

## FEDERAL RESERVE SYSTEM

## 12 CFR Parts 220, 221 and 224

[Regulations T, U and X; Docket No. R-0995]

## Securities Credit Transactions

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Advance notice of proposed rulemaking and request for comment.

**SUMMARY:** In 1995 and 1996, the Board proposed three sets of amendments to its securities credit or margin regulations (Regulations G, T and U). These amendments were proposed in part based on a review of the margin regulations the Board is conducting pursuant to its internal policy of periodically reviewing its regulations and section 303 of the Riegle Community Redevelopment and Regulatory Improvement Act of 1994 and in part on statutory amendments to the Board's margin authority under the Securities Exchange Act of 1934 (the '34 Act) contained in the National Securities Markets Improvement Act of 1996. In a separate document published elsewhere in today's **Federal Register**, the Board is adopting final amendments to Regulations G, T and U in response to the three proposals. The final amendments include the extension of Regulation U to cover lenders formerly subject to Regulation G and the elimination of Regulation G.

In the course of the comment process for the Board's 1995-1996 proposals, commenters raised a number of issues not addressed by the Board in the proposals. In order to complete the periodic review of its margin regulations, the Board is publishing this advance notice and request for comment for Regulations T, U and X. After reviewing the comments, the Board may issue specific proposed amendments for public comment.

**DATES:** Comments should be received by April 1, 1998.

**ADDRESSES:** Comments should refer to Docket No. R-0995 and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Comments also may be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, N.W. between Constitution Avenue and C Street, N.W. at any time. Comments received will be available for inspection in Room MP-500 of the

Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.14 of the Board's rules regarding availability of information.

**FOR FURTHER INFORMATION CONTACT:**

Oliver Ireland, Associate General Counsel (202) 452-3625; Scott Holz, Senior Attorney (202) 452-2966; or Jean Anderson, Staff Attorney (202) 452-2966, Legal Division; for the hearing impaired only, Telecommunications Device for the Deaf (TDD), Diane Jenkins (202) 452-3544.

**SUPPLEMENTARY INFORMATION:** Pursuant to its authority under sections 3, 7, 17 and 23 of the Securities Exchange Act of 1934, the Board is requesting comment on its securities credit or margin regulations: Regulation T ("Credit by brokers and dealers"),<sup>1</sup> Regulation U ("Credit by banks and lenders other than brokers or dealers for the purpose of purchasing or carrying margin stock")<sup>2</sup> and Regulation X ("Borrowers of securities credit").<sup>3</sup> The Board is soliciting comment on all aspects of these regulations, including issues stemming from the consolidation of Regulation G into Regulation U and issues that have been raised by commenters in the past two years and not addressed in the Board's earlier amendments. The Board is soliciting comment on whether and how to address these issues. Any additional amendments would be proposed for public comment before adoption.

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<sup>1</sup> 12 CFR Part 220.

<sup>2</sup> 12 CFR Part 221.

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**I. Regulation T***A. Definitions*

## 1. Current Market Value

The Board's margin requirement for an equity security is a percentage of the security's current market value. As a technical amendment contained in a separate document published elsewhere in today's **Federal Register**, the Board adopted a Regulation T definition of the phrase *current market value* that incorporates former § 220.3(g) of Regulation T ("Valuing securities"). This definition is not exactly the same as the definition in Regulation U. Under the Regulation T definition, a broker-dealer must use the cost of a security or the proceeds of its sale to compute the current market value of a security on trade date. Under the Regulation U definition, a lender other than a broker-dealer extending credit on trade date may use either the security's cost or the closing price of the security on the preceding day. The Board is soliciting comment on whether the definitions of current market value in the two regulations should be harmonized.

## 2. Good Faith

The Board is requesting comment on whether it should propose to replace the current definition of *good faith* found in § 220.2 of Regulation T with a simpler, more universal definition. For example, the Uniform Commercial Code defines "good faith" in § 3-103(a)(4) as "honesty in fact and the observance of reasonable commercial standards of fair dealing." The Board seeks comment on whether this definition would be appropriate in the context of margin regulation.

## 3. Margin Security

Last year, the Board amended the definition of *margin security* to include "any debt security convertible into a margin security." The Board stated that this would mirror the treatment of convertible bonds in Regulations G and U. The actual language of Regulation U (which now covers banks and lenders formerly subject to Regulation G) is somewhat broader: "any debt security convertible into a margin stock or carrying a warrant or right to subscribe

to or purchase a margin stock." The Board is soliciting comment on whether it should propose to use the same regulatory language in Regulation T. The Board is also soliciting comment on whether it should propose to further amend Regulation T's definition of *margin security* to include "any warrant or right to subscribe to or purchase a margin stock," as this language is also found in Regulation U. Finally, the Board is soliciting comment on whether it should propose to broaden the coverage of convertible securities under the Regulation T definition of *margin security* to include any security convertible into a margin security. This last change would allow loan value for nonmargin equity securities which are convertible into a margin security.

