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**REGULATION U TRAINING  
FOR THE PRIVATE BANK LENDERS  
AUGUST 1996**

**Jan Grote (713) 750-2299/ fax: 750-2346  
David Giles (713) 750-2307/ fax: 750-2346**

This training has been developed to  
respond to legal questions that  
have been and continue to be presented  
to the Commercial Loan Legal Gateway

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**EXHIBITS:**

- EXHIBIT 1 .....LOAN POLICY
- EXHIBIT 2 .....BOB BISHOP MEMO DATED JUNE 14, 1996
- EXHIBIT 3 .....REGULATION U
- EXHIBIT 4 .....PROPOSED AMENDMENT TO REGULATION U

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## INTRODUCTION

### **OBJECTIVES**

The purpose of this training and the materials is to review in detail the provisions of Regulation U that have come into play for officers making stock secured loans or making loans for the purpose of purchasing or carrying margin stock. Lenders are encouraged to obtain legal advice on their transactions subject to the Regulation U requirements. Since our time is limited, we will review the major points and walk through some sample questions and answers that illustrate the requirements of Regulation U. A Flow Chart is included as a reference tool to walk you through the logic of Regulation U. Keep in mind there are policy requirements that may be more stringent than the Regulation. The policy is intended to help you avoid violations, including personal liability for willful violations. The policy was recently changed by the Compliance Committee and implemented on the commercial side by a memo distributed under Bob Bishop's signature dated June 14, 1996. Whenever you are faced with a mixed collateral loan, legal counsel in the Legal Group's Commercial Loan Legal Services division ("CLLS") should be included to help you properly document your loan.

### **GOALS**

We would like you to leave this class with the following knowledge and understanding:

1. Regulation U is confusing and complex. It is not a safety-and-soundness rule designed to assure good underwriting.
2. When you have any purpose credit that is not secured 2 to 1 with margin stock seek help from your Legal colleagues in CLLS (Jan Grote 713/750-2299; David Giles 713/750-2307) and your Credit Deputy. These situations should also trigger a call:
  - mixed collateral purpose loans
  - purpose and non-purpose credit to the same customer when any of the loans are stock secured
3. Obtain a Reg U-1 purpose statement on any loan (including a letter of credit application, and if you secure a deposit arrangement make sure overdrafts paid do not exceed the maximum loan value of the stock) secured directly or indirectly by margin stock. This includes an assignment or pledge of a trust account that includes only one share of margin stock.
4. There is a thing called the Single-Credit Rule that sometimes combines loans for Reg U purposes.
5. Read the Form U-1 Purpose Statement and don't forget to sign and have your customer sign a completed form.
6. Obtain a Form U-1 for any loan secured directly or indirectly by a mutual fund unless 95% of the assets of the fund are continuously invested in U.S. government, agency, state or municipal obligations.

**LOAN POLICY** (see Exhibit 1)

**BOB BISHOP MEMO** (see Exhibit 2)

### **SUMMARY OF REGULATION U**

Regulation U imposes credit restrictions upon banks that extend credit for the purpose of buying or carrying margin stock if the credit is secured directly or indirectly by margin stock. The bank may not extend more than the maximum loan value of the collateral securing such credit as set by the Federal Reserve Board. The maximum loan value is currently 50% of the stock's current market value.

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Regulation U has two major requirements - (1) a reporting obligation for loans secured by any margin stock and (2) a maximum loan value requirement on purpose credit loans secured by margin stock. The collateral value requirement applies **regardless** of the size of the credit if the credit is a purpose credit secured directly or indirectly by any margin stock. Obtaining a purpose statement is regulatorily triggered by the amount of all credits (purpose and nonpurpose) secured directly or indirectly by any margin stock.

- **REPORTING REQUIREMENT - PURPOSE STATEMENT (FORM FR U-1) - LEGAL**

The customer must execute a Purpose Statement (Form FR U-1) whenever the bank extends credit **secured directly or indirectly by ANY MARGIN STOCK**, in an amount exceeding **\$100,000**. In determining whether the \$100,000 threshold is met, the lender must **aggregate all loans** to the customer **secured directly or indirectly by any margin stock**.

**Margin Stock** includes any equity security registered or having unlisted trading privileges on a national securities exchange; any OTC margin stock (appears on the list published by the Federal Reserve Board); any OTC security designated as qualified for trading in the National Market System under a designation plan approved by the SEC (NMS security); any debt security convertible into a margin stock or carrying a warrant or right to subscribe to or purchase a margin stock; any warrant or right to subscribe to or purchase a margin stock; and any security issued by an investment company registered under section 8 of the Investment Company Act with some limited exemptions. The Purpose Statement must be completed in its entirety and be signed by the customer and a bank officer. The bank's standard practice on a revolving credit is to obtain the Purpose Statement at the time the credit arrangement is originally established rather than at the time of each disbursement. A loan secured by shares of mutual funds is considered secured by margin stock unless 95% of the assets of the fund are continuously invested in U. S. government, agency, state, or municipal obligations. When in doubt on a loan secured by stock, obtain a purpose statement on Form FR U-1.

"**Indirectly secured**" includes any arrangement with the customer under which

- (1) 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
- (2) the exercise of such right is or may be cause for accelerating the maturity of the credit.

"Indirectly secured" then will include any standard negative pledge agreement that includes margin stock.

"**Indirectly secured**" DOES NOT INCLUDE such an arrangement if

- (1) after applying the proceeds of the credit, not more than 25% of the value (as determined by any reasonable method) of the assets subject to the arrangement is represented by margin stock;
- (2) 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 bank;
- (3) the bank holds the margin stock only in the capacity of custodian, depository, or trustee, or under similar circumstances, and, in good faith, has not relied upon the margin stock as collateral; or
- (4) the bank, in good faith, has not relied upon the margin stock as collateral in extending or maintaining the particular credit.

