the circumstances surrounding the credit, and if in possession of information that would cause a prudent person not to make the determination or accept the notice or certification without inquiry, investigates and is satisfied that it is correct.

Margin call means a demand by a creditor to a customer for a deposit of additional cash or securities to eliminate or reduce a margin deficiency as required under this part.

Margin deficiency means the amount by which the required margin exceeds the equity in the margin account.

Margin equity security means a margin security that is an equity security (as defined in section 3(a)(11) of the Act).

Margin excess means the amount by which the equity in the margin account exceeds the required margin. When the margin excess is represented by securities, the current value of the securities is subject to the percentages set forth in § 220.12 (the Supplement).

Margin security means:

(1) Any security registered or having unlisted trading privileges on a national securities exchange;

(2) After January 1, 1999, any security listed on the Nasdaq Stock Market;

(3) Any non-equity security;

(4) Any security issued by either an open-end investment company or unit investment trust which is registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8);

(5) Any foreign margin stock;

(6) Any debt security convertible into a margin security;

(7) Until January 1, 1999, any OTC margin stock; or

(8) Until January 1, 1999, any OTC security designated as qualified for trading in the national market system under a designation plan approved by the Securities and Exchange Commission (NMS security).

Money market mutual fund means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8) that is considered a money market fund under SEC Rule 2a--7 (17 CFR 270.2a-7).

Non-equity security means a security that is not an equity security (as defined in section 3(a)(11) of the Act).

Nonexempted security means any security other than an exempted security (as defined in section 3(a)(12) of the Act).

OTC margin stock means any equity security traded over the counter that the Board has determined has the degree of national investor interest, the depth and breadth of market, the availability of information respecting the security and its issuer, and the character and permanence of the issuer to warrant being treated like an equity security treaded on a national securities exchange. An OTC stock is not considered to be an OTC margin stock unless it appears on the Board's periodically published list of OTC margin stocks.

Payment period means the number of business days in the standard securities settlement cycle in the United States, as defined in paragraph (a) of SEC Rule 15c6-1 (17 CFR 240.15c6-1(a)), plus two business days.

Purpose credit means credit for the purpose of:

(1) Buying, carrying, or trading in securities; or

(2) Buying or carrying any part of an investment contract security which shall be deemed credit for the purpose of buying or carrying the entire security.

Short call or short put means a call option or a put option that is issued, endorsed, or guaranteed in or for an account.

(1) A short call that is not cash-settled obligates the customer to sell the underlying asset at the exercise price upon receipt of a valid exercise notice or as otherwise required by the option contract.

(2) A short put that is not cash-settled obligates the customer to purchase the underlying asset at the exercise price upon receipt of a valid exercise notice or as otherwise required by the option contract.

(3) A short call or a short put that is cash-settled obligates the customer to pay the holder of an in the money long put or long call who has, or has been deemed to have, exercised the option the cash difference between the exercise price and the current assigned value of the option as established by the option contract.

Underlying asset means:

(1) The security or other asset that will be delivered upon exercise of an option; or

(2) In the case of a cash-settled option, the securities or other assets which comprise the index or other measure from which the option's value is derived.

§ 220.3 General provisions.

(a) Records. The creditor shall maintain a record for each account showing the full details of all transactions.

(b) Separation of accounts. (1) In general. The requirements of one account may not be met by considering items in any other account. If withdrawals of cash or securities are permitted under this part, written entries shall be made when cash or securities are used for purposes of meeting requirements in another account.

(2) Exceptions. Notwithstanding paragraph (b)(1) of this section:

(i) For purposes of calculating the required margin for a security in a margin account, assets held in the good faith account pursuant to § 220.6(e)(1)(i) or (ii) may serve in lieu of margin;

(ii) Transfers may be effected between the margin account and the special memorandum account pursuant to §§ 220.4 and 220.5.

(c) Maintenance of credit. Except as prohibited by this part, any credit initially extended in compliance with this part may be maintained regardless of:

(1) Reductions in the customer's equity resulting from changes in market prices;

(2) Any security in an account ceasing to be margin or exempted; or

(3) Any change in the margin requirements prescribed under this part.

(d) Guarantee of accounts. No guarantee of a customer's account shall be given any effect for purposes of this part.

(e) Receipt of funds or securities. (1) A creditor, acting in good faith, may accept as immediate payment:

(i) Cash or any check, draft, or order payable on presentation; or

(ii) Any security with sight draft attached.

(2) A creditor may treat a security, check or draft as received upon written notification from another creditor that the specified security, check, or draft has been sent.

(3) Upon notification that a check, draft, or order has been dishonored or when securities have not been received within a reasonable time, the creditor shall take the action required by this part when payment or securities are not received on time.

(4) To temporarily finance a customer's receipt of securities pursuant to an employee benefit plan registered on SEC Form S-8 or the withholding taxes for an employee stock award plan, a creditor may accept, in lieu of the securities, a properly executed exercise notice, where applicable, and instructions to the issuer to deliver the stock to the creditor. Prior to acceptance, the creditor must verify that the issuer will deliver the securities promptly and the customer must designate the account into which the securities are to be deposited.

(f) Exchange of securities. (1) To enable a customer to participate in an offer to exchange securities which is made to all holders of an issue of securities, a creditor may submit for exchange any securities held in a margin account, without regard to the other provisions of this part, provided the consideration received is deposited into the account.

(2) If a nonmargin, nonexempted security is acquired in exchange for a margin security, its retention, withdrawal, or sale within 60 days following its acquisition shall be treated as if the security is a margin security.

(g) Arranging for loans by others. A creditor may arrange for the extension or maintenance of credit to or for any customer by any person, provided the creditor does not willfully arrange credit that violates parts 221 or 224 of this chapter.

(h) Innocent mistakes. If any failure to comply with this part results from a mistake made in good faith in executing a transaction or calculating the amount of margin, the creditor shall not be deemed in violation of this part if, promptly after the discovery of the mistake, the creditor takes appropriate corrective action.

(i) Foreign currency. (1) Freely convertible foreign currency may be treated at its U.S. dollar equivalent, provided the currency is marked-to-market daily.

(2) A creditor may extend credit denominated in any freely convertible foreign currency.

(j) Exempted borrowers. (1) A member of a national securities exchange or a registered broker or dealer that has been in existence for less than one year may meet the definition of exempted borrower based on a six-month period.

(2) Once a member of a national securities exchange or registered broker or dealer ceases to qualify as an exempted borrower, it shall notify its lender of this fact before obtaining additional

credit. Any new extensions of credit to such a borrower, including rollovers, renewals, and additional draws on existing lines of credit, are subject to the provisions of this part.

§ 220.4 Margin account.

(a) Margin transactions. (1) All transactions not specifically authorized for inclusion in another account shall be recorded in the margin account.

(2) A creditor may establish separate margin accounts for the same person to:

(i) Clear transactions for other creditors where the transactions are introduced to the clearing creditor by separate creditors; or

(ii) Clear transactions through other creditors if the transactions are cleared by separate creditors; or

(iii) Provide one or more accounts over which the creditor or a third party investment adviser has investment discretion.

(b) Required margin. (1) Applicability. The required margin for each long or short position in securities is set forth in § 220.12 (the Supplement) and is subject to the following exceptions and special provisions.

(2) Short sale against the box. A short sale "against the box" shall be treated as a long sale for the purpose of computing the equity and the required margin.

(3) When-issued securities. The required margin on a net long or net short commitment in a when-issued security is the margin that would be required if the security were an issued margin security, plus any unrealized loss on the commitment or less any unrealized gain.

(4) Stock used as cover. (i) When a short position held in the account serves in lieu of the required margin for a short put, the amount prescribed by paragraph (b)(1) of this section as the amount to be added to the required margin in respect of short sales shall be increased by any unrealized loss on the position.

(ii) When a security held in the account serves in lieu of the required margin for a short call, the security shall be valued at no greater than the exercise price of the short call.

(5) Accounts of partners. If a partner of the creditor has a margin account with the creditor, the creditor shall disregard the partner's financial relations with the firm (as shown in the partner's capital and ordinary drawing accounts) in calculating the margin or equity of the partner's margin account.

(6) Contribution to joint venture. If a margin account is the account of a joint venture in which the creditor participates, any interest of the creditor in the joint account in excess of the interest which the creditor would have on the basis of its right to share in the profits shall be treated as an extension of credit to the joint account and shall be margined as such.

(7) Transfer of accounts. (i) A margin account that is transferred from one creditor to another may be treated as if it had been maintained by the transferee from the date of its origin, if the transferee accepts, in good faith, a signed statement of the transferor (or, if that is not practicable, of the customer), that any margin call issued under this part has been satisfied.

(ii) A margin account that is transferred from one customer to another as part of a transaction, not undertaken to avoid the requirements of this part, may be treated as if it had been maintained for the transferee from the date of its origin, if the creditor accepts in good faith and keeps with the transferee account a signed statement of the transferor describing the circumstances for the transfer.

(8) Sound credit judgment. In exercising sound credit judgment to determine the margin required in good faith pursuant to § 220.12 (the Supplement), the creditor shall make its determination for a specified security position without regard to the customer's other assets or securities positions held in connection with unrelated transactions.

(c) When additional margin is required. (1) Computing deficiency. All transactions on the same day shall be combined to determine whether additional margin is required by the creditor. For the purpose of computing equity in an account, security positions are established or eliminated and a credit or debit created on the trade date of a security transaction. Additional margin is required on any day when the day's transactions create or increase a margin deficiency in the account and shall be for the amount of the margin deficiency so created or increased.

(2) Satisfaction of deficiency. The additional required margin may be satisfied by a transfer from the special memorandum account or by a deposit of cash, margin securities, exempted securities, or any combination thereof.

(3) Time limits. (i) A margin call shall be satisfied within one payment period after the margin deficiency was created or increased.

(ii) The payment period may be extended for one or more limited periods upon application by the creditor to its examining authority unless the examining authority believes that the creditor is not acting in good faith or that the creditor has not sufficiently determined that exceptional circumstances warrant such action. Applications shall be filed and acted upon prior to the end of the payment period or the expiration of any subsequent extension.

(4) Satisfaction restriction. Any transaction, position, or deposit that is used to satisfy one requirement under this part shall be unavailable to satisfy any other requirement.

(d) Liquidation in lieu of deposit. If any margin call is not met in full within the required time, the creditor shall liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less. If the margin deficiency created or increased is $1000 or less, no action need be taken by the creditor.

(e) Withdrawals of cash or securities. (1) Cash or securities may be withdrawn from an account, except if:

(i) Additional cash or securities are required to be deposited into the account for a transaction on the same or a previous day; or

(ii) The withdrawal, together with other transactions, deposits, and withdrawals on the same day, would create or increase a margin deficiency.

(2) Margin excess may be withdrawn or may be transferred to the special memorandum account (§ 220.5) by making a single entry to that account which will represent a debit to the margin account and a credit to the special memorandum account.

(3) If a creditor does not receive a distribution of cash or securities which is payable with respect to any security in a margin account on the day it is payable and withdrawal would not be permitted under paragraph (e) of this section, a withdrawal transaction shall be deemed to have occurred on the day the distribution is payable.

(f) Interest, service charges, etc. (1) Without regard to the other provisions of this section, the creditor, in its usual practice, may debit the following items to a margin account if they are considered in calculating the balance of such account:

(i) Interest charged on credit maintained in the margin account;

(ii) Premiums on securities borrowed in connection with short sales or to effect delivery;

(iii) Dividends, interest, or other distributions due on borrowed securities;

(iv) Communication or shipping charges with respect to transactions in the margin account; and

(v) Any other service charges which the creditor may impose.