### B. Margin Account

#### 1. Guarantees as Collateral

Guarantees are currently given no effect for purposes of meeting federal margin requirements pursuant to § 220.3(d) of Regulation T, but guaranteed accounts are permitted by the rules of some self-regulatory organizations (SROs)<sup>4</sup> for maintenance margin purposes. These SRO rules effectively allow two or more customers with accounts at a single broker-dealer to "cross-guarantee" some or all of their accounts. The guarantee must be in writing and allow the broker-dealer to use the money and securities in the guaranteeing account without restriction to carry the guaranteed account or pay any deficit therein. The Board is soliciting comment on whether it should propose an amendment to Regulation T to allow broker-dealers to recognize guarantees to the extent permitted by their SROs.

#### 2. Cashless Exercise of Employee Benefit Securities

Section 220.3(e)(4) of Regulation T was adopted in 1988 to allow broker-dealers to temporarily finance the exercise of their customers' employee stock options. This procedure has come to be known as "cashless exercise." In 1995, the Board proposed new language for § 220.3(e)(4) to expand its coverage to other types of employee benefit securities, such as employee stock warrants. The proposed amendment, which was adopted in 1996 substantially in the form proposed, changed the reference in § 220.3(e)(4) of Regulation T from "a stock option issued by the customer's employer" to securities received "pursuant to an

employee benefit plan registered on SEC Form S-8." After adoption of the amendment, the Board received several comments which noted that the amended provision in some respects covers fewer securities than the original version in that it no longer covered employee stock options not registered on SEC Form S-8. The Board is soliciting comment on whether it should propose further amendments to §§ 220.3(e)(4) to ensure that broker-dealers may use the provision to help all customers who need short-term financing to acquire employee benefit securities. Comment is invited on whether the Board should define what is meant by the phrase "employee benefit securities."

### C. Cash Account: Net Settlement and Free Riding

All transactions in a margin account on a given day are combined to determine whether additional margin is required. In contrast, transactions in the cash account are generally settled on a transaction-by-transaction basis. Although net settlement in the cash account would be more efficient than current practice, the requirement that securities be paid for before being sold and the 90-day freeze<sup>5</sup> on delaying payment beyond trade date for customers who have sold securities before paying therefor have been adopted to prevent "free riding," the purchase of a security that is paid for with the proceeds of its sale. The Board believes that free riding raises supervisory as well as credit issues and is soliciting comment on whether it would be appropriate to modify the cash account to encourage efficiencies while still preventing free riding and if so, how. The Board is also soliciting comment on whether it should leave the issue of free riding to the broker-dealers' supervisory authorities: the Securities and Exchange Commission (SEC) and SROs. The Board is also soliciting comment on appropriate methods for addressing free riding in Regulation U.

### D. Lending Foreign Securities to Foreign Branches of U.S. Banks

The Regulation T section on borrowing and lending securities<sup>6</sup> was amended in 1996 to allow broker-dealers to lend most foreign securities to foreign persons without many of the restrictions applied to loans of U.S. securities. Three commenters pointed out that the term "foreign persons" does not include foreign branches of U.S.

banks. The Board is soliciting comment on whether it should propose an amendment to allow foreign branches of U.S. banks to qualify as foreign persons for purposes of Regulation T's requirements for borrowing and lending equity securities.

### E. Broker-Dealer Purchases of Privately Placed Debt Securities

The Board views the purchase of a privately placed debt security as an extension of credit to the issuer. Broker-dealers who wish to purchase privately placed debt securities (generally for resale) whose proceeds will be used by the issuer to purchase or carry securities have been unable to do so if the debt securities are unsecured or secured by collateral other than margin and exempted securities because the Board had interpreted section 7 of the '34 Act to prohibit the extension of purpose credit that is unsecured or secured by collateral other than securities valued in accordance with Regulation T. Banks and persons other than broker-dealers who purchase these privately placed securities have not had the same problem as they have never been restricted in their ability to make purpose loans that are unsecured or secured by collateral other than securities.