- **COLLATERAL VALUE REQUIREMENT - PURPOSE CREDIT SECURED BY ANY MARGIN STOCK**

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Regulation U specifies what loan value to give to collateral. Presently, margin stock has a maximum loan value of 50% of its current market value. Generally, puts, calls, and combinations thereof have no loan value for purposes of Regulation U. All *other collateral is valued at its good faith loan value which means that amount* (not exceeding 100% of the current market value of the collateral) *which a bank, exercising sound banking judgment, would lend, without regard to the customer's other assets held as collateral in connection with unrelated transactions.* The "excess" margin required by Regulation U cannot be taken into account in determining the loan value of other collateral.

Regulation U prohibits the bank from extending 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. **PURPOSE CREDIT** means any credit for the purpose, whether immediate, incidental, or ultimate, of buying or carrying margin stock. There is no dollar threshold for the collateral requirement - a \$50,000 purpose credit secured by any margin stock is subject to the collateral value requirements even though a purpose statement may not be regulatorily required. The records maintained should clearly establish the value of the collateral securing the credit. This is particularly important when a mixed collateral loan is made.

- **THE "SINGLE CREDIT RULE"**

The **single credit rule** treats a series of purpose loans, made at different times to the same customer, as a "single credit" for certain Regulation U purposes.

- If the bank lent purpose credit secured by margin stock it cannot 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. (prior secured purpose credit) - or said another way - If the credit is purpose credit and the credit is not secured directly or indirectly by margin stock, then Regulation U collateral requirements do not apply unless the bank has previously extended purpose credit secured by margin stock. In that case, the bank cannot extend the unsecured purpose credit unless the combined credit does not exceed the maximum loan value of the collateral securing the prior credit.
- If the bank extended unsecured purpose credit to a customer prior to the extension of purpose credit secured by margin stock, the credits are combined and treated as a single credit solely for the purposes of the withdrawal and substitution provisions of the regulation. (prior unsecured purpose credit)
- Where purpose credit secured by any margin stock and nonpurpose credit are extended to the same customer, the bank must treat the credits as two separate loans and may not rely upon the required collateral securing the purpose credit for the nonpurpose credit.

Who is the Customer? “Customer” includes any person or persons acting jointly, to or for whom a bank extends or maintains credit.

## Regulation U PURPOSE STATEMENT

Do you need one?

Is the loan secured directly or indirectly by MARGIN STOCK?

(1) What is margin stock?

(2) Does margin stock directly secure the loan?

(3) Does margin stock indirectly secure the loan?

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### DEFINITION OF MARGIN STOCK

- (1) any equity security registered or having unlisted trading privileges on a national securities exchange;
- (2) any OTC margin stock;
- (3) 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);
- (4) any debt security convertible into a margin stock or carrying a warrant or right to subscribe to or purchase a margin stock;
- (5) any warrant or right to subscribe to or purchase a margin stock; or
- (6) any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 USC 80a-8), other than--
  - (i) a company licensed under the Small Business Investment Act of 1958, as amended (15 USC 661); or
  - (ii) a company which has at least 95 percent of its assets continuously invested in exempted securities (as defined in 15 USC 78c(a)(12)); or
  - (iii) a company which issues face-amount certificates as defined in 15 USC 80a-2(a)(15), but only with respect of such securities.

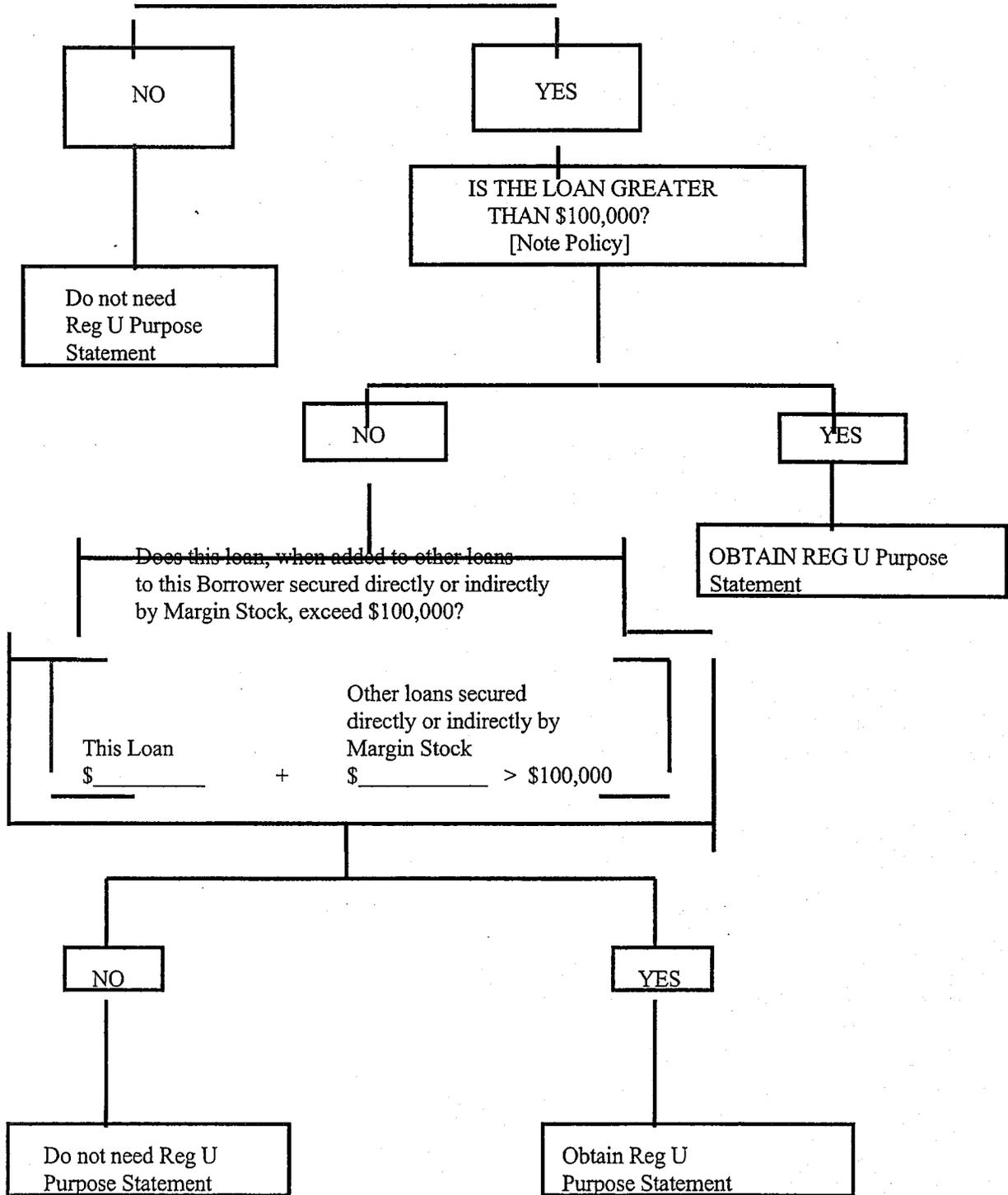
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### "INDIRECTLY SECURED"