(2) A creditor may permit interest, dividends, or other distributions credited to a margin account to be withdrawn from the account if:

(i) The withdrawal does not create or increase a margin deficiency in the account; or

(ii) The current market value of any securities withdrawn does not exceed 10 percent of the current market value of the security with respect to which they were distributed.

§ 220.5 Special memorandum account.

(a) A special memorandum account (SMA) may be maintained in conjunction with a margin account. A single entry amount may be used to represent both a credit to the SMA and a debit to the margin account. A transfer between the two accounts may be effected by an increase or reduction in the entry. When computing the equity in a margin account, the single entry amount shall be considered as a debit in the margin account. A payment to the customer or on the customer's behalf or a transfer to any of the customer's other accounts from the SMA reduces the single entry amount.

(b) The SMA may contain the following entries:

(1) Dividend and interest payments;

(2) Cash not required by this part, including cash deposited to meet a maintenance margin call or to meet any requirement of a self-regulatory organization that is not imposed by this part;

(3) Proceeds of a sale of securities or cash no longer required on any expired or liquidated security position that may be withdrawn under § 220.4(e); and

(4) Margin excess transferred from the margin account under §220.4(e)(2).

§ 220.6 Good faith account.

In a good faith account, a creditor may effect or finance customer transactions in accordance with the following provisions:

(a) Securities entitled to good faith margin. (1) Permissible transactions. A creditor may effect and finance transactions involving the buying, carrying, or trading of any security entitled to “good faith” margin as set forth in § 220.12 (the Supplement).

(2) Required margin. The required margin is set forth in § 220.12 (the Supplement).

(3) Satisfaction of margin. Required margin may be satisfied by a transfer from the special memorandum account or by a deposit of cash, securities entitled to “good faith” margin as set forth in § 220.12 (the Supplement), any other asset that is not a security, or any combination thereof. An asset that is not a security shall be have a margin value determined by the creditor in good faith.

(b) Arbitrage. A creditor may effect and finance for any customer bona fide arbitrage transactions. For the purpose of this section, the term "bona fide arbitrage" means:

(1) A 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 as nearly the same time as practicable for the purpose of taking advantage of a difference in prices in the two markets; or

(2) A purchase of a security which is, without restriction other then the payment of money, exchangeable or convertible within 90 calendar days of the purchase into a second security together with an offsetting sale of the second security at or about the same time, for the purpose of taking advantage of a concurrent disparity in the prices of the two securities.

(c) "Prime broker" transactions. A creditor may effect transactions for a customer as part of a "prime broker" arrangement in conformity with SEC guidelines.

(d) Credit to ESOPs. A creditor may extend and maintain credit to employee stock ownership plans without regard to the other provisions of this part.

(e) Nonpurpose credit. (1) A creditor may:

(i) Effect and carry transactions in commodities;

(ii) Effect and carry transactions in foreign exchange;

(iii) Extend and maintain secured or unsecured nonpurpose credit, subject to the requirements of paragraph (e)(2) of this section.

(2) Every extension of credit, except as provided in paragraphs (e)(1)(i) and (e)(1)(ii) of this section, shall be deemed to be purpose credit unless, prior to extending the credit, the creditor accepts in good faith from the customer a written statement that it is not purpose credit. The statement shall conform to the requirements established by the Board.

§ 220.7 Broker-dealer credit account.

(a) Requirements. In a broker-dealer credit account, a creditor may effect or finance transactions in accordance with the following provisions.

(b) Purchase or sale of security against full payment. A creditor may purchase any security from or sell any security to another creditor or person regulated by a foreign securities authority under a good faith agreement to promptly deliver the security against full payment of the purchase price.

(c) Joint back office. A creditor may effect or finance transactions of any of its owners if the creditor is a clearing and servicing broker or dealer owned jointly or individually by other creditors.

(d) Capital contribution. A creditor may extend and maintain credit to any partner or stockholder of the creditor for the purpose of making a capital contribution to, or purchasing stock of, the creditor, affiliated corporation or another creditor.

(e) Emergency and subordinated credit. A creditor may extend and maintain, with the approval of the appropriate examining authority:

(1) Credit to meet the emergency needs of any creditor; or

(2) Subordinated credit to another creditor for capital purposes, if the other creditor:

(i) Is an affiliated corporation or would not be considered a customer of the lender apart from the subordinated loan; or

(ii) Will not use the proceeds of the loan to increase the amount of dealing in securities for the account of the creditor, its firm or corporation or an affiliated corporation.

(f) Omnibus credit (1) A creditor may effect and finance transactions for a broker or dealer who is registered with the SEC under section 15 of the Act and who gives the creditor written notice that:

(i) All securities will be for the account of customers of the broker or dealer; and

(ii) Any short sales effected will be short sales made on behalf of the customers of the broker or dealer other than partners.

(2) The written notice required by paragraph (f)(1) of this section shall conform to any SEC rule on the hypothecation of customers' securities by brokers or dealers.

(g) Special purpose credit. A creditor may extend the following types of credit with good faith margin:

(1) Credit to finance the purchase or sale of securities for prompt delivery, if the credit is to be repaid upon completion of the transaction.

(2) Credit to finance securities in transit or surrendered for transfer, if the credit is to be repaid upon completion of the transaction.

(3) Credit to enable a broker or dealer to pay for securities, if the credit is to be repaid on the same day it is extended.

(4) Credit to an exempted borrower.

§ 220.8 Cash account.

(a) Permissible transactions. In a cash account, a creditor, may:

(1) Buy for or sell to any customer any security or other asset if:

(i) There are sufficient funds in the account; or

(ii) The creditor accepts in good faith the customer's agreement that the customer will promptly make full cash payment for the security or asset before selling it and does not contemplate selling it prior to making such payment;

(2) Buy from or sell for any customer any security or other asset if:

(i) The security is held in the account; or

(ii) The creditor accepts in good faith the customer's statement that the security is owned by the customer or the customer's principal, and that it will be promptly deposited in the account;

(3) Issue, endorse, or guarantee, or sell an option for any customer as part of a covered option transaction; and

(4) Use an escrow agreement in lieu of the cash, cash equivalents or underlying asset position if:

(i) In the case of a short call or a short put, the creditor is advised by the customer that the required securities, assets or cash are held by a person authorized to issue an escrow agreement and the creditor independently verifies that the appropriate escrow agreement will be delivered by the person promptly; or

(ii) In the case of a call issued, endorsed, guaranteed, or sold on the same day the underlying asset is purchased in the account and the underlying asset is to be delivered to a person authorized to issue an escrow agreement, the creditor verifies that the appropriate escrow agreement will be delivered by the person promptly.

(b) Time periods for payment; cancellation or liquidation. (1) Full cash payment. A creditor shall obtain full cash payment for customer purchases:

(i) Within one payment period of the date:

(A) Any nonexempted security was purchased;

(B) Any when-issued security was made available by the issuer for delivery to purchasers;

(C) Any "when distributed" security was distributed under a published plan;

(D) A security owned by the customer has matured or has been redeemed and a new refunding security of the same issuer has been purchased by the customer, provided:

(1) The customer purchased the new security no more than 35 calendar days prior to the date of maturity or redemption of the old security;

(2) The customer is entitled to the proceeds of the redemption; and

(3) The delayed payment does not exceed 103 percent of the proceeds of the old security.

(ii) In the case of the purchase of a foreign security, within one payment period of the trade date or within one day after the date on which settlement is required to occur by the rules of the foreign securities market, provided this period does not exceed the maximum time permitted by this part for delivery against payment transactions.

(2) Delivery against payment. If a creditor purchases for or sells to a customer a security in a delivery against payment transaction, the creditor shall have up to 35 calendar days to obtain payment if delivery of the security is delayed due to the mechanics of the transaction and is not related to the customer's willingness or ability to pay.

(3) Shipment of securities, extension. If any shipment of securities is incidental to consummation of a transaction, a creditor may extend the payment period by the number of days required for shipment, but not by more than one additional payment period.

(4) Cancellation; liquidation; minimum amount. A creditor shall promptly cancel or otherwise liquidate a transaction or any part of a transaction for which the customer has not made full cash payment within the required time. A creditor may, at its option, disregard any sum due from the customer not exceeding $1000.

(c) 90 day freeze. (1) If a nonexempted security in the account is sold or delivered to another broker or dealer without having been previously paid for in full by the customer, the privilege of delaying payment beyond the trade date shall be withdrawn for 90 calendar days following the date of sale of the security. Cancellation of the transaction other than to correct an error shall constitute a sale.

(2) The 90 day freeze shall not apply if:

(i) Within the period specified in paragraph (b)(1) of this section, full payment is received or any check or draft in payment has cleared and the proceeds from the sale are not withdrawn prior to such payment or check clearance; or

(ii) The purchased security was delivered to another broker or dealer for deposit in a cash account which holds sufficient funds to pay for the security. The creditor may rely on a written statement accepted in good faith from the other broker or dealer that sufficient funds are held in the other cash account.

(d) Extension of time periods; transfers. (1) Unless the creditor's examining authority believes that the creditor is not acting in good faith or that the creditor has not sufficiently determined that exceptional circumstances warrant such action, it may upon application by the creditor:

(i) Extend any period specified in paragraph (b) of this section;

(ii)Authorize transfer to another account of any transaction involving the purchase of a margin or exempted security; or

(iii) Grant a waiver from the 90 day freeze.

(2) Applications shall be filed and acted upon prior to the end of the payment period, or in the case of the purchase of a foreign security within the period specified in paragraph (b)(1)(ii) of this section, or the expiration of any subsequent extension.

§ 220.9 Clearance of securities, options, and futures.

(a) Credit for clearance of securities. The provisions of this part shall not apply to the extension or maintenance of any credit that is not for more than one day if it is incidental to the clearance of transactions in securities directly between members of a national securities exchange or association or through any clearing agency registered with the SEC.

(b) Deposit of securities with a clearing agency. The provisions of this part shall not apply to the deposit of securities with an options or futures clearing agency for the purpose of meeting the deposit requirements of the agency if:

(1) The clearing agency:

(i) Issues, guarantees performance on, or clears transactions in, any security (including options on any security, certificate of deposit, securities index or foreign currency); or

(ii) Guarantees performance of contracts for the purchase or sale of a commodity for future delivery or options on such contracts;

(2) The clearing agency is registered with the Securities and Exchange Commission or is the clearing agency for a contract market regulated by the Commodity Futures Trading Commission; and

(3) The deposit consists of any margin security and complies with the rules of the clearing agency that have been approved by the Securities and Exchange Commission or the Commodity Futures Trading Commission.

§ 220.10 Borrowing and lending securities.

(a) Without regard to the other provisions of this part, a creditor may borrow or lend securities for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations. If a creditor reasonably anticipates a short sale or fail transaction, such borrowing may be made up to one standard settlement cycle in advance of trade date.

(b) A creditor may lend foreign securities to a foreign person (or borrow such securities for the purpose of relending them to a foreign person) for any purpose lawful in the country in which they are to be used.

(c) A creditor that is an exempted borrower may lend securities without regard to the other provisions of this part and a creditor may borrow securities from an exempted borrower without regard to the other provisions of this part..

§ 220.11 Requirements for the list of marginable OTC stocks and the list of foreign margin stocks.

