''investment banking service'' and the credit does not violate Regulations G and U. Investment banking services are defined to include, but not be limited to, ''underwritings, private placements, and advice and other services in connection with exchange offers, mergers, or acquisitions, except for underwritings that involve the public distribution of an equity security with installment or other deferred-payment provisions.'' To comply with Regulations G and U where the proceeds of debt securities sold under Rule 144A may be used to purchase or carry margin stock and the debt securities are secured in whole or in part, directly or indirectly by margin stock (see 12 CFR 207.2(f), 207.112, and 221.2(g)), the margin requirements of the regulations must be met.

(e) The SEC's objective in adopting Rule 144A is to achieve ''a more liquid and efficient institutional resale market for unregistered securities.'' To further this objective, the Board believes it is appropriate for Regulation T purposes to characterize the participation of broker-dealers in this unique and limited market as an ''investment banking service.'' The Board is therefore of the view that the purchase by a creditor of debt securities for resale pursuant to SEC Rule 144A may be considered an investment banking service under the arranging section of Regulation T. The market-making activities of broker-dealers who hold themselves out to other institutions as willing to buy and sell Rule 144A securities on a regular and continuous basis may also be considered an arranging of credit permissible under § 220.13(a) of Regulation T.

[Reg. T, 55 FR 29566, July 20, 1990]

§ 220.132 Credit to brokers and dealers.

For text of this interpretation, see § 207.114 of this subchapter.

[Reg. T, 61 FR 60167, Nov. 26, 1996]

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

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

SOURCE: Reg. U, 63 FR 2827, Jan. 16, 1998, unless otherwise noted.

§ 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) 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.

(c) *Availability of forms.* The forms referenced in this part are available from the Federal Reserve Banks.

§ 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 as follows:

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) *Bank.* 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;

In the ordinary course of business 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.

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.

Lender means:

(1) Any bank; or

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

Margin stock 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)); or

(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 §221.7 (the Supplement) 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 nonpurpose 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 in effect prior to April 1, 1998, (See part 207 appearing in the 12 CFR parts 200 to 219 edition revised as of January 1, 1997), 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 (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 (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.* Capital contribution loans include:

(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.

(10) Credit to clearing brokers or dealers. Credit to a member of a national securities exchange or registered broker or dealer whose nonproprietary business is limited to financing and carrying the accounts of registered market makers.

§ 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.

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:

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

(b) 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 § 221.7 (the Supplement) would be applicable unless the loan should be of a kind exempted under this part. 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 elsewhere in this section.

§ 221.104 Federal credit unions.

For text of the interpretation on Federal credit unions, see 12 CFR 220.110.

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

For text of the interpretation on Arranging for extensions of credit to be made by a bank, 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 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) The examples in this section 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 this part 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 the interpretation on Arranging loan to purchase open-end investment company shares, 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 this part.

(a) This part 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 the language in paragraph (a) of this section to the two following questions:

(1) *Loan secured by stock.* First, is a loan to purchase or carry margin stock subject to this part 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 this part, 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 (*See*, § 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 this part applies to a loan ''secured directly or indirectly by margin stock.''

(2) *Loan to acquire controlling shares.* (i) The second question is whether this part 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 this part 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 this part, 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 this part.

(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 in paragraph (b) of this section, 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 (12 CFR part 220), 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 the Code of Federal Regulations which was published at page 874 of the 1946 Federal Reserve Bulletin (*See* 12 CFR 261.10(f) for information on how to obtain Board publications.), 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 this part.

(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 *indirectly secured* 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 in paragraph (f) of this section 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 § 221.7 (the Supplement).

(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 this part, and it may also be observed that a contrary conclusion could largely defeat the basic purpose of the margin regulations.

(e) 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 § 221.7 (the Supplement).

§ 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 this part 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 this part.

(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 (12 CFR part 224), which makes the borrower liable for willful violations of the margin regulations, will allow a lender subject to this part 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 in paragraph (c) of this section, 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.

(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 *in the ordinary course of business means* ''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) 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) This part 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 in § 221.3(d)(4) 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 § 221.7 (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 this part 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. (The guidelines are available pursuant to the Board's Rules Regarding Availability of Information, 12 CFR part 261.) 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) The guidelines referenced in paragraph (a) of this section 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 §221.4(a)(2) 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 this part. *See* §221.3(b). Since the debt securities contain no direct security agreement involving the margin stock, applicability of the lending restrictions of this part 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* §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* §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. (*See* 12 CFR 261.10(f) for information on how to obtain Board publications.) 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 in paragraph (b) of this section. 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 this part 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)

AUTHORITY: 15 U.S.C. 78g.

SOURCE: Reg. X, 48 FR 56572, Dec. 22, 1983, unless otherwise noted.

EDITORIAL NOTE: See the List of CFR Sections Affected in the Finding Aids section of this volume for FR citations to Part 224 OTC Margin Stocks changes.

§224.1 Authority, purpose, and scope.

(a) *Authority and purpose.* Regulation X (this part) is issued by the Board of Governors of the Federal Reserve System (the Board) under the Securities Exchange Act of 1934, as amended (the Act) (15 U.S.C. 78a et seq.). This part implements section 7(f) of the Act (15 U.S.C. 78g(f)), the purpose of which is to require that credit obtained within or outside the United States complies with the limitations of the Board's Margin Regulations T and U (12 CFR parts 220 and 221, respectively).

(b) *Scope and exemptions.* The Act and this part apply the Board's margin regulations to United States persons and foreign persons controlled by or acting on behalf of or in conjunction with United States persons (hereinafter borrowers), who obtain credit outside the United States to purchase or carry United States securities, or within the United States to purchase or carry any securities (both types of credit are hereinafter referred to as purpose credit). The following borrowers are exempt from the Act and this part:

(1) Any borrower who obtains purpose credit within the United States, unless the borrower willfully causes the credit to be extended in contravention of Regulations T or U.

(2) Any borrower whose permanent residence is outside the United States and who does not obtain or have outstanding, during any calendar year, a total of more than $100,000 in purpose credit obtained outside the United States; and

(3) Any borrower who is exempt by Order upon terms and conditions set by the Board.

[Reg. X, 48 FR 56572, Dec. 22, 1983, as amended by Reg. X, 63 FR 2839, Jan. 16, 1998]

§224.2 Definitions.

The terms used in this part have the meanings given to them in sections 3(a) and 7(f) of the Act, and in Regulations T and U. Section 7(f) of the Act contains the following definitions:

(a) *United States person* includes a person which is organized or exists under the laws of any State or, in the case of a natural person, a citizen or resident of the United States; a domestic estate; or a trust in which one or more of the foregoing persons has a cumulative direct or indirect beneficial interest in excess of 50 per centum of the valve of the trust.