- (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 bank;
  - (iii) the bank holds the margin stock only in the capacity of custodian, depository, or trustee, or under similar circumstances, and, in good faith, has not relied upon the margin stock as collateral; or
  - (iv) the bank, in good faith, has not relied upon the margin stock as collateral in extending or maintaining the particular credit.

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**IS THE LOAN SECURED DIRECTLY OR INDIRECTLY BY MARGIN STOCK?  
(FLOW CHART - LEGAL)**



(attach first page of Form U-1)

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(attach second page of Form U-1)

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If a loan secured by margin stock is for the purpose of purchasing or carrying margin stock the loan is subject to the credit limitations and related requirements of Regulation U. Because of the Single Credit Rule it is important to know what purpose credits the bank has made and are outstanding. Definitions are important.

### **"PURPOSE CREDIT"**

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

### **"CARRYING"**

"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.

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*The Regulation's Single Credit Rule reads as follows:*

*“(221.3)(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.*

- (2) A bank 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 bank 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 bank extends purpose credit secured by any margin stock and nonpurpose credit to the same customer, the bank shall treat the credits as two separate loans and may not rely upon the required collateral securing the purpose credit for the nonpurpose credit.*

**“SECTION 221.3 - General Requirements**

**221.3(a) Extending, maintaining, and arranging credit.**

- (1) Extending credit. No bank shall extend any purpose credit, secured directly or indirectly by margin stocks in an amount that exceeds the maximum loan value of the collateral securing the credit. The maximum loan value of margin stock (set forth in section 221.8 of this part) is assigned by the Board in terms of a percentage of the current market value of the margin stock [currently 50%]. All other collateral has "good faith" loan value, as defined in section 221.2(f) of this part.**
- (2) Maintaining credit. A bank 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 bank may arrange for the extension or maintenance of any purpose credit except upon the same terms and conditions under which the bank itself may extend or maintain purpose credit under this part.”**

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***“221.3(e) Mixed-collateral loans. “A purpose credit secured in part by margin stock, and in part by other collateral shall be treated as two separate loans, one secured by margin stock and one by all other collateral. A bank may use a single credit agreement, if it maintains records identifying each portion of the credit and its collateral.”***

***“(i) "Maximum loan value" is the percentage of current market value assigned by the Board under section 221.8 of this part to specified types of collateral. The maximum loan value of margin stock is stated as a percentage of its current market value [50%]. Puts, calls, and combinations thereof have no loan value except for purposes of section 221.5(c)(10) of this part. All other collateral has good faith loan value.”***

**“221.2(d) “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 bank 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 in accordance with sound banking practices.”**

**“221.2(f) “Good faith” with respect to -**

- (1) the loan value of collateral, means that amount (not exceeding 100 percent of the current market value of the collateral) which a bank exercising sound banking judgment, would lend, without regard to the customer's other assets held as collateral in connection with unrelated transactions;**
- (2) accepting notice or certification from or on behalf of a customer means that the bank 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 accept the notice or certification without inquiry, investigates and is satisfied that it is truthful;”**

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It is not possible to make an unsecured purpose credit and a stock secured purpose credit at the same time because of the Single-Credit rule which states unequivocally that *“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.”*

- **MIXED COLLATERAL PURPOSE LOANS - SPECIAL NOTES**

Regulation U does allow a bank to extend purpose credit on collateral other than securities. When a purpose credit loan is made that is secured in part by margin stock, and in part by other collateral then the Bank must treat the credit as two separate loans, one secured by margin stock and one by all other collateral. A single credit agreement can be used provided the bank maintains records identifying each portion of the credit and its collateral. The stock collateral must be allocated only to that portion of the credit that its maximum loan value will support. The portion of the credit to be secured by nonstock collateral cannot exceed an amount that the bank, exercising sound banking judgment, would lend, without regard to the customer's other assets held as collateral in connection with unrelated transactions. One of the goals of the mixed collateral loan provisions is to ensure that a lender does not inflate the loan value of nonmargin collateral to offset the fact that the margin regulations limit the value of margin stock to 50% of its current market value. The maximum loan value of collateral other than margin stock should be the amount which the bank would customarily lend on such collateral if that were the only collateral for the loan. The Board has long held that a guaranty of a loan is not “collateral” and therefore cannot be attributed any loan value.