(a) <u>Requirements for inclusion on the list of marginable OTC stocks</u>. Except as provided in paragraph (f) of this section, OTC margin stock shall meet the following requirements:

(1) Four or more dealers stand willing to, and do in fact, make a market in such stock and regularly submit bona fide bids and offers to an automated quotations system for their own accounts;

(2) The minimum average bid price of such stock, as determined by the Board, is at least $5 per share;

(3) The stock is registered under section 12 of the Act, is issued by an insurance company subject to section 12(g)(2)(G) of the Act, is issued by a closed-end investment management company subject to registration pursuant to section 8 of the Investment Company Act of 1940 (15

U.S.C. 80a-8), is an American Depository Receipt (ADR) of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of an issuer required to file reports under section 15(d) of the Act;

(4) Daily quotations for both bid and asked prices for the stock are continuously available to the general public;

(5) The stock has been publicly traded for at least six months;

(6) The issuer has at least $4 million of capital, surplus, and undivided profits;

(7) There are 400,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors or beneficial owners of more than 10 percent of the stock;

(8) There are 1,200 or more holders of record, as defined in SEC Rule 12g5-1 (17 CFR 240.12g5-1), of the stock who are not officers, directors or beneficial owners of 10 percent or more of the stock, or the average daily trading volume of such stock as determined by the Board, is at least 500 shares; and

(9) The issuer or a predecessor in interest has been in existence for at least three years.

(b) Requirements for continued inclusion on the list of marginable OTC stocks. Except as provided in paragraph (f) of this section, OTC margin stock shall meet the following requirements:

(1) Three or more dealers stand willing to, and do in fact, make a market in such stock and regularly submit bona fide bids and offers to an automated quotations system for their own accounts;

(2) The minimum average bid price of such stocks, as determined by the Board, is at least $2 per share;

(3) The stock is registered as specified in paragraph (a)(3) of this section;

(4) Daily quotations for both bid and asked prices for the stock are continuously available to the general public;

(5) The issuer has at least $1 million of capital, surplus, and undivided profits;

(6) There are 300,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors, or beneficial owners of more than 10 percent of the stock; and

(7) There continue to be 800 or more holders of record, as defined in SEC Rule 12g5-1 (17 CFR 240.12g5-1), of the stock who are not officers, directors, or beneficial owners of 10 percent or more of the stock, or the average daily trading volume of such stock, as determined by the Board, is at least 300 shares.

(c) Requirements for inclusion on the list of foreign margin stocks. Except as provided in paragraph (f) of this section, a foreign security shall meet the following requirements before being placed on the List of Foreign Margin Stocks:

(1) The security is an equity security that is listed for trading on or through the facilities of a foreign securities exchange or a recognized foreign securities market and has been trading on such exchange or market for at least six months;

(2) Daily quotations for both bid and asked or last sale prices for the security provided by the foreign securities exchange or foreign securities market on which the security is traded are continuously available to creditors in the United States pursuant to an electronic quotation system;

(3) The aggregate market value of shares, the ownership of which is unrestricted, is not less than $1 billion;

(4) The average weekly trading volume of such security during the preceding six months is either at least 200,000 shares or $1 million; and

(5) The issuer or a predecessor in interest has been in existence for at least five years.

(d) Requirements for continued inclusion on the list of foreign margin stocks. Except as provided in paragraph (f) of this section, a foreign security shall meet the following requirements to remain on the List of Foreign Margin Stocks:

(1) The security continues to meet the requirements specified in paragraphs (a) (1) and (2) of this section;

(2) The aggregate market value of shares, the ownership of which is unrestricted, is not less than $500 million; and

(3) The average weekly trading volume of such security during the preceding six months is either at least 100,000 shares or $500,000.

(e) Removal from the list. The Board shall periodically remove from the lists any stock that:

(1) Ceases to exist or of which the issuer ceases to exist; or

(2) No longer substantially meets the provisions of paragraphs (b) or (d) of this section or the definition of OTC margin stock.

(f) Discretionary authority of Board. Without regard to other paragraphs of this section, the Board may add to, or omit or remove from the list of marginable OTC stocks and the list of foreign margin stocks an equity security, if in the judgment of the Board, such action is necessary or appropriate in the public interest.

(g) Unlawful representations. It shall be unlawful for any creditor to make, or cause to be made, any representation to the effect that the inclusion of a security on the list of marginable OTC stocks or the list of foreign margin stocks is evidence that the Board or the SEC has in any way passed upon the merits of, or given approval to, such security or any transactions therein. Any statement in an advertisement or other similar communication containing a reference to the Board in connection with the lists or stocks on those lists shall be an unlawful representation.

§ 220.12 Supplement: Margin requirements.

The required margin for each security position held in a margin account shall be as follows:

(a) Margin equity security, except for an exempted security, money market mutual fund or exempted securities mutual fund, warrant on a securities index or foreign currency or a long position in an option: 50 percent of the current market value of the security or the percentage set by the regulatory authority where the trade occurs, whichever is greater.

(b) Exempted security, non-equity security, money market mutual fund or exempted securities mutual fund: The margin required by the creditor in good faith or the percentage set by the regulatory authority where the trade occurs, whichever is greater.

(c) Short sale of a nonexempted security, except for a non-equity security:

(1) 150 percent of the current market value of the security, or

(2) 100 percent of the current market value if a security exchangeable or convertible within 90 calendar days without restriction other than the payment of money into the security sold short is held in the account, provided that any long call to be used as margin in connection with a short sale of the underlying security is an American-style option issued by a registered clearing corporation and listed or traded on a registered national securities exchange with an exercise price that does not exceed the price at which the underlying security was sold short.

(d) Short sale of an exempted security or non-equity security: 100 percent of the current market value of the security plus the margin required by the creditor in good faith.

(e) Nonmargin, nonexempted equity security: 100 percent of the current market value.

(f) Put or call on a security, certificate of deposit, securities index or foreign currency or a warrant on a securities index or foreign currency:

(1) In the case of puts and calls issued by a registered clearing corporation and listed or traded on a registered national securities exchange or a registered securities association and registered warrants on a securities index or foreign currency, the amount, or other position , specified by the rules of the registered national securities exchange or the registered securities association authorized to trade the option or warrant, provided that all such rules have been approved or amended by the SEC; or

(2) In the case of all other puts and calls, the amount, or other position, specified by the maintenance rules of the creditor's examining authority.

§§ 220.13 - 220.18 [Removed]

3. Section 220.13 through 220.18 are removed.

§ 220.126 [Removed and Reserved]

4. Section 220.126 is removed.

PART 221 -- CREDIT BY BANKS AND PERSONS OTHER THAN BROKERS AND DEALERS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCKS (REGULATION U)

1. The authority citation for Part 221 continues to read as follows:
Authority: 15 U.S.C. 78c, 78g, 78q, and 78w.

2. Part 221 is revised to read as follows:

PART 221--CREDIT BY BANKS AND PERSONS OTHER THAN BROKERS OR DEALERS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCK (REGULATION U)

Sec.

INTERPRETATIONS

§ 221.1 Authority, purpose, and scope.

(a) Authority. Regulation U (this part) is issued by the Board of Governors of the Federal Reserve System (the Board) pursuant to the Securities Exchange Act of 1934 (the Act) (15 U.S.C. 78a et seq.).

(b) Purpose and scope. (1) This part imposes credit restrictions upon persons other than brokers or dealers (hereinafter lenders) that extend credit for the purpose of buying or carrying margin stock if the credit is secured directly or indirectly by margin stock. Lenders include "banks" (as defined in § 221.2 of this part) and other persons who are required to register with the Board under
§ 221.3(b). Lenders may not extend more than the maximum loan value of the collateral securing such credit, as set by the Board in § 221.7 (the Supplement).

(2) This part does not apply to clearing agencies regulated by the Securities and Exchange Commission or the Commodity Futures Trading Commission that accept deposits of margin stock in connection with:

(i) The issuance of, or guarantee of, or the clearance of transactions in, any security (including options on any security, certificate of deposit, securities index or foreign currency); or

(ii) The guarantee of contracts for the purchase or sale of a commodity for future delivery or options on such contracts.

(3) This part does not apply to credit extended to an exempted borrower.

§ 221.2 Definitions.

The terms used in this part have the meanings given them in section 3(a) of the Act or as defined in this section.

Affiliate means:

(1) For banks:

(i) Any bank holding company of which a bank is a subsidiary within the meaning of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(d));

(ii) Any other subsidiary of such bank holding company; and

(iii) Any other corporation, business trust, association, or other similar organization that is an affiliate as defined in section 2(b) of the Banking Act of 1933 (12 U.S.C. 221a(c));

(2) For nonbank lenders, affiliate means any person who, directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with the lender.

Bank (1) has the meaning given to it in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)) and includes:

(i) Any subsidiary of a bank;

(ii) Any corporation organized under section 25(a) of the Federal Reserve Act (12 U.S.C. 611); and

(iii) Any agency or branch of a foreign bank located within the United States.

(2) Bank does not include:

(i) Any savings and loan association,

(ii) Any credit union,

(iii) Any lending institution that is an instrumentality or agency of the United States, or

(iv) Any member of a national securities exchange.

Carrying credit is credit that enables a customer to maintain, reduce, or retire indebtedness originally incurred to purchase a security that is currently a margin stock.

Current market value of:

(1) A security means:

(i) If quotations are available, the closing sale price of the security on the preceding business day, as appearing on any regularly published reporting or quotation service; or

(ii) If there is no closing sale price, the lender may use any reasonable estimate of the market value of the security as of the close of business on the preceding business day; or

(iii) If the credit is used to finance the purchase of the security, the total cost of purchase, which may include any commissions charged.

(2) Any other collateral means a value determined by any reasonable method.

Customer excludes an exempted borrower and includes any person or persons acting jointly, to or for whom a lender extends or maintains credit.

Examining authority means:

(1) The national securities exchange or national securities association of which a broker or dealer is a member or

(2) If a member of more than one self-regulatory organization, the organization designated by the Securities and Exchange Commission as the examining authority for the broker or dealer.

Exempted borrower means a member of a national securities exchange or a registered broker or dealer, a substantial portion of whose business consists of transactions with persons other than brokers or dealers, and includes a borrower who:

(1) Maintains at least 1000 active accounts on an annual basis for persons other than brokers, dealers, and persons associated with a broker or dealer;

(2) Earns at least $10 million in gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer; or

(3) Earns at least 10 percent of its gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker-dealer.

Good faith with respect to:

(1) The loan value of collateral, means that amount (not exceeding 100 per cent of the current market value of the collateral) which a lender, exercising sound credit judgment, would lend, without regard to the customer's other assets held as collateral in connection with unrelated transactions.

(2) Making a determination or accepting a statement concerning a borrower means that the lender or its duly authorized representative is alert to the circumstances surrounding the credit, and if in possession of information that would cause a prudent person not to make the determination or accept the notice or certification without inquiry, investigates and is satisfied that it is correct;

Indirectly secured. (1) Includes any arrangement with the customer under which:

(i) The customer's right or ability to sell, pledge, or otherwise dispose of margin stock owned by the customer is in any way restricted while the credit remains outstanding; or

(ii) The exercise of such right is or may be cause for accelerating the maturity of the credit.

(2) Does not include such an arrangement if:

(i) After applying the proceeds of the credit, not more than 25 percent of the value (as determined by any reasonable method) of the assets subject to the arrangement is represented by margin stock;

(ii) It is a lending arrangement that permits accelerating the maturity of the credit as a result of a default or renegotiation of another credit to the customer by another lender that is not an affiliate of the lender;

(iii) The lender holds the margin stock only in the capacity of custodian, depositary, or trustee, or under similar circumstances, and, in good faith, has not relied upon the margin stock as collateral; or

(iv) The lender, in good faith, has not relied upon the margin stock as collateral in extending or maintaining the particular credit.

<u>In the ordinary course of business</u> means occurring or reasonably expected to occur in carrying out or furthering any business purpose, or in the case of an individual, in the course of any activity for profit or the management or preservation of property.

<u>Lender</u> means:

(1) Any bank, or

(2) Any person subject to the registration requirements of this part.