In 1990, the Board issued an interpretation of the arranging provision in Regulation T to address purchases by broker-dealers of debt securities issued pursuant to SEC Rule 144A.<sup>7</sup> Under the interpretation, the purchase of a privately placed debt security whose proceeds will be used by the issuer to purchase, carry, or trade securities is permitted for a broker-dealer if the security is issued pursuant to SEC Rule 144A on the theory that the broker-dealer is arranging for the ultimate purchaser to acquire the security.<sup>8</sup>

The Board is soliciting comment on whether it should propose any amendments to Regulation T to allow broker-dealers to purchase privately placed securities that either comply with or are not covered by Regulations U and X. Possible amendments could address this issue as one of extending

<sup>7</sup>The Board interpretation is codified at 12 CFR 220.131 and reprinted in the *Federal Reserve Regulatory Service* at 5-470.1. SEC Rule 144A, "Private resales of securities to institutions" is codified at 17 CFR 230.144A.

<sup>8</sup>The Board interpretation described the broker-dealer's role as an "investment banking service" because the version of Regulation T in effect at the time had limited exceptions to the general arranging prohibition. The Board has since amended the arranging section in Regulation T to broaden permissible activities and in the process has eliminated the need for a specific investment banking services exception.

<sup>4</sup>The primary SROs for broker-dealers in this area are the New York Stock Exchange and the National Association of Securities Dealers.

<sup>5</sup> See § 220.8(c) of Regulation T.

<sup>6</sup> Formerly § 220.16, now § 220.10 of Regulation T.

rather than arranging credit and could cover debt securities beyond those covered in the Board's 1990 interpretation.

#### *F. Presumption of Purpose Credit*

Section 220.6(f)(2) of Regulation T (formerly § 220.9(b)) states that every extension of credit (aside from those effected to carry transactions in commodities or foreign exchange) is deemed to be purpose credit unless the broker-dealer obtains in good faith a written statement from its customer that the credit is not purpose credit. The Board is soliciting comment on whether it should propose to modify or eliminate this presumption and if so, how to assure compliance with the Board's margin requirements in Regulation T.

## **II. Regulation U**

### *A. Forms*

#### **1. Purpose Statement**

Both Regulation G and Regulation U require lenders to obtain a written statement from their customers as to the purpose of a loan if the credit is secured by margin stock. This form is known as a "purpose statement" and is designated as the FR G-3 and FR U-1, respectively. Although the margin requirements apply to all purpose loans secured by margin stock, banks are not required to obtain a purpose statement for loans that do not exceed \$100,000. Nonbank lenders, who are not required to register with the Board until they have extended at least \$200,000 in margin stock secured credit,<sup>9</sup> must obtain a purpose statement for every loan they make after reaching the registration threshold. The Board is soliciting comment on whether it would be appropriate to amend Regulation U to provide uniform requirements for purpose statements, including possible elimination of the form.

#### **2. Other Forms and Registration Requirements**

*a. Use of Regulation G forms under Regulation U:* The FR G-1 ("Registration Statement For Persons Who Extend Credit Secured by Margin Stock (Other Than Banks, Brokers or Dealers)"), FR G-2 ("Deregistration Statement For Persons Registered Pursuant to Regulation G") and FR G-4 ("Annual Report") were retained as part of

Regulation U when it was extended to cover lenders formerly subject to Regulation G. These forms' approval from the Office of Management and Budget expires on July 31, 1998. Pending review of the comments received in response to this request for comment, the Board intends to redesignate these forms as Regulation U forms and is soliciting comment on ways to improve the reporting requirements and eliminate unnecessary burden, including possible elimination of the forms.

*b. Registration requirements:* The registration requirements for lenders formerly subject to Regulation G have been moved to § 221.3(b) of Regulation U. Nonbank lenders who extend credit secured by margin stock for any purpose are required to register with the Federal Reserve within 30 days after any calendar quarter in which the lender either: (1) Extends \$200,000 or more in credit secured by margin stock; or (2) has a total of \$500,000 or more in credit secured by margin stock outstanding. Persons other than banks and broker-dealers who extend securities credit below these thresholds are not subject to the registration requirements and are not limited by the Board's 50 percent margin requirement for purpose loans secured by margin stock.

*(1) Dollar thresholds:* When Regulation G was first adopted in 1968, the Board established dollar thresholds for registration so that lenders other than banks and broker-dealers who extended small amounts of credit secured by margin stock would not be regulated. These thresholds were initially \$50,000 in margin stock secured credit extended or arranged in one calendar quarter or \$100,000 in such credit outstanding at any time. These thresholds were last raised in 1983 to \$200,000 and \$500,000 and the scope of the regulation was reduced at that time to eliminate coverage of persons who arranged, but did not extend, securities credit.