Reallocation of the portion of the loans secured by margin stock versus the portion secured by non-margin stock collateral is not permitted. Therefore, any increase in the value of nonstock collateral has no effect on the portion of the credit allocated to the stock collateral as far as withdrawals or loan increases are concerned. The regulation does not permit a reallocation whereby more of the total indebtedness is deemed to be secured by non-margin stock. The initial division of the credit into one portion secured by margin stock and another secured by non-margin stock for regulatory purposes is binding throughout the life of the credit and can be changed only pursuant to the withdrawal and substitution rules. The stock collateral may not be withdrawn or the loan may not be increased unless changes in the market value of the stock collateral or a reduction in the loan will support such withdrawal or unless additional stock collateral is deposited. The withdrawal and substitutions rule provides as follows:

*“(1) A bank 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.”*

- **PURPOSE AND NON-PURPOSE CREDIT TO THE SAME CUSTOMER**

A Staff Opinion of August 16, 1983 explains this issue: The regulation specifically requires a bank that extends both purpose credit, secured by any margin stock, and non-purpose credit to the same customer, to treat the two different types of credits as two separate loans and not to use the required collateral securing the purpose credit to secure directly or indirectly the non-purpose loan (Section 221.3(d)(4)). If a bank sought to extend both purpose and non-purpose credit to the same customer, it could keep a customer's purpose loans segregated from the customer's non-purpose loans and establish separate credits for the two different types of loans.

The original Questions and Answers published by the Federal Reserve reads:

*“Q 20: May a bank extend to the same customer a nonpurpose loan secured by stock and a purpose loan either unsecured or secured by collateral consisting of other than stock?”*

*A: For Regulation U purposes, whenever a bank extends two loans to the same customer, one a purpose loan and the other nonpurpose, any stock collateral would first be identified with the purpose loan. Any excess collateral, whether stock or nonstock, not so identified with the purpose loan could be utilized for the collateral requirement as to the nonpurpose loan, if deemed necessary to the bank.”*

Do not confuse the distinction between making stock secured non-purpose credit loans and unsecured purpose credit and the importance of documentation. It may be possible (assuming your good faith credit evaluation permits) to make to a customer an unsecured purpose credit and a margin stock secured non purpose credit so long as the credits are documented so that the margin stock does not directly or indirectly secure the purpose credit. Timing may also be important. Remember that “indirectly secured” 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.* Therefore, the security agreement pledging the margin stock must only cover the non-purpose credit debt and there must not be any negative pledge on the stock while the purpose credit is on the books or the maturity of the purpose credit cannot be accelerated because the customer exercises its right or ability to sell, pledge or otherwise dispose of the stock. Remember, the rule provides that *“If a bank extends purpose credit secured by any margin stock and non-purpose credit to the same customer, the bank shall treat the credits as two separate loans and may not rely upon the required collateral securing the purpose credit for the non-purpose credit.”*

The situation where the bank has extended an unsecured purpose loan to a customer and the customer later requests a secured non purpose credit loan secured by margin stock is a situation where the single credit rule does not apply and nothing in Regulation U prohibits it. However, you need to watch your documents. In response to a question regarding a situation where the bank has extended nonpurpose credit secured by margin stock and is later asked to extend an unsecured purpose credit to the same customer, the FRB Staff Opinion of February 4, 1986 stated: “Although the single credit rule does not cover this situation, the question arises whether the margin stock collateral securing the first loan might be indirectly securing the second loan.” In that case the staff could not make a determination without additional information.

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## Sample Questions

(Answers and Reasons follow on the next four pages, so please try to answer before looking)

### EXAMPLE 1

YOU MAKE THE FIRST PURPOSE CREDIT TO JOHN CARR IN THE AMOUNT OF \$500,000 SECURED BY MARGIN STOCK.

WHAT MUST THE MINIMUM MARKET VALUE OF THE MARGIN STOCK BE IN ORDER TO SECURE THIS LOAN UNDER REGULATION U.

Answer:

WHY? LOAN VALUE WOULD BE \_\_\_\_\_.

### EXAMPLE 2

You are making a Purpose Loan to a Borrower in the amount of \$800,000.00 secured by margin stock. There is a prior unsecured purpose credit in the amount of \$1,000,000. What must the minimum value of the margin stock be?

Answer:

Why?

### EXAMPLE OF SINGLE PURPOSE CREDIT RULE

#### EXAMPLE 3

You want to make an \$800,000 unsecured purpose loan to a Borrower who has previously obtained a \$1,000,000 loan secured by margin stock valued at \$2,500,000.00. Can you make it unsecured?

Answer:

#### EXAMPLE 4

EXAMPLE OF A MIXED COLLATERAL PURPOSE CREDIT LOAN

LOAN FOR THE PURPOSE OF

REFINANCING A MARGIN STOCK LOAN

LOAN IS FOR \$1,500,000.00 SECURED BY VACANT LAND APPRAISED AT \$1,200,000.00 AND THE FOLLOWING MARGIN STOCK:

Loan Value		
	DISNEY stock (\$40/share)	8,000 shares \$320,000
	IBM stock (\$50/share)	1,000 shares \$50,000
	Eastman Kodak stock	8,000 shares

	(\$30/share)	\$240,000
	Mobil stock (\$40/share)	5,000 shares \$200,000
Total Loan Value of Margin Stock		

1,500,000.00 loan

(See other examples in Loan Policy at Exhibit \_)

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## EXAMPLE 1

*(first purpose credit)*

YOU MAKE THE FIRST PURPOSE CREDIT TO JOHN CARR IN THE AMOUNT OF \$500,000 SECURED BY MARGIN STOCK.

WHAT MUST THE MINIMUM MARKET VALUE OF THE MARGIN STOCK BE IN ORDER TO SECURE THIS LOAN UNDER REGULATION U.

Answer: \$1,000,000.00

WHY? LOAN VALUE WOULD BE 50% OF 1,000,000.00 OR \$500,000.00.

## EXAMPLE 2

*(existing prior unsecured purpose credit)*

You are making a Purpose Loan to a Borrower in the amount of \$800,000 secured by margin stock. There is a prior unsecured purpose credit in the amount of \$1,000,000. What must the minimum value of the margin stock be?

Answer: \$1,600,000.

Why? The loan value of the \$1,600,000 margin stock is \$800,000 (That is, the unsecured prior purpose loan does not affect the calculation for this loan.).

However, collateral cannot be withdrawn unless the combined credit (\$1,800,000) complies with the collateral withdrawal and substitution rules of Regulation U.