<u>Margin stock</u> means:

(1) Any equity security registered or having unlisted trading privileges on a national securities exchange;

(2) Any OTC security designated as qualified for trading in the National Market System under a designation plan approved by the Securities and Exchange Commission (NMS security);

(3) Any debt security convertible into a margin stock or carrying a warrant or right to subscribe to or purchase a margin stock;

(4) Any warrant or right to subscribe to or purchase a margin stock; or

(5) Any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), other than:

(i) A company licensed under the Small Business Investment Company Act of 1958, as amended (15 U.S.C. 661); or

(ii) A company which has at least 95 percent of its assets continuously invested in exempted securities (as defined in 15 U.S.C. 78c(a)(12));

(iii) A company which issues face-amount certificates as defined in 15 U.S.C. 80a-2(a)(15), but only with respect of such securities; or

(iv) A company which is considered a money market fund under SEC Rule 2a-7 (17 CFR 270.2a-7).

Maximum loan value is the percentage of current market value assigned by the Board under § 221.8 to specified types of collateral. The maximum loan value of margin stock is stated as a percentage of its current market value. Puts, calls and combinations thereof that do not qualify as margin stock have no loan value . All other collateral has good faith loan value.

Nonbank lender means any person subject to the registration requirements of this part.

Purpose credit is any credit for the purpose, whether immediate, incidental, or ultimate, of buying or carrying margin stock.

§ 221.3 General requirements.

(a) Extending, maintaining, and arranging credit. (1) Extending credit. No lender, except a plan-lender, as defined in §221.4(a), shall extend any purpose credit, secured directly or indirectly by margin stock, in an amount that exceeds the maximum loan value of the collateral securing the credit.

(2) Maintaining credit. A lender may continue to maintain any credit initially extended in compliance with this part, regardless of:

(i) Reduction in the customer's equity resulting from change in market prices;

(ii) Change in the maximum loan value prescribed by this part; or

(iii) Change in the status of the security (from nonmargin to margin) securing an existing purpose credit.

(3) Arranging credit. No lender may arrange for the extension or maintenance of any purpose credit, except upon the same terms and conditions under which the lender itself may extend or maintain purpose credit under this part.

(b) Registration of nonbank lenders; termination of registration; annual report. (1) Registration. Every person other than a person subject to part 220 of this chapter or a bank who, in the ordinary course of business, extends or maintains credit secured, directly or indirectly, by any margin stock shall register on Federal Reserve Form FR G-1 (OMB control number 7100-0011) within 30 days after the end of any calendar quarter during which:

(i) The amount of credit extended equals $200,000 or more, or

(ii) The amount of credit outstanding at any time during that calendar quarter equals $500,000 or more.

(2) Deregistration. A registered nonbank lender may apply to terminate its registration, by filing Federal Reserve Form FR G-2 (OMB control number 7100-0011), if the lender has not, during the preceding six calendar months, had more than $200,000 of such credit outstanding. Registration shall be deemed terminated when the application is approved by the Board.

(3) Annual report. Every registered nonbank lender shall, within 30 days following June 30 of every year, file Form FR G-4 (OMB control number 7100-0011).

(4) Where to register and file applications and reports. Registration statements, applications to terminate registration, and annual reports shall be filed with the Federal Reserve Bank of the district in which the principal office of the lender is located.

(c) Purpose statement. (1) General rule. (i) Banks. Except for credit extended under paragraph (c)(2) of this section, whenever a bank extends credit secured directly or indirectly by any margin stock, in an amount exceeding $100,000, the bank shall require its customer to execute Form FR U-1 (OMB No. 7100-0115), which shall be signed and accepted by a duly authorized officer of the bank acting in good faith.

(ii) Nonbank lenders. Except for credit extended under paragraph (c)(2) of this section or §221.4, whenever a nonbank lender extends credit secured directly or indirectly by any margin stock, the nonbank lender shall require its customer to execute Form FR G-3 (OMB control number 7100-0018), which shall be signed and accepted by a duly authorized representative of the nonbank lender acting in good faith.

(2) Purpose statement for revolving-credit or multiple-draw agreements or financing of securities purchases on a payment-against-delivery basis. (i) Banks. If a bank extends credit, secured directly or indirectly by any margin stock, in an amount exceeding $100,000, under a revolving-credit or other multiple-draw agreement, Form FR U-1 must be executed at the time the

credit arrangement is originally established and must be amended as described in paragraph (c)(2)(iv) of this section for each disbursement if all of the collateral for the agreement is not pledged at the time the agreement is originally established.

(ii) Nonbank lenders. If a nonbank lender extends credit, secured directly or indirectly by any margin stock, under a revolving-credit or other multiple-draw agreement, Form FR G-3 must be executed at the time the credit arrangement is originally established and must be amended as described in paragraph (c)(2)(iv) of this section for each disbursement if all of the collateral for the agreement is not pledged at the time the agreement is originally established.

(iii) Collateral. If a purpose statement executed at the time the credit arrangement is initially made indicates that the purpose is to purchase or carry margin stock, the credit will be deemed in compliance with this part if:

(A) The maximum loan value of the collateral at least equals the aggregate amount of funds actually disbursed; or

(B) At the end of any day on which credit is extended under the agreement, the lender calls for additional collateral sufficient to bring the credit into compliance with § 221.7 (the Supplement).

(iv) Amendment of purpose statement. For any purpose credit disbursed under the agreement, the lender shall obtain and attach to the executed Form FR U-1 or FR G-3 a current list of collateral which adequately supports all credit extended under the agreement.

(d) Single credit rule. (1) All purpose credit extended to a customer shall be treated as a single credit, and all the collateral securing such credit shall be considered in determining whether or not the credit complies with this part, except that syndicated loans need not be aggregated with other unrelated purpose credit extended by the same lender.

(2) A lender that has extended purpose credit secured by margin stock may not subsequently extend unsecured purpose credit to the same customer unless the combined credit does not exceed the maximum loan value of the collateral securing the prior credit.

(3) If a lender extended unsecured purpose credit to a customer prior to the extension of purpose credit secured by margin stock, the credits shall be combined and treated as a single credit solely for the purposes of the withdrawal and substitution provision of paragraph (f) of this section.

(4) If a lender extends purpose credit secured by any margin stock and non-purpose credit to the same customer, the lender shall treat the credits as two separate loans and may not rely upon the required collateral securing the purpose credit for the nonpurpose credit.

(e) Exempted borrowers. (1) An exempted borrower that has been in existence for less than one year may meet the definition of exempted borrower based on a six-month period.

(2) Once a member of a national securities exchange or registered broker or dealer ceases to qualify as an exempted borrower, it shall notify its lenders of this fact. Any new extensions of credit to such a borrower, including rollovers, renewals, and additional draws on existing lines of credit, are subject to the provisions of this part.

(f) Withdrawals and substitutions. (1) A lender may permit any withdrawal or substitution of cash or collateral by the customer if the withdrawal or substitution would not:

(i) Cause the credit to exceed the maximum loan value of the collateral; or

(ii) Increase the amount by which the credit exceeds the maximum loan value of the collateral.

(2) For purposes of this section, the maximum loan value of the collateral on the day of the withdrawal or substitution shall be used.

(g) Exchange offers. To enable a customer to participate in a reorganization, recapitalization or exchange offer that is made to holders of an issue of margin stock, a lender may permit substitution of the securities received. A nonmargin, nonexempted security acquired in exchange for a margin stock shall be treated as if it is margin stock for a period of 60 days following the exchange.

(h) Renewals and extensions of maturity. A renewal or extension of maturity of a credit need not be considered a new extension of credit if the amount of the credit is increased only by the addition of interest, service charges, or taxes with respect to the credit.

(i) Transfers of credit. (1) A transfer of a credit between customers or between lenders shall not be considered a new extension of credit if:

(i) The original credit was extended by a lender in compliance with this part or by a lender subject to part 207 of this chapter before its repeal on April 1, 1998, in a manner that would have complied with this part;

(ii) The transfer is not made to evade this part;

(iii) The amount of credit is not increased; and

(iv) The collateral for the credit is not changed.

(2) Any transfer between customers at the same lender shall be accompanied by a statement by the transferor customer describing the circumstances giving rise to the transfer and shall be accepted and signed by a representative of the lender acting in good faith. The lender shall keep such statement with its records of the transferee account.

(3) When a transfer is made between lenders , the transferee shall obtain a copy of the Form FR U-1 or Form FR G-3 originally filed with the transferor and retain the copy with its records of the transferee account. If no form was originally filed with the transferor, the transferee may accept in good faith a statement from the transferor describing the purpose of the loan and the collateral securing it.

(j) Action for lender's protection. Nothing in this part shall require a bank to waive or forego any lien or prevent a bank from taking any action it deems necessary in good faith for its protection.

(k) Mistakes in good faith. A mistake in good faith in connection with the extension or maintenance of credit shall not be a violation of this part.

§ 221.4 Employee stock option, purchase and ownership plans.

(a) Plan-lender; eligible plan. (1) Plan-lender means any corporation, (including a wholly-owned subsidiary, or a lender that is a thrift organization whose membership is limited to employees and former employees of the corporation, its subsidiaries or affiliates) that extends or maintains credit to finance the acquisition of margin stock of the corporation, its subsidiaries or affiliates under an eligible plan.

(2) Eligible plan. An eligible plan means any employee stock option, purchase, or ownership plan adopted by a corporation and approved by its stockholders that provides for the purchase of margin stock of the corporation, its subsidiaries, or affiliates.

(b) Credit to exercise rights under or finance an eligible plan.

(1) If a plan-lender extends or maintains credit under an eligible plan, any margin stock that directly or indirectly secured that credit shall have good faith loan value.

(2) Credit extended under this section shall be treated separately from credit extended under any other section of this part except §§221.3(b)(1) and 221.3(b)(3).

(c) Credit to ESOPs. A nonbank lender may extend and maintain purpose credit without regard to the provisions of this part, except for §§221.3(b)(1) and 221.3(b)(3), if such credit is extended to an employee stock ownership plan (ESOP) qualified under section 401 of the Internal Revenue Code, as amended (26 U.S.C. 401).

§ 221.5 Special purpose loans to brokers and dealers.

(a) Special purpose loans. A lender may extend and maintain purpose credit to brokers and dealers without regard to the limitations set forth in §§ 221.3 and 221.7, if the credit is for any of the specific purposes and meets the conditions set forth in paragraph (c) of this section.

(b) Written notice. Prior to extending credit for more than a day under this section, the lender shall obtain and accept in good faith a written notice or certification from the borrower as to the purposes of the loan. The written notice or certification shall be evidence of continued eligibility for the special credit provisions until the borrower notifies the lender that it is no longer eligible or the lender has information that would cause a reasonable person to question whether the credit is being used for the purpose specified.

(c) Types of special purpose credit. The types of credit that may be extended and maintained on a good faith basis are as follows:

(1) Hypothecation loans. Credit secured by hypothecated customer securities that, according to written notice received from the broker or dealer, may be hypothecated by the broker or dealer under Securities and Exchange Commission (SEC) rules.

(2) Temporary advances in payment-against-delivery transactions. Credit to finance the purchase or sale of securities for prompt delivery, if the credit is to be repaid upon completion of the transaction.

(3) Loans for securities in transit or transfer. Credit to finance securities in transit or surrendered for transfer, if the credit is to be repaid upon completion of the transaction.

(4) Intra-day loans. Credit to enable a broker or dealer to pay for securities, if the credit is to be repaid on the same day it is extended.

(5) Arbitrage loans. Credit to finance proprietary or customer bona fide arbitrage transactions. For the purpose of this section bona fide arbitrage means:

(i) 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 nearly the same time as practicable, for the purpose of taking advantage of a difference in prices in the two markets; or

(ii) Purchase of a security that is, without restriction other than the payment of money, exchangeable or convertible within 90 calendar days of the purchase into a second security, together with an offsetting sale of the second security at or about the same time, for the purpose of taking advantage of a concurrent disparity in the price of the two securities.