The Board is soliciting comment on whether it should propose changes to the \$200,000 and \$500,000 thresholds for nonbank lenders.

*(2) Nonpurpose lenders:* When Regulation G was first proposed by the Board in 1967, lenders other than banks and broker-dealers were to be subject to the regulation only if they extended or arranged purpose credit (which was proposed to mean credit to purchase or carry an exchange traded security). Regulation G lenders who extended or arranged nonpurpose credit would not have been required to register with the Federal Reserve System even if the collateral for the loan included

exchange-traded securities. When Regulation G was adopted the following year, the collateral coverage of the regulation was reduced to eliminate debt securities but the registration requirement was broadened to include any lender other than a bank or broker-dealer involved in a loan secured by margin equity securities, regardless of the purpose of the loan. Although the Board was originally concerned with the difficulty of assuring that previously unregulated lenders understood the concept of "purpose credit" (i.e. credit for the purpose of purchasing or carrying securities covered by Board regulation), the passage of time may have reduced the need to register nonpurpose lenders solely to determine that the registrants are not extending credit that is subject to the margin requirements.

The Board is soliciting comment on whether it should propose changes to the registration requirements for lenders other than banks and broker-dealers who do not extend purpose credit, such as eliminating the need for registration or establishing higher dollar thresholds. An example of a nonpurpose lender would be a mortgage finance company that extends only purchase money mortgage loans but occasionally takes margin stock as collateral in addition to mortgages.

### *B. Loan Value*

#### **1. Options**

In a separate document published elsewhere in today's **Federal Register**, the Board is eliminating the Regulation U prohibition on loan value for exchange-traded options. When the Board first proposed this change in 1995, it did not propose to remove the prohibition on loan value for unlisted or over-the-counter (OTC) options.<sup>10</sup> Since that proposal however, the Board has amended Regulation T to allow securities self-regulatory organizations such as the New York Stock Exchange to adopt SEC-approved rules granting loan value to all options, both exchange-traded and over-the-counter. The Board is soliciting comment on whether it should propose to modify the prohibition on loan value for OTC options currently contained in Regulation U.

<sup>9</sup>The \$200,000 threshold is based on the amount of credit secured by margin stock extended in any calendar quarter. Lenders who extend less than \$200,000 in credit secured by margin stock in any calendar quarter are required to register with the Board if they have \$500,000 in credit secured by margin stock outstanding during any calendar quarter.

<sup>10</sup>Unlisted or OTC options are not *margin stock* as defined in § 221.2 of Regulation U. Therefore, a loan secured by OTC options and other nonmargin stock collateral would not be subject to Regulation U. However, a purpose loan secured in part by margin stock (a "mixed collateral loan") would be subject to Regulation U and any OTC options that secure such a loan have no loan value under the current version of Regulation U.

## 2. Mutual Funds

Although most mutual funds are covered by the definition of *margin stock* in Regulation U, the Board has long excluded mutual funds that have at least 95 percent of its assets continuously invested in exempted securities.<sup>11</sup> In a separate document published elsewhere in today's **Federal Register**, the Board is excluding money market mutual funds from the definition of *margin stock* in Regulation U as well. The Board is soliciting comment on whether it should propose additional exclusions from the definition of margin stock for mutual funds which invest almost exclusively in securities entitled to good faith loan value under Regulation T, such as corporate bond funds.

## C. Exempted Transactions

The Board extended Regulation U to cover lenders formerly subject to Regulation G because the National Securities Market Improvement Act eliminated the distinction between bank and nonbank lenders with respect to loans to broker-dealers. The Board now permits bank and nonbank lenders to make loans to broker-dealers on the same basis, including the exemptions contained in § 221.5, "Special purpose loans to brokers and dealers." Banks are also permitted to make unregulated loans to persons other than broker-dealers pursuant to § 221.6, "Exempted transactions." The only one of the eight exemptions listed in § 221.6 was contained in former Regulation G: loans to employee stock ownership plans (ESOPs) qualified under section 401 of the Internal Revenue Code. This exemption, formerly found in § 207.5(c) of Regulation G, has been retained for nonbank lenders in § 221.4(c) of Regulation U. The Board is soliciting comment on whether it should propose to extend the exemptions for banks in § 221.6 of Regulation U to nonbank lenders as well. The Board seeks comment on whether it should propose to consolidate the exemption for loans to ESOPs with loans to "plan lenders" as defined in § 221.4(b) of Regulation U.