## EXAMPLE OF SINGLE PURPOSE CREDIT RULE

### EXAMPLE 3

*(prior secured purpose credit)*

You want to make an \$800,000 unsecured purpose loan to a Borrower who has previously obtained a \$1,000,000 loan secured by margin stock valued at \$2,500,000.00. Can you make it unsecured?

Answer: No.

[Single Purpose Credit Rule]

The loan value of the margin stock is \$1,250,000  
[50% of \$2,500,000].

However, the combined credit is \$1,800,000  
[\$1,000,000 + \$800,000]

This illustrates the SINGLE PURPOSE CREDIT RULE which means that if the Bank previously extended purpose credit secured directly or indirectly by margin stock then the Bank cannot extend unsecured purpose credit unless the combined credit does not exceed the maximum loan value of the collateral securing the prior credit.

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EXAMPLE 4

EXAMPLE OF A MIXED COLLATERAL PURPOSE CREDIT LOAN

LOAN FOR THE PURPOSE OF REFINANCING A MARGIN STOCK LOAN

LOAN IS FOR \$1,500,000.00 SECURED BY VACANT LAND APPRAISED AT \$1,200,000.00 AND THE FOLLOWING MARGIN STOCK:

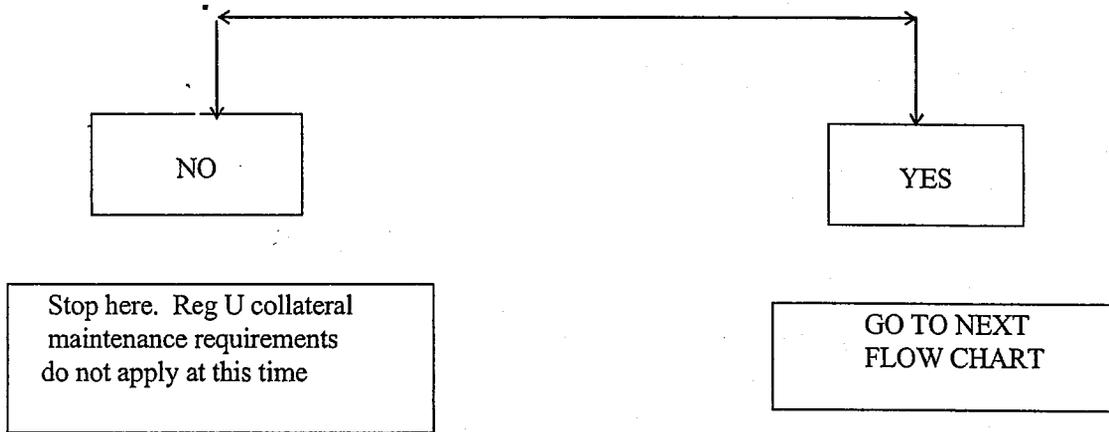
Loan Value	<i>(Forgive assumptions)</i>	
160,000	DISNEY stock (\$40/share)	8,000 shares \$320,000
25,000	IBM stock (\$50/share)	1,000 shares \$50,000
120,000	Eastman Kodak stock (\$30/share)	8,000 shares \$240,000
100,000	Mobil stock (\$40/share)	5,000 shares \$200,000
\$405,000 Total Loan Value of Margin Stock		
	1,500,000.00	
	- 405,000.00	
	-----	
	\$1,095,000.00	loan must be secured by other collateral having good faith loan value.

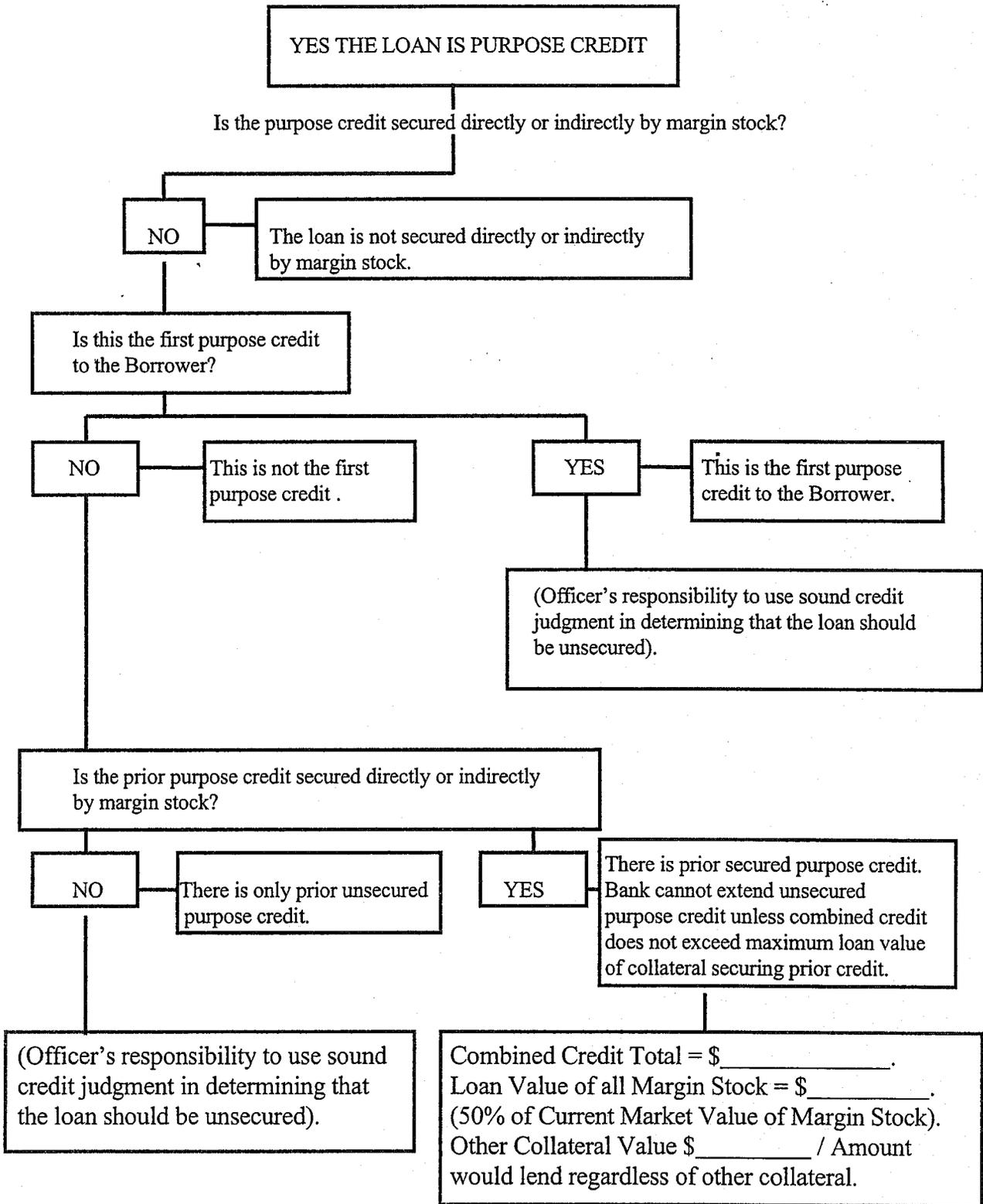
Would the bank exercising sound judgment lend \$1,095,000 to borrower without regard to borrower's other assets held as collateral in connection with unrelated transactions secured by the real property?