(6) Market maker and specialist loans. Credit to a member of a national securities exchange or registered broker or dealer to finance its activities as a market maker or specialist.

(7) Underwriter loans. Credit to a member of a national securities exchange or registered broker or dealer to finance its activities as an underwriter.

(8) Emergency loans. Credit that is essential to meet emergency needs of the broker-dealer business arising from exceptional circumstances.

(9) Capital contribution loans. (i) Credit that Board has exempted by order upon a finding that the exemption is necessary or appropriate in the public interest or for the protection of investors, provided the Securities Investor Protection Corporation certifies to the Board that the exemption is appropriate; or

(ii) Credit to a customer for the purpose of making a subordinated loan or capital contribution to a broker or dealer in conformity with the SEC's net capital rules and the rules of the broker's or dealer's examining authority, provided:

(A) The customer reduces the credit by the amount of any reduction in the loan or contribution to the broker or dealer; and

(B) The credit is not used to purchase securities issued by the broker or dealer in a public distribution.

§ 221.6 Exempted transactions.

A bank may extend and maintain purpose credit without regard to the provisions of this part if such credit is extended:

(a) To any bank;

(b) To any foreign banking institution;

(c) Outside the United States;

(d) To an employee stock ownership plan (ESOP) qualified under section 401 of the Internal Revenue Code (26 U.S.C. 401);

(e) To any plan lender as defined in § 221.4(a) to finance an eligible plan as defined in § 221.4(b), provided the bank has no recourse to any securities purchased pursuant to the plan;

(f) To any customer, other than a broker or dealer, to temporarily finance the purchase or sale of securities for prompt delivery, if the credit is to be repaid in the ordinary course of business upon completion of the transaction and is not extended to enable the customer to pay for securities purchased in an account subject to part 220 of this chapter;

(g) Against securities in transit, if the credit is not extended to enable the customer to pay for securities purchased in an account subject to part 220 of this chapter; or

(h) To enable a customer to meet emergency expenses not reasonably foreseeable, and if the extension of credit is supported by a statement executed by the customer and accepted and signed by an officer of the bank acting in good faith. For this purpose, emergency expenses include expenses arising from circumstances such as the death or disability of the customer, or some other change in circumstances involving extreme hardship, not reasonably foreseeable at the time the credit was extended. The opportunity to realize monetary gain or to avoid loss is not a "change in circumstances" for this purpose.

§ 221.7 Supplement, maximum loan value of margin stock and other collateral.

(a) Maximum loan value of margin stock. The maximum loan value of any margin stock is fifty per cent of its current market value.

(b) Maximum loan value of nonmargin stock and all other collateral. The maximum loan value of nonmargin stock and all other collateral except puts, calls, or combinations thereof is their good faith loan value.

(c) Maximum loan value of options. Except for options that qualify as margin stock, puts, calls, and combinations thereof have no loan value.

INTERPRETATIONS

§ 221.101 Determination and effect of purpose of loan.

(a) Under this part the original purpose of a loan is controlling. In other words, if a loan originally is not for the purpose of purchasing or carrying margin stock, changes in the collateral for the loan do not change its exempted character.

(b) However, a so-called increase in the loan is necessarily on an entirely different basis. So far as the purpose of the credit is concerned, it is a new loan, and the question of whether or not it is subject to this part must be determined accordingly.

(c) Certain facts should also be mentioned regarding the determination of the purpose of a loan. Section 221.3(c) provides in that whenever a lender is required to have its customer execute a “Statement of Purpose for an Extension of Credit Secured by Margin Stock,” the statement must be accepted by the lender “acting in good faith.” The requirement of "good faith" is of vital importance here. Its application will necessarily vary with the facts of the particular case, but it is clear that the bank must be alert to the circumstances surrounding the loan. For example, if the loan is to be made to a customer who is not a broker or dealer in securities, but such a broker or dealer is to deliver margin stock to secure the loan or is to receive the proceeds of the loan, the bank would be put on notice that the loan would probably be subject to this part. It could not accept in good faith a statement to the contrary without obtaining a reliable and satisfactory explanation of the situation.

(d) Furthermore, the purpose of a loan means just that. It cannot be altered by some temporary application of the proceeds. For example, if a borrower is to purchase Government securities with the proceeds of a loan, but is soon thereafter to sell such securities and replace them with margin stock, the loan is clearly for the purpose of purchasing or carrying margin stock.

§ 221.102 Application to committed credit where funds are disbursed thereafter.

(a) The Board has concluded that the date a commitment to extend credit becomes binding should be regarded as the date when the credit is extended, since:

(1) On that date the parties should be aware of law and facts surrounding the transaction; and

(2) Generally, the date of contract is controlling for purposes of margin regulations and Federal securities law, regardless of the delivery of cash or securities.

§ 221.103 Loans to brokers or dealers.

Questions have arisen as to the adequacy of statements received by lending banks under § 221.3(c), “Purpose Statement,” in the case of loans to brokers or dealers secured by margin stock where the proceeds of the loans are to be used to finance customer transactions involving the purchasing or carrying of margin stock. While some such loans may qualify for exemption under §§ 221.1(b)(2), 221.4, 221.5 or 221.6, unless they do qualify for such an exemption they are subject to this part. For example, if a loan so secured is made to a broker to furnish cash working capital for the conduct of his brokerage business (i.e., for purchasing and carrying securities for the account of customers), the maximum loan value prescribed in the Supplement, § 221.8 would be applicable unless the loan should be of a kind exempted under the regulation. This result would not be affected by the fact that the margin stock given as security for the loan was or included margin stock owned by the brokerage firm. In view of the foregoing, the statement referred to in § 221.3(c) which the lending bank must accept in good faith in determining the purpose of the loan would be inadequate if the form of statement accepted or used by the bank failed to call for answers which would indicate whether or not the loan was of the kind discussed above.

§ 221.104 Federal credit unions.

For text of this interpretation, see 12 CFR 220.110.

§ 221.105 Arranging for extensions of credit to be made by a bank.

For text of this interpretation, see 12 CFR 220.111.

§ 221.106 Reliance in "good faith" on statement of purpose of loan.

(a) Certain situations have arisen from time to time under this part wherein it appeared doubtful that, in the circumstances, the lending banks may have been entitled to rely upon the statements accepted by them in determining whether the purposes of certain loans were such as to cause the loans to be not subject to the part.

(b) The use by a lending bank of a statement in determining the purpose of a particular loan is, of course, provided for by §221.3(c). However, under that paragraph a lending bank may accept such statement only if it is " acting in good faith." As the Board stated in the interpretation contained in § 221.101, the "requirement of ‘good faith’ is of vital importance"; and, to fulfill such requirement, "it is clear that the bank must be alert to the circumstances surrounding the loan."

(c) Obviously, such a statement would not be accepted by the bank in "good faith" if at the time the loan was made the bank had knowledge, from any source, of facts or circumstances which were contrary to the natural purport of the statement, or which were sufficient reasonably to put the bank on notice of the questionable reliability or completeness of the statement.

(d) Furthermore, the same requirement of "good faith" is to be applied whether the statement accepted by the bank is signed by the borrower or by an officer of the bank. In either case, "good faith" requires the exercise of special diligence in any instance in which the borrower is not personally known to the bank or to the officer who processes the loan.

(e) The interpretation set forth in § 221.101 contains an example of the application of the "good faith" test. There it was stated that "if the loan is to be made to a customer who is not a broker or dealer in securities, but such a broker or dealer is to deliver margin stock to secure the loan or is to receive the proceeds of the loan, the bank would be put on notice that the loan would probably be subject to this part. It could not accept in good faith a statement to the contrary without obtaining a reliable and satisfactory explanation of the situation".

(f) Moreover, and as also stated by the aforementioned interpretation contained in § 221.101, the purpose of a loan, of course, "cannot be altered by some temporary application of the proceeds. For example, if a borrower is to purchase Government securities with the proceeds of a loan, but is soon thereafter to sell such securities and replace them with margin stock, the loan is clearly for the purpose of purchasing or carrying margin stock". The purpose of a loan therefore, should not be determined upon a narrow analysis of the immediate use to which the proceeds of the loan are put. Accordingly, a bank acting in "good faith" should carefully scrutinize cases in which there is any indication that the borrower is concealing the true purpose of the loan, and there would be reason for special vigilance if margin stock is substituted for bonds or nonmargin stock soon after the loan is made, or on more than one occasion.

(g) Similarly, the fact that a loan made on the borrower's signature only, for example, becomes secured by margin stock shortly after the disbursement of the loan usually would afford reasonable grounds for questioning the bank's apparent reliance upon merely a statement that the purpose of the loan was not to purchase or carry margin stock.

(h) These examples are, of course, by no means exhaustive. They simply illustrate the fundamental fact that no statement accepted by a lender is of any value for the purposes of the regulation unless the lender accepting the statement is " acting in good faith", and that "good faith" requires, among other things, reasonable diligence to learn the truth.

§ 221.107 Arranging loan to purchase open-end investment company shares.

For text of this interpretation, see 12 CFR 220.112.

§ 221.108 Effect of registration of stock subsequent to making of loan.

(a) The Board recently was asked whether a loan by a bank to enable the borrower to purchase a newly issued nonmargin stock during the initial over-the-counter trading period prior to the stock becoming registered (listed) on a national securities exchange would be subject to this part. The Board replied that, until such stock qualifies as margin stock, this would not be applicable to such a loan.

(b) The Board has now been asked what the position of the lending bank would be under this part if, after the date on which the stock should become registered, such bank continued to hold a loan of the kind just described. It is assumed that the loan was in an amount greater than the maximum loan value for the collateral specified in this part.

(c) If the stock should become registered, the loan would then be for the purpose of purchasing or carrying a margin stock, and, if secured directly or indirectly by any margin stock, would be subject to this part as from the date the stock was registered. Under this part, this does not mean that the bank would have to obtain reduction of the loan in order to reduce it to an amount no more than the specified maximum loan value. It does mean, however, that so long as the loan balance exceeded the specified maximum loan value, the bank could not permit any withdrawals or substitutions of collateral that would increase such excess; nor could the bank increase the amount of the loan balance unless there was provided additional collateral having a maximum loan value at least equal to the amount of the increase. In other words, as from the date the stock should become a margin stock, the loan would be subject to this part in exactly the same way, for example, as a loan subject to this part that became under-margined because of a decline in the current market value of the loan collateral or because of a decrease by the Board in the maximum loan value of the loan collateral.

§ 221.109 Loan to open-end investment company.

In response to a question regarding a possible loan by a bank to an open-end investment company that customarily purchases stocks registered on a national securities exchange, the Board stated that in view of the general nature and operations of such a company, any loan by a bank to such a company should be presumed to be subject to this part as a loan for the purpose of purchasing or carrying margin stock. This would not be altered by the fact that the open-end company had used, or proposed to use, its own funds or proceeds of the loan to redeem some of its own shares, since mere application of the proceeds of a loan to some other use cannot prevent the ultimate purpose of a loan from being to purchase or carry registered stocks.

§ 221.110 Questions arising under Regulation U.

(a) Regulation U governs “any purpose credit” extended by a lender “secured directly or indirectly by margin stock” and defines “purpose credit”as “any credit for the purpose, whether immediate, incidental, or ultimate, of buying or carrying margin stock ”, with certain exceptions, and provides that the maximum loan value of such margin stock shall be a fixed percentage "of its current market value."

(b) The Board of Governors has had occasion to consider the application of this language to the two following questions:

(1) <u>Loan secured by stock</u>. First, is a loan to purchase or carry margin stock subject to Regulation U where made in unsecured form, if margin stock is subsequently deposited as security with the lender, and surrounding circumstances indicate that the parties originally contemplated that the loan should be so secured? The Board answered that in a case of this kind, the loan would be subject to the Regulation, for the following reasons.