## III. Regulation X

Regulation X ("Borrowers of securities credit") implements section 7(f) of the '34 Act, which applies the margin requirements to borrowers.<sup>12</sup> Most of the language in Regulation X is taken

directly from the statute. If the Board were to repeal Regulation X, section 7(f) would still apply to borrowers of securities credit. The only substantive reason for the Board's adoption of a regulation covering borrowers is to exercise its authority under section 7(f)(3) of the '34 Act to exempt persons from the application of section 7(f). These exemptions are found in §§ 224.1(b)(1), (b)(2) and (b)(3) of Regulation X.

### A. National Securities Markets Improvement Act

In response to the Board's request for comment on appropriate amendments to its margin regulations to reflect the statutory changes contained in NSMIA, two commenters expressed concern that foreign affiliates of exempt U.S. broker-dealers continue to be subject to Regulation X (because they are "foreign persons controlled by a U.S. person") and their borrowings therefore have to comply with Regulation U, while the borrowings of their parent would not be subject to Board regulation. The commenters urged the Board to exempt foreign broker-dealer affiliates of exempt U.S. broker-dealers from Regulation X. The Board seeks comment on whether it should propose such an amendment.

### B. Periodic Review

In conjunction with its periodic review of the margin regulations, and the requirements of section 303 of the Riegle Community Redevelopment and Regulatory Improvement Act of 1994, the Board is requesting comment on other appropriate amendments to Regulation X to reduce unnecessary regulatory burden.

## IV. All Regulations

### A. Definition of National Securities Exchange

The Board's margin regulations have always covered all equity securities registered on a national securities exchange. Although the phrase "national securities exchange" is not defined in the Board's margin regulations or section 3(a) of the Securities Exchange Act of 1934,<sup>13</sup> the Board has understood the term to mean a securities exchange registered with the Securities and Exchange Commission (SEC) under section 6 of the '34 Act ("National securities exchanges;" 15 U.S.C. 78f). The Board is soliciting comment on whether it should propose to add a definition of the phrase

"national securities exchange" into Regulations T and U.

### B. Purpose Statements as Model Forms

The Board has established three purpose statements (FR G-3, FR T-4, and FR U-1) for the three types of lenders covered under its securities credit regulations. Lenders other than broker-dealers are specifically required by the Board's regulation to obtain the FR G-3 and FR U-1 in certain circumstances. However, Regulation T does not refer to the FR T-4 and states only that in certain circumstances a broker-dealer shall accept "a written statement" that "shall conform to the requirements established by the Board."

The Board is requesting comment on the continuing need for purpose statements, the form of which is prescribed by regulation, or whether model forms would serve the Board's purposes, or whether the form of the statement should be left to the affected institution or its regulatory supervisors.

### C. Repurchase of Securities by Issuer

The Board held in 1962 that credit extended to an issuer to repurchase its own securities *for immediate retirement* is not purpose credit subject to the Board's margin requirements.<sup>14</sup> The 1962 interpretation states that "[i]t should not be regarded as governing any other situations; for example, the interpretation does not deal with cases where securities are being transferred \* \* \* to the issuer for a purpose other than immediate retirement. Whether the margin requirements are inapplicable to any such situations would depend upon the relevant facts of actual cases presented." Three commenters requested that this interpretation be expanded to cover all credit extended to an issuer to repurchase its securities. While the interpretation requires immediate retirement of the securities repurchased, this limitation can be circumvented by having the issuer retire the securities it repurchases and then reissue those or similar securities later. The Board is soliciting comment on whether it should propose to incorporate its 1962 interpretation into Regulations T and U and whether the coverage of the interpretation should be broadened.

### D. Forward Transactions

Commenters in earlier dockets and members of the securities bar and industry have requested guidance from the Board on the proper treatment of forward purchases and sales of

<sup>11</sup> The definition of *margin stock* is found in § 221.2 of Regulation U.

<sup>12</sup> In contrast, the Board's other margin regulations were adopted under the authority of sections 7(c) and 7(d) of the '34 Act and apply to lenders of securities credit.

<sup>13</sup> Definitions found in section 3(a) of the '34 Act are incorporated by cross-reference in the Board's margin regulations.

<sup>14</sup> 12 CFR 220.119, reprinted in the *Federal Reserve Regulatory Service* at 5-490.

securities. Forwards on nonequity and exempted securities are permitted in the good faith account in Regulation T and are not covered by Regulation U. The Board is soliciting comment on whether and how it should amend Regulations T and U to address transactions involving forward purchases and sales of equity securities.

By order of the Board of Governors of the Federal Reserve System, December 18, 1997.

**William W. Wiles,**

*Secretary of the Board.*

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