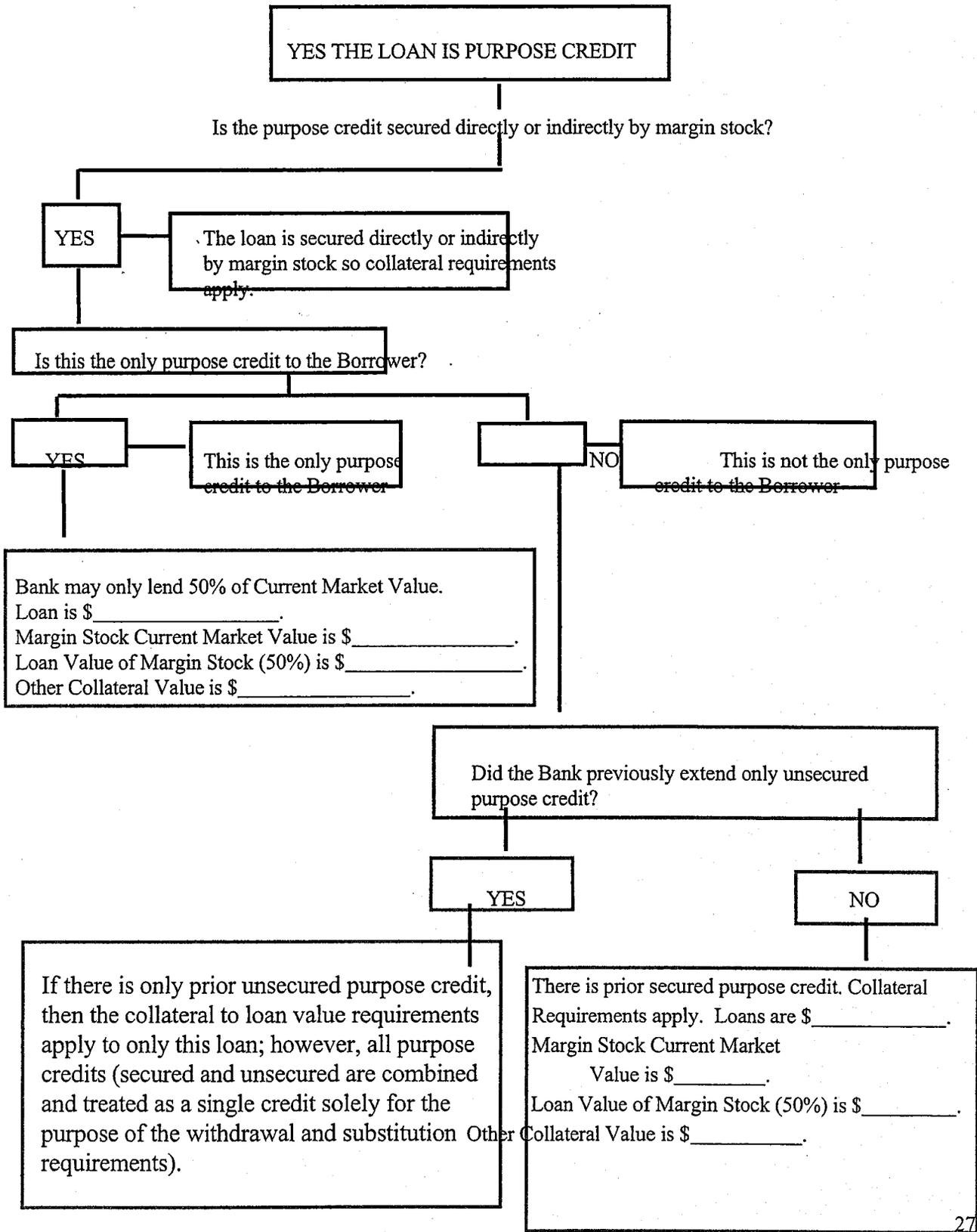
<a credit decision>

**COLLATERAL MAINTENANCE REQUIREMENTS**  
[FLOW CHART - LEGAL]

**Is the loan for the PURPOSE, whether immediate, incidental, or ultimate, of buying or carrying margin stock? (Purpose Credit)**