(i) The Board has long held, in the closely related purpose area, that the original purpose of a loan should not be determined upon a narrow analysis of the technical circumstances under which a loan is made. Instead, the fundamental purpose of the loan is considered to be controlling. Indeed, "the fact that a loan made on the borrower's signature only, for example, becomes secured by registered stock shortly after the disbursement of the loan" affords reasonable grounds for questioning whether the bank was entitled to rely upon the borrower's statement as to the purpose of the loan. 1953 Fed. Res. Bull. 951 (<u>See</u>, 12 CFR 221.106).

(ii) Where security is involved, standards of interpretation should be equally searching. If, for example, the original agreement between borrower and lender contemplated that the loan should be secured by margin stock, and such stock is in fact delivered to the bank when available, the transaction must be regarded as fundamentally a secured loan. This view is strengthened by the fact that the regulation applies to a loan "secured directly or indirectly by margin stock."

(2) Loan to acquire controlling shares. (i) The second question is whether the Regulation governs a margin stock-secured loan made for the business purpose of purchasing a controlling interest in a corporation, or whether such a loan would be exempt on the ground that the Regulation is directed solely toward purchases of stock for speculative or investment purposes. The Board answered that a margin stock-secured loan for the purpose of purchasing or carrying margin stock is subject to this part, regardless of the reason for which the purchase is made.

(ii) The answer is required, in the Board's view, since the language of this part is explicitly inclusive, covering "any purpose credit, secured directly or indirectly by margin stock." Moreover, the withdrawal in 1945 of the original section 2(e) of the Regulation, which exempted "any loan for the purpose of purchasing a stock from or through a person who is not a member of a national securities exchange . . ." plainly implies that transactions of the sort described are now subject to the general prohibition of § 221.3(a).

§ 221.111 Contribution to joint venture as extension of credit when the contribution is disproportionate to the contributor's share in the venture's profits or losses.

(a) The Board considered the question whether a joint venture, structured so that the amount of capital contribution to the venture would be disproportionate to the right of participation in profits or losses, constitutes an "extension of credit" for the purpose of Regulation U.

(b) An individual and a corporation plan to establish a joint venture to engage in the business of buying and selling securities, including margin stock. The individual would contribute 20 percent of the capital and receive 80 percent of the profits or losses; the corporate share would be the reverse. In computing profits or losses, each participant would first receive interest at the rate of 8 percent on his respective capital contribution. Although purchases and sales would be mutually agreed upon, the corporation could liquidate the joint portfolio if the individual's share of the losses equaled or exceeded his 20 percent contribution to the venture. The corporation would hold the securities, and upon termination of the venture, the assets would first be applied to repayment of capital contributions.

(c) In general, the relationship of joint venture is created when two or more persons combine their money, property, or time in the conduct of some particular line of trade or some particular business and agree to share jointly, or in proportion to capital contributed, the profits and losses of the undertaking.

(d) The incidents of the joint venture described above, however, closely parallel those of an extension of margin credit, with the corporation as lender and the individual as borrower. The corporation supplies 80 percent of the purchase price of securities in exchange for a net return of 8 percent of the amount advanced plus 20 percent of any gain. Like a lender of securities credit, the corporation is insulated against loss by retaining the right to liquidate the collateral before the securities decline in price below the amount of its contribution. Conversely, the individual--like a customer who borrows to purchase securities--puts up only 20 percent of their cost, is entitled to the principal portion of any appreciation in their value, bears the principal risk of loss should that value decline, and does not stand to gain or lose except through a change in value of the securities purchased.

(e) The Board is of the opinion that where the right of an individual to share in profits and losses of such a joint venture is disproportionate to his contribution to the venture:

(1) The joint venture involves an extension of credit by the corporation to the individual;

(2) The extension of credit is to purchase or carry margin stock, and is collateralized by such margin stock; and

(3) If the corporation is not a broker or dealer subject to Regulation T, the credit is of the kind described by § 221.3(a).

§ 221.112 Loans by bank in capacity as trustee.

(a) The Board's advice has been requested whether a bank's activities in connection with the administration of an employees' savings plan are subject to this part.

(b) Under the plan, any regular, full-time employee may participate by authorizing the sponsoring company to deduct a percentage of his salary and wages and transmit the same to the bank as trustee. Voluntary contributions by the company are allocated among the participants. A participant may direct that funds held for him be invested by the trustee in insurance, annuity contracts, Series E Bonds, or in one or more of three specified securities which are listed on a stock exchange. Loans to purchase the stocks may be made to participants from funds of the trust, subject to approval of the administrative committee, which is composed of five participants, and of the trustee. The bank's right to approve is said to be restricted to the mechanics of making the loan, the purpose being to avoid cumbersome procedures.

(c) Loans are secured by the credit balance of the borrowing participants in the savings fund, including stock, but excluding (in practice) insurance and annuity contracts and government securities. Additional stocks may be, but, in practice, have not been pledged as collateral for loans. Loans are not made, under the plan, from bank funds, and participants do not borrow from the bank upon assignment of the participants' accounts in the trust.

(d) It is urged that loans under the plan are not subject to this part because a loan should not be considered as having been made by a bank where the bank acts solely in its capacity of trustee, without exercise of any discretion.

(e) The Board reviewed this question upon at least one other occasion, and full consideration has again been given to the matter. After considering the arguments on both sides, the Board has reaffirmed its earlier view that, in conformity with an interpretation not published in CFR which was published at page 874 of the 1946 Federal Reserve Bulletin, this part applies to the activities of a bank when it is acting in its capacity as trustee. Although the bank in that case had at best a limited discretion with respect to loans made by it in its capacity as trustee, the Board concluded that this fact did not affect the application of the regulation to such loans.

§ 221.113 Loan which is secured indirectly by stock.

(a) A question has been presented to the Board as to whether a loan by a bank to a mutual investment fund is "secured . . . indirectly by margin stock" within the meaning of § 221.(3)(a), so that the loan should be treated as subject to the regulation.

(b) Briefly, the facts are as follows. Fund X, an open-end investment company, entered into a loan agreement with Bank Y, which was (and still is) custodian of the securities which comprise the portfolio of Fund X. The agreement includes the following terms, which are material to the question before the Board;

(1) Fund X agrees to have an "asset coverage" (as defined in the agreements) of 400 percent of all its borrowings, including the proposed borrowing, at the time when it takes down any part of the loan.

(2) Fund X agrees to maintain an "asset coverage" of at least 300 percent of its borrowings at all times.

(3) Fund X agrees not to amend its custody agreement with Bank Y, or to substitute another custodian without Bank Y's consent.

(4) Fund X agrees not to mortgage, pledge, or otherwise encumber any of its assets elsewhere than with Bank Y.

(c) In § 221.109 the Board stated that because of "the general nature and operations of such a company", any "loan by a bank to an open-end investment company that customarily purchases margin stock * * * should be presumed to be subject to this part as a loan for the purpose of purchasing or carrying margin stock" (purpose credit). The Board's interpretation went on to say that: “this would not be altered by the fact that the open-end company had used, or proposed to use, its own funds or proceeds of the loan to redeem some of its own shares . . .”.

(d) Accordingly, the loan by Bank Y to Fund X was and is a "purpose credit". However, a loan by a bank is not subject to this part unless: it is a purpose credit; and it is "secured directly or indirectly by margin stock". In the present case, the loan is not "secured directly" by stock in the ordinary sense, since the portfolio of Fund X is not pledged to secure the credit from Bank Y. But the word "indirectly" must signify some form of security arrangement other than the "direct" security which arises from the ordinary "transaction that gives recourse against a particular chattel or land or against a third party on an obligation" described in the American Law Institute's Restatement of the Law of Security, page 1. Otherwise the word "indirectly" would be superfluous, and a regulation, like a statute, must be construed if possible to give meaning to every word.

(e) The Board has indicated its view that any arrangement under which margin stock is more readily available as security to the lending bank than to other creditors of the borrower may amount to indirect security within the meaning of this part. In an interpretation published at § 221.110 it stated: “The Board has long held, in the . . . purpose area, that the original purpose of a loan should not be determined upon a narrow analysis of the technical circumstances under which a loan is made . . . . Where security is involved, standards of interpretation should be equally searching.” In its pamphlet issued for the benefit and guidance of banks and bank examiners, entitled "Questions and Answers Illustrating Application of Regulation U", the Board said: “In determining whether a loan is "indirectly" secured, it should be borne in mind that the reason the Board has thus far refrained . . . from regulating loans not secured by stock has been to simplify operations under the regulation. This objective of simplifying operations does not apply to loans in which arrangements are made to retain the substance of stock collateral while sacrificing only the form”.

(f) A wide variety of arrangements as to collateral can be made between bank and borrower which will serve, to some extent, to protect the interest of the bank in seeing that the loan is repaid, without giving the bank a conventional direct "security" interest in the collateral. Among such arrangements which have come to the Board's attention are the following:

(1) The borrower may deposit margin stock in the custody of the bank. An arrangement of this kind may not, it is true, place the bank in the position of a secured creditor in case of bankruptcy, or even of conflicting claims, but it is likely effectively to strengthen the bank's position. The definition of <u>indirectly secured</u> in § 221.2, which provides that a loan is not indirectly secured if the lender “ holds the margin stock only in the capacity of custodian, depositary or trustee, or under similar circumstances, and, in good faith has not relied upon the margin stock as collateral,” does not exempt a deposit of this kind from the impact of the regulation unless it is clear that the bank "has not relied" upon the margin stock deposited with it.

(2) A borrower may not deposit his margin stock with the bank, but agree not to pledge or encumber his assets elsewhere while the loan is outstanding. Such an agreement may be difficult to police, yet it serves to some extent to protect the interest of the bank if only because the future credit standing and business reputation of the borrower will depend upon his keeping his word. If

the assets covered by such an agreement include margin stock, then, the credit is “indirectly secured” by the margin stock within the meaning of this part.

(3) The borrower may deposit margin stock with a third party who agrees to hold the stock until the loan has been paid off. Here, even though the parties may purport to provide that the stock is not "security" for the loan (for example, by agreeing that the stock may not be sold and the proceeds applied to the debt if the borrower fails to pay), the mere fact that the stock is out of the borrower's control for the duration of the loan serves to some extent to protect the bank.

(g) The three instances described above are merely illustrative. Other methods, or combinations of methods, may serve a similar purpose. The conclusion that any given arrangement makes a credit "indirectly secured" by margin stock may, but need not, be reinforced by facts such as that the stock in question was purchased with proceeds of the loan, that the lender suggests or insists upon the arrangement, or that the loan would probably be subject to criticism by supervisory authorities were it not for the protective arrangement.

(h) Accordingly, the Board concludes that the loan by Bank Y to Fund X is indirectly secured by the portfolio of the fund and must be treated by the bank as a regulated loan.

§ 221.114 Bank loans to purchase stock of American Telephone and Telegraph Company under Employees' Stock Plan.

(a) The Board of Governors interpreted this part in connection with proposed loans by a bank to persons who are purchasing shares of stock of American Telephone and Telegraph Company pursuant to its Employees' Stock Plan.

(b) According to the current offering under the Plan, an employee of the AT&T system may purchase shares through regular deductions from his pay over a period of 24 months. At the end of that period, a certificate for the appropriate number of shares will be issued to the participating employee by AT&T. Each employee is entitled to purchase, as a maximum, shares that will cost him approximately three-fourths of his annual base pay. Since the program extends over two years, it follows that the payroll deductions for this purpose may be in the neighborhood of 38 percent of base pay and a larger percentage of "take-home pay." Deductions of this magnitude are in excess of the saving rate of many employees.

(c) Certain AT&T employees, who wish to take advantage of the current offering under the Plan, are the owners of shares of AT&T stock that they purchased under previous offerings. A bank proposed to receive such stock as collateral for a "living expenses" loan that will be advanced to the employee in monthly installments over the 24-month period, each installment being in the amount of the employee's monthly payroll deduction under the Plan. The aggregate amount of the advances over the 24-month period would be substantially greater than the maximum loan value of the collateral as prescribed in § 221.8, the Supplement to Regulation U .

(d) In the opinion of the Board of Governors, a loan of the kind described would violate this part if it exceeded the maximum loan value of the collateral. The regulation applies to any margin stock-secured loan for the purpose of purchasing or carrying margin stock (§ 221.3(a)). Although the proposed loan would purport to be for living expenses, it seems quite clear, in view of the relationship of the loan to the Employees' Stock Plan, that its actual purpose would be to enable the borrower to purchase AT&T stock, which is margin stock. At the end of the 24-month period the borrower would acquire a certain number of shares of that stock and would be indebted to the lending bank in an amount approximately equal to the amount he would pay for such shares. In these circumstances, the loan by the bank must be regarded as a loan "for the purpose of purchasing" the stock, and therefore it is subject to the limitations prescribed by this part. This conclusion follows from the provisions of the part, and it may also be observed that a contrary conclusion could largely defeat the basic purpose of the margin regulations.

(c) Accordingly, the Board concluded that a loan of the kind described may not be made in an amount exceeding the maximum loan value of the collateral, as prescribed by the current Supplement to Regulation U (§ 221.8).

§ 221.115 Accepting a purpose statement through the mail without benefit of face-to-face interview.

(a) The Board has been asked whether the acceptance of a purpose statement submitted through the mail by a lender subject to the provisions of Regulation U will meet the good faith requirement of § 221.3(c). Section 221.3(c) states that in connection with any credit secured by collateral which includes any margin stock, a nonbank lender must obtain a purpose statement executed by the borrower and accepted by the lender in good faith. Such acceptance requires that the lender be alert to the circumstances surrounding the credit and if further information suggests inquiry, he must investigate and be satisfied that the statement is truthful.

(b) The lender is a subsidiary of a holding company which also has another subsidiary which serves as underwriter and investment advisor to various mutual funds. The sole business of the lender will be to make "non-purpose" consumer loans to shareholders of the mutual funds, such loans to be collateralized by the fund shares. Most mutual funds shares are margin stock for purposes of this part. Solicitation and acceptance of these consumer loans will be done principally through the mail and the lender wishes to obtain the required purpose statement by mail rather than by a face-to-face interview. Personal interviews are not practicable for the lender because shareholders of the funds are scattered throughout the country. In order to provide the same safeguards inherent in face-to-face interviews, the lender has developed certain procedures designed to satisfy the good faith acceptance requirement of the regulation.

(c) The purpose statement will be supplemented with several additional questions relevant to the prospective borrower's investment activities such as purchases of any security within the last 6 months, dollar amount, and obligations to purchase or pay for previous purchases; present plans to purchase securities in the near future, participations in securities purchase plans, list of unpaid debts, and present income level. Some questions have been modified to facilitate understanding but no questions have been deleted. If additional inquiry is indicated by the answers on the form, a loan officer of the lender will interview the borrower by telephone to make sure the loan is "non-purpose". Whenever the loan exceeds the "maximum loan value" of the collateral for a regulated loan, a telephone interview will be done as a matter of course.

(d) One of the stated purposes of Regulation X (12 CFR Part 224) was to prevent the infusion of unregulated credit into the securities markets by borrowers falsely certifying the purpose of a loan. The Board is of the view that the existence of Regulation X, which makes the borrower liable for willful violations of the margin regulations, will allow a lender subject to Regulation U to meet the good faith acceptance requirement of § 221.3(c) without a face-to-face interview if the lender adopts a program, such as the one described above, which requires additional detailed information from the borrower and proper procedures are instituted to verify the truth of the information received. Lenders intending to embark on a similar program should discuss proposed plans with their district Federal Reserve Bank. Lenders may have existing or future loans with the prospective customers which could complicate the efforts to determine the true purpose of the loan.

§ 221.116 Bank loans to replenish working capital used to purchase mutual fund shares.

(a) In a situation considered by the Board of Governors, a business concern (X) proposed to purchase mutual fund shares, from time to time, with proceeds from its accounts receivable, then pledge the shares with a bank in order to secure working capital. The bank was prepared to lend amounts equal to 70 percent of the current value of the shares as they were purchased by X. If the loans were subject to this part, only 50 percent of the current market value of the shares could be lent.

(b) The immediate purpose of the loans would be to replenish X's working capital. However, as time went on, X would be acquiring mutual fund shares at a cost that would exceed the net earnings it would normally have accumulated, and would become indebted to the lending bank in an amount approximately 70 percent of the prices of said shares.

(c) The Board held that the loans were for the purpose of purchasing the shares, and therefore subject to the limitations prescribed by this part. As pointed out in § 221.114 with respect to a similar program for putting a high proportion of cash income into stock, the borrowing against the margin stock to meet needs for which the cash would otherwise have been required, a contrary conclusion could largely defeat the basic purpose of the margin regulations.

(d) Also considered was an alternative proposal under which X would deposit proceeds from accounts receivable in a time account for 1 year, before using those funds to purchase mutual fund shares. The Board held that this procedure would not change the situation in any significant way. Once the arrangement was established, the proceeds would be flowing into the time account at the same time that similar amounts were released to purchase the shares, and over any extended period of time the result would be the same. Accordingly, the Board concluded that bank loans made under the alternative proposal would similarly be subject to this part.

§ 221.117 When bank in "good faith" has not relied on stock as collateral.

(a) The Board has received questions regarding the circumstances in which an extension or maintenance of credit will not be deemed to be "indirectly secured" by stock as indicated by the phrase, "if the lender, in good faith, has not relied upon the margin stock as collateral," contained in paragraph (2)(iv) of the definition of indirectly secured in § 221.2 of Regulation U.

(b) In response, the Board noted that in amending this portion of the regulation in 1968 it was indicated that one of the purposes of the change was to make clear that the definition of indirectly secured does not apply to certain routine negative covenants in loan agreements. Also, while the question of whether or not a bank has relied upon particular stock as collateral is necessarily a question of fact to be determined in each case in the light of all relevant circumstances, some indication that the bank had not relied upon stock as collateral would seem to be afforded by such circumstances as the fact that:

(1) The bank had obtained a reasonably current financial statement of the borrower and this statement could reasonably support the loan; and

(2) The loan was not payable on demand or because of fluctuations in market value of the stock, but instead was payable on one or more fixed maturities which were typical of maturities applied by the bank to loans otherwise similar except for not involving any possible question of stock collateral.

§ 221.118 Bank arranging for extension of credit by corporation.

(a) The Board considered the questions whether:

(1) The guaranty by a corporation of an "unsecured" bank loan to exercise an option to purchase stock of the corporation is an "extension of credit" for the purpose of this part;

(2) Such a guaranty is given "in the ordinary course of business" of the corporation, as defined in § 221.2; and

(3) The bank involved took part in arranging for such credit on better terms than it could extend under the provisions of this part.

(b) The Board understood that any officer or employee included under the corporation's stock option plan who wished to exercise his option could obtain a loan for the purchase price of the stock by executing an unsecured note to the bank. The corporation would issue to the bank a guaranty of the loan and hold the purchased shares as collateral to secure it against loss on the guaranty. Stock of the corporation is registered on a national securities exchange and therefore qualifies as "margin stock" under this part.

(c) A nonbank lender is subject to the registration and other requirements of this part if, in the ordinary course of his business, he extends credit on collateral that includes any margin stock in the amount of $200,000 or more in any calendar quarter, or has such credit outstanding in any calendar quarter in the amount of $500,000 or more. The Board understood that the corporation in question had sufficient guaranties outstanding during the applicable calendar quarter to meet the dollar thresholds for registration.

(d) In the Board's judgment a person who guarantees a loan, and thereby becomes liable for the amount of the loan in the event the borrower should default, is lending his credit to the borrower. In the circumstances described, such a lending of credit must be considered an "extension of credit" under this part in order to prevent circumvention of the regulation's limitation on the amount of credit that can be extended on the security of margin stock.

(e) Under § 221.2, the term <u>in the ordinary course of business means</u> "occurring or reasonably expected to occur in carrying out or furthering any business purpose. . . ." In general, stock option plans are designed to provide a company's employees with a proprietary interest in the company in the form of ownership of the company's stock. Such plans increase the company's ability to attract and retain able personnel and, accordingly, promote the interest of the company and its stockholders, while at the same time providing the company's employees with additional incentive to work toward the company's future success. An arrangement whereby participating employees may finance the exercise of their options through an unsecured bank loan guaranteed by the company, thereby facilitating the employees' acquisition of company stock, is likewise designed to promote the company's interest and is, therefore, in furtherance of a business purpose.

(f) For the reasons indicated, the Board concluded that under the circumstances described a guaranty by the corporation constitutes credit extended in the ordinary course of business under this part, that the corporation is required to register pursuant to § 221.3(b), and that such guaranties may not be given in excess of the maximum loan value of the collateral pledged to secure the guaranty.

(g) Section 221.3(a)(3) of this part provides that "no lender may arrange for the extension or maintenance of any purpose credit, except upon the same terms and conditions on which the lender itself may extend or maintain purpose credit under this part". Since the Board concluded that the giving of a guaranty by the corporation to secure the loan described above constitutes an extension of credit, and since the use of a guaranty in the manner described could not be effectuated without the concurrence of the bank involved, the Board further concluded that the bank took part in "arranging" for the extension of credit in excess of the maximum loan value of the margin stock pledged to secure the guaranties.

§ 221.119 Applicability of plan-lender provisions to financing of stock options and stock purchase rights qualified or restricted under Internal Revenue Code.

(a) The Board has been asked whether the plan-lender provisions of § 221.4(a) and (b) were intended to apply to the financing of stock options restricted or qualified under the Internal Revenue Code where such options or the option plan do not provide for such financing.

(b) It is the Board's experience that in some nonqualified plans, particularly stock purchase plans, the credit arrangement is distinct from the plan. So long as the credit extended, and particularly, the character of the plan-lender, conforms with the requirements of the regulation, the fact that option and credit are provided for in separate documents is immaterial. It should be emphasized that the Board does not express any view on the preferability of qualified as opposed to nonqualified options; its role is merely to prevent excessive credit in this area.

(c) Section 221.4(a) provides that a plan-lender may include a wholly-owned subsidiary of the issuer of the collateral (taking as a whole, corporate groups including subsidiaries and affiliates). This clarifies the Board's intent that, to qualify for special treatment under that section, the lender must stand in a special employer-employee relationship with the borrower, and a special relationship of issuer with regard to the collateral. The fact that the Board, for convenience and practical reasons, permitted the employing corporation to act through a subsidiary or other entity should not be interpreted to mean the Board intended the lender to be other than an entity whose overriding interests were coextensive with the issuer. An independent corporation, with independent interests was never intended, regardless of form, to be at the base of exempt stock-plan lending.

§ 221.120 Allocation of stock collateral to purpose and nonpurpose credits to same customer.

(a) A bank proposes to extend two credits (Credits A and B) to its customer. Although the two credits are proposed to be extended at the same time, each would be evidenced by a separate agreement. Credit A would be extended for the purpose of providing the customer with working capital (nonpurpose credit), collateralized by margin stock. Credit B would be extended for the purpose of purchasing or carrying margin stock (purpose credit), without collateral or on collateral other than stock.