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**CASE STUDY**

**COMMON STRUCTURING PROBLEMS  
and  
HOW TO APPLY THE RULES IN REAL SITUATIONS**

**PROBLEM:** *Jo Sargent, a private banker, just inherited a loan to Junior Lotto, an executive of an important customer. The loan was a single payment term loan of \$300,000 secured by margin stock that was at the time the loan was made worth \$610,000 and there is a purpose statement in the file showing the loan was for the purpose of refinancing purpose credit at another bank. The margin stock's loan value at the time the loan was made was \$305,000. Let's assume the current market value of the stock is now \$620,000 making its loan value \$310,000. When the original loan was made by John Oiler he didn't even think of Reg U, (being the big time energy lender that he was); he took the stock because it was offered to him. Well, Junior wants a \$200,000 unsecured loan to buy some margin stock for a gift to his grandkid graduating from college and Jo decides after looking at his financials that she wants to make the loan unsecured but being diligent she checks the system and finds the outstanding term purpose loan secured by margin stock. She (being the smart private banker) knows he will not be happy if he can't have the loan unsecured so she makes the following list of her ideas and facts important to her and credit analysis to take to her favorite in-house attorney, Legal Ease, and Credit Deputy, Penny Wise, for guidance because she desperately wants to have the business and provide Star Treatment. What may be potential solutions in the quest for Star Treatment?*

*1- From a credit standpoint, the \$300,000 term loan could have been done unsecured and Jo is willing to release all the collateral so it will be unsecured so the only loan on the books is unsecured.*

*2- Junior Lotto's credit which was impeccable when the \$300,000 loan was made has substantially improved!*

*3- Jo would be happy to make an unsecured \$500,000 loan to pay off the existing loan and to make the new loan.*

**ANALYSIS AND WHAT HAVE WE LEARNED?**

1. There is that Single Credit Rule that gets you in trouble since it makes you treat all purpose credit extended to a customer as a single credit and makes the lender consider all the collateral securing such credit in determining whether or not the credit complies with the regulation. Furthermore when the lender has extended purpose credit secured by margin stock the lender 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. So, in this case Jo cannot make the second purpose credit unsecured notwithstanding the improved credit position.

2. Collateral may only be released in accordance with the regulation's requirements repeated as follows:  
***Withdrawals and substitutions.***

***(1) A bank 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.***

Thus, notwithstanding the improved and impeccable prior credit, Jo is not able to release all the collateral.

3. If Junior had available cash sufficient to pay off that first loan and does, then Bank could make the subsequent loan unsecured and could thereafter make available other amounts consistent with sound lending practices should Junior later need the cash for personal expenses since he used up his other in paying off the

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purpose credit. Note, that the Bank could not make a larger unsecured loan and payoff the first secured purpose loan with the proceeds because of timing issues and the single credit purpose rule.

4. Another bank may be willing to lend to Junior the purpose loan unsecured; perhaps your friendly counterpart at Chase would be willing to make the unsecured loan following a referral by you so your customer will not go to Nations Bank or be willing to buy your secured purpose credit and then with you no longer having a secured purpose credit on the books you may be freed up to make the second loan unsecured. However, you should consult with your legal counsel on this as one of the general requirements of Regulation is the following: *"No bank may arrange for the extension or maintenance of any purpose credit, except upon the same terms and conditions under which the bank itself may extend or maintain purpose credit under this part."* There is a very fine line between making a referral and arranging. In response to a Question asking what kinds of activity are encompassed by the term "arranging" the Board responded:

" Q 34: What kinds of activity are encompassed by the term "arranging?"

A: For the purpose of the rule, prohibited arranging embraces activity that may fall short of actual negotiations to procure credit for the borrower from the other person. For example, arranging includes any act on the part of a bank, such as an introduction, leading to an extension of credit from a third person. Further a bank cannot refer a borrower or potential borrower to another lender not subject to Regulation U, such as the bank's parent holding company or an affiliated finance company, for a purpose loan secured by nonmargin stock in an amount greater than is permitted by Regulation U. However, the prohibition against arranging would not preclude a bank from furnishing credit information concerning a customer in accordance with its general business practice.

5. **PRACTICAL ADVICE.** From a structuring point of view, if you anticipate making multiple purpose credits to the same customer over time consider the effect of making the first, or any loan thereafter secured by margin stock as it affects your ability to make subsequent unsecured loans. Consult with your credit deputy.

**PROBLEM:** Private Banker is making a \$300,000 loan secured by a Trust Account (good there are no common trust funds in the account - remember Regulation 9) with a current market value of \$1,000,000 and there is one share of margin stock with a market value of 37 dollars. Is a Regulation U purpose statement required?

**ANSWER/ANALYSIS:** Yes. The mere existence of one share of margin stock in a trust account pledged and assigned to the bank is sufficient to trigger the requirement of executing a Form U-1 if a loan is secured directly or indirectly by stock, regardless of the number of the shares serving as security. A subsequent addition of margin stock to a trust that had not held stock at the time it was first assigned would not trigger the Form unless new credit were being extended.

**PROBLEM:** Bank makes an unsecured nonpurpose credit. A guaranty is obtained. The guaranty is secured by margin stock. Is a Regulation U-1 statement required?

**ANSWER/ANALYSIS:** STAFF OP. of Feb. 15, 1979.

*"FORM U-1.*

*A bank makes a loan to a borrower on an unsecured note, with no collateral of any type being pledged. The bank accepts a guarantee of this same loan from another individual, who collateralizes the guarantee with stock. The intent of Regulation U would best be served by having the guarantor sign the form, since his stock is actually being pledged. The form could easily be modified to indicate the guarantor's status. STAFF OP. of Feb. 15, 1979.*

*Authority: 12 CFR 221.3(a) (revised 1983; now 12 CFR 221.2(f)(2) and 221.3(b) and (c))."*

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*"INDIRECTLY SECURED - Guaranty*

*A bank loan will be secured by a guaranty with the guarantor pledging securities to back up the guaranty. Staff stated that the bank loan could be indirectly secured by the securities pledged to back up the guaranty, but before such a determination could be made, all the relevant documents would have to be examined. STAFF OP. of Dec. 4, 1980.*

*Authority: 12 CFR 221.3(c) (revised 1983; now 221.2(g))*

**PROBLEM:** Loan workout officer is in the midst of the restructure of unsecured purpose credit. There is some margin stock available. Can he take the stock even if the Regulation U collateral requirements are not met. If so, what would permit it?