(b) Regulation U allows a bank to extend purpose and nonpurpose credits simultaneously or successively to the same customer. This rule is expressed in § 221.3(d)(4) which provides in substance that for any nonpurpose credit to the same customer, the lender shall in good faith require as much collateral not already identified to the customer's purpose credit as the lender would require if it held neither the purpose loan nor the identified collateral. This rule also takes into account that the lender would not necessarily be required to hold collateral for the nonpurpose credit if, consistent with good faith banking practices, it would normally make this kind of nonpurpose loan without collateral.

(c) The Board views § 221.3(d)(4), when read in conjunction with § 221.3(c) and (f), as requiring that whenever a lender extends two credits to the same customer, one a purpose credit and the other nonpurpose, any margin stock collateral must first be identified with and attributed to the purpose loan by taking into account the maximum loan value of such collateral as prescribed in § 221.8 (the Supplement).

(d) The Board is further of the opinion that under the foregoing circumstances Credit B would be indirectly secured by stock, despite the fact that there would be separate loan agreements for both credits. This conclusion flows from the circumstance that the lender would hold in its possession stock collateral to which it would have access with respect to Credit B, despite any ostensible allocation of such collateral to Credit A.

§ 221.121 Extension of credit in certain stock option and stock purchase plans.

Questions have been raised as to whether certain stock option and stock purchase plans involve extensions of credit subject to Regulation U when the participant is free to cancel his participation at any time prior to full payment, but in the event of cancellation the participant remains liable for damages. It thus appears that the participant has the opportunity to gain and bears the risk of loss from the time the transaction is executed and payment is deferred. In some cases brought to the Board's attention damages are related to the market price of the stock, but in others, there may be no such relationship. In either of these circumstances, it is the Board's view that such plans involve extensions of credit. Accordingly, where the security being purchased is a margin security and the credit is secured, directly or indirectly, by any margin security, the creditor must register and the credit must conform with either the regular margin requirements of § 221.3(a) or the special "plan-lender" provisions set forth in § 221.4, whichever is applicable. This assumes, of course, that the amount of credit extended is such that the creditor is subject to the registration requirements of § 221.3(b).

§ 221.122 Applicability of margin requirements to credit in connection with Insurance Premium Funding Programs.

(a) The Board has been asked numerous questions regarding purpose credit in connection with insurance premium funding programs. The inquiries are included in a set of guidelines in the format of questions and answers which follow. A glossary of terms customarily used in connection with insurance premium funding credit activities is included in the guidelines. Under a typical insurance premium funding program, a borrower acquires mutual fund shares for cash, or takes fund shares which he already owns, and then uses the loan value (currently 50 percent as set by the Board) to buy insurance. Usually, a funding company (the issuer) will sell both the fund shares and the insurance through either independent broker/dealers or subsidiaries or affiliates of the issuer. A typical plan may run for 10 or 15 years with annual insurance premiums due. To illustrate, assuming an annual insurance premium of $300, the participant is required to put up mutual fund shares equivalent to 250 percent of the premium or $600 ($600 x 50 percent loan value equals $300 the amount of the insurance premium which is also the amount of the credit extended).

(b) These guidelines also:

(1) Clarify an earlier 1969 Board interpretation to show that the public offering price of mutual fund shares (which includes the front load, or sales commission) may be used as a measure of their current market value when the shares serve as collateral on a purpose credit throughout the day of the purchase of the fund shares; and

(2) Relax a 1965 Board position in connection with accepting purpose statements by mail.

(c) It is the Board's view that when it is clearly established that a purpose statement supports a purpose credit then such statement executed by the borrower may be accepted by mail, provided it is received and also executed by the lender before the credit is extended.

§ 221.123 Combined credit for exercising employee stock options and paying income taxes incurred as a result of such exercise.

(a) Section 221.4(a) and (b), which provides special treatment for credit extended under employee stock option plans, was designed to encourage their use in recognition of their value in giving an employee a proprietary interest in the business. Taking a position that might discourage the exercise of options because of tax complications would conflict with the purpose of § 221.4(a) and (b).

(b) Accordingly, the Board has concluded that the combined loans for the exercise of the option and the payment of the taxes in connection therewith under plans complying with § 207.4(a) may be regarded as purpose credit within the meaning of § 221.2.

§ 221.124 Purchase of debt securities to finance corporate takeovers.

(a) Petitions have been filed with the Board raising questions as to whether the margin requirements in this part apply to two types of corporate acquisitions in which debt securities are issued to finance the acquisition of margin stock of a target company.

(b) In the first situation, the acquiring company, Company A, controls a shell corporation that would make a tender offer for the stock of Company B, which is margin stock (as defined in § 221.2). The shell corporation has virtually no operations, has no significant business function other than to acquire and hold the stock of Company B, and has substantially no assets other than the margin stock to be acquired. To finance the tender offer, the shell corporation would issue debt securities which, by their terms, would be unsecured. If the tender offer is successful, the shell corporation would seek to merge with Company B. However, the tender offer seeks to acquire fewer shares of Company B than is necessary under state law to effect a short form merger with Company B, which could be consummated without the approval of shareholders or the board of directors of Company B.

(c) The purchase of the debt securities issued by the shell corporation to finance the acquisition clearly involves purpose credit (as defined in § 221.2). In addition, such debt securities would be purchased only by sophisticated investors in very large minimum denominations, so that the purchasers may be lenders for purposes of Regulation U. See 12 CFR 221.3(b). Since the debt securities contain no direct security agreement involving the margin stock, applicability of the lending restrictions of the Regulation turns on whether the arrangement constitutes an extension of credit that is secured indirectly by margin stock.

(d) As the Board has recognized, indirect security can encompass a wide variety of arrangements between lenders and borrowers with respect to margin stock collateral that serve to protect the lenders' interest in assuring that a credit is repaid where the lenders do not have a conventional direct security interest in the collateral. See 12 CFR 221.124. However, credit is not “indirectly secured” by margin stock if the lender in good faith has not relied on the margin stock as collateral extending or maintaining credit. See 12 CFR 221.2.

(e) The Board is of the view that, in the situation described in paragraph (b) of this section, the debt securities would be presumed to be indirectly secured by the margin stock to be acquired by the shell acquisition vehicle. The staff has previously expressed the view that nominally unsecured credit extended to an investment company, a substantial portion of whose assets consist of margin stock, is indirectly secured by the margin stock. See Federal Reserve Regulatory Service 5-917.12. This opinion notes that the investment company has substantially no assets other than margin stock to support indebtedness and thus credit could not be extended to such a company in good faith without reliance on the margin stock as collateral.

(f) The Board believes that this rationale applies to the debt securities issued by the shell corporation described above. At the time the debt securities are issued, the shell corporation has substantially no assets to support the credit other than the margin stock that it has acquired or intends to acquire and has no significant business function other than to hold the stock of the target company in order to facilitate the acquisition. Moreover, it is possible that the shell may hold the margin stock for a significant and indefinite period of time, if defensive measures by the target prevent consummation of the acquisition. Because of the difficulty in predicting the outcome of a contested takeover at the time that credit is committed to the shell corporation, the Board believes that the purchasers of the debt securities could not, in good faith, lend without reliance on the margin stock as collateral. The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow. This presumption would also not apply if there is a merger agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities or in any event before loan funds are advanced. In addition, the presumption would not apply if the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without the approval of either the shareholders or directors of the target company. In these two situations where the merger will take place promptly, the Board believes the lenders could reasonably be presumed to be relying on the assets of the target for repayment.

(g) In addition, the Board is of the view that the debt securities described in paragraph (b) of this section are indirectly secured by margin stock because there is a practical restriction on the ability of the shell corporation to dispose of the margin stock of the target company. Indirectly secured is defined in § 221.2 to include any arrangement under which the customer's right or ability to sell, pledge, or otherwise dispose of margin stock owned by the customer is in any way restricted while the credit remains outstanding. The purchasers of the debt securities issued by a shell corporation to finance a takeover attempt clearly understand that the shell corporation intends to acquire the margin stock of the target company in order to effect the acquisition of that company. This understanding represents a practical restriction on the ability of the shell corporation to dispose of the target's margin stock and to acquire other assets with the proceeds of the credit.

(h) In the second situation, Company C, an operating company with substantial assets or cash flow, seeks to acquire Company D, which is significantly larger than Company C. Company C establishes a shell corporation that together with Company C makes a tender offer for the shares of Company D, which is margin stock. To finance the tender offer, the shell corporation would obtain a bank loan that complies with the margin lending restrictions of Regulation U and Company C would issue debt securities that would not be directly secured by any margin stock. The Board is of the opinion that these debt securities should not be presumed to be indirectly secured by the margin stock of Company D, since, as an operating business, Company C has substantial assets or cash flow without regard to the margin stock of Company D. Any presumption would not be appropriate because the purchasers of the debt securities may be relying on assets other than margin stock of Company D for repayment of the credit.

§ 221.125 Credit to brokers and dealers.

(a) The National Securities Markets Improvement Act of 1996 (Pub. L. 104-290, 110 Stat. 3416) restricts the Board's margin authority by repealing section 8(a) of the Securities Exchange Act of 1934 (the Exchange Act) and amending section 7 of the Exchange Act (15 U.S.C. 78g) to exclude the borrowing by a member of a national securities exchange or a registered broker or dealer "a substantial portion of whose business consists of transactions with persons other than brokers or dealers" and borrowing by a member of a national securities exchange or a registered broker or dealer to finance its activities as a market maker or an underwriter. Notwithstanding this exclusion, the Board may impose such rules and regulations if it determines they are "necessary or appropriate in the public interest or for the protection of investors."

(b) The Board has not found that it is necessary or appropriate in the public interest or for the protection of investors to impose rules and regulations regarding loans to brokers and dealers covered by the National Securities Markets Improvement Act of 1996.

PART 224 -- BORROWERS OF SECURITIES CREDIT (REGULATION X)

1. The authority citation for Part 224 is revised to read as follows:
Authority: 15 U.S.C. 78g.

2. Section 224.1 is revised as follows:

a. Remove the letter “G” and number “207" from the last sentence in paragraph (a).
b. Remove the letter “G” from paragraph (b)(1).

3. Section 224.2 is revised by removing the letter “G” from the introductory sentence.

4. Section 224.3 is revised to read as follows:

§ 224.3 Margin regulations to be applied by nonexempted borrowers.

(a) Credit transactions outside the United States. No borrower shall obtain purpose credit from outside the United States unless it conforms to the following margin regulations:

(1) Regulation T (12 CFR part 220) if the credit is obtained from a foreign branch of a broker-dealer;

(2) Regulation U (12 CFR part 221), as it applies to banks, if the credit is obtained from a foreign branch of a bank, except for the requirement of a purpose statement (12 CFR 221.3(c)(1)(i) and (c)(2)(i)); and

(3) Regulation U (12 CFR part 221), as it applies to nonbank lenders, if the credit is obtained from any other lender outside the United States, except for the requirement of a purpose statement (12 CFR 221.3(c)(1)(ii) and (c)(2)(ii).

(b) Credit transactions within the United States. Any borrower who willfully causes credit to be extended in contravention of Regulations T and U, and who, therefore, is not exempted by § 224.1(b)(1), must conform the credit to the margin regulation that applies to the lender.

PART 265 -- RULES REGARDING DELEGATION OR AUTHORITY

1. The authority citation for Part 265 continues to read as follows:
Authority: 12 U.S.C. 248(i) and (k).

2. Section 265.11(f) is revised as follows:

(f) Securities. To approve applications by a registered lender for termination of the registration under § 221.3(b)(2) of Regulation U (12 CFR part 221).

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By order of the Board of Governors of the Federal Reserve System, December 18, 1998.

(signed) William W. Wiles
William W. Wiles,
Secretary of the Board.