**ANSWER/ANALYSIS:** The Regulation allows the bank to take action for its own protection. 221.3(j) states **"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."** These situations require careful analysis and documentation and legal counsel should be consulted.

**Reproduced below are Staff Rulings and Opinions that address questions we have seen and provide us with some guidance:**

### **FORM U-1 Loan Secured by Partnership Interest**

"The question was raised whether a loan collateralized by an interest in a limited partnership that invests in margin stock could be used for the purchase of a new similar limited partnership interest. Neither interest is registered on a national securities exchange.

The regulation ordinarily does not necessitate looking through the form of a partnership to ascertain the purposes for which it was formed. However, substance of a transaction will be examined if the purpose of the arrangement appears to be circumvention of the margin regulations. Also, if an entity that invests in margin stocks is registered or is required to be registered under section 8 of the Investment Company Act of 1940, the securities issued by that entity would be margin stock (§221.2(h)(6)).

Completion of a Form U-1 is required whenever a loan, regardless of purpose, is secured by margin stock. The credit restrictions apply when the loan is both secured by margin stock and for the purpose of purchasing margin stock. STAFF OP. of April 19, 1985.

*Authority: 12 CFR 221.3"*

### **PURPOSE CREDIT - PAYMENT OF INCOME TAX**

"Credit extended by a bank for the sole purpose of allowing the customer to pay income tax due upon the exercise of nonqualified stock options is not purpose credit within the meaning of Regulation U despite the fact that the stock obtained upon the option exercise is margin stock. STAFF OP. of March 21, 1979.

*Authority: 12 CFR 221.3(e) (revised 1983; now 12 CFR 221.3(h))"*

### **PURPOSE CREDIT - PRESENT STATUS OF STOCK CONTROLS**

"A corporation obtained a bank loan for the purpose of purchasing stock. Subsequent to the date of the loan commitment, the stock was added to the Board's list of OTC margin stocks.

Staff concluded that the loan was not subject to the 50 percent loan limitation imposed by Regulation U. However, the loan would be a regulated loan after funds are advanced, and substitutions or withdrawals of collateral would have to comply with the applicable provisions of Regulation U. STAFF OP. of Aug. 28, 1980.

*Authority: 12 CFR 221.108"*

### **RENEWALS AND EXTENSIONS OF MATURITY**

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"A bank extended credit for the purchase of margin stock and secured the credit, directly and indirectly, with the margin stock. At the time of the loan, the bank did not obtain sufficient collateral to satisfy the margin requirements under Regulation U. The borrowers executed notes providing for payment of the credit. Each year, the bank requests and the borrowers agree to execute additional notes in order to renew the original notes. The terms of the later notes are the same as the original notes. The bank does not request an increase in collateral, and the margin requirements under Regulation U remain unsatisfied. After the applicable statute of limitations ran on the original notes, a dispute arose between the bank and the borrowers concerning the payment of the notes and the application of Regulation U.

Section 221.3(e) states that a renewal of a credit or the extension of a maturity need not be treated as extensions of credit if the amount of the credit is not increased except by the addition of interest, service charges, or transaction taxes. The purpose of the section is to permit continued maintenance of a credit initially extended in compliance with Regulation U, regardless of change in the Board's margin rate or the stock's market value.

**If the bank had in good faith accepted a customer's statement that the loan was not a purpose credit, it would not be considered in violation of Regulation U. If, however, the bank learned that it had been misled about the purpose of the loan, the bank would be expected to take whatever steps were necessary to comply with the regulation.** Section 224.6(b) of Regulation X states that any person (this could be a bank) who willfully aids in the violation of Regulation X by another person is also in violation of the regulation. Although a bank might not have violated Regulation U when it originally extended a loan, it could be in violation of Regulation X if it renewed the loan knowing that the borrower had falsely certified the purpose of the loan when it was made. Although the statute of limitations may have run for purposes of a private cause of action, the bank is not excused from the requirement that it try to effect compliance with all the Board's margin regulations. STAFF OP. of April 9, 1980.

*Authority: 12 CFR 221.3(e) (revised 1983; now 12 CFR 221.3(h))."*

### VALUATION - INDIRECT SECURITY

"A bank is not required to use different methods of valuing direct and indirect security. Although Regulation U is not specific on the point, it is the staff's opinion that a bank should not attribute any value to an asset that at the time of the bank's commitment already directly or indirectly secures another loan. If the value of the asset exceeds the amount needed to secure the outstanding loan properly, the excess could be used to support a new loan. This opinion is consistent with various provisions of all the margin regulations prohibiting the double-counting of collateral. STAFF OP. Jan. 2, 1981.

*Authority: 12 CFR 221.1 (a) (revised 1983; now 12 CFR 221.3 (a))."*

### TRANSFER OF CREDIT

"A bank proposes to refinance a loan currently at another bank. It asks whether the original purpose of the loan applies so that it may treat the refinancing of the existing loan as a nonpurpose loan.

The original loan was used to purchase the nonmargin stock of a registered broker-dealer. The loan was secured by stock. The original loan has been reduced and is presently collateralized by margin stock. The borrower expects to reduce the loan so that it will equal 50 percent of the stock value and then move it to a brokerage firm, in a general account.

Section 221.3(f) allows a bank to accept, directly from another bank, the transfer of a credit originally extended in conformity with Regulation U. The unavailability of the original Form U-1 does present a problem, but if the bank believes that the original purpose applies and that the loan is therefore a nonpurpose loan, the bank may accept it and treat it as such.

Even if the bank deems the loan to be a purpose loan, it may still accept it, but since the loan would be undermargined, it would be subject to the substitution and withdrawal requirement of Regulation U, section 221.1(b). In either case, when the loan reaches 50 percent of the stock value, it could be transferred to a broker-dealer. STAFF OP. of June 27, 1978.

*Authority: 12 CFR 221.3(f) (revised 1983; now 12 CFR 221.3(i))."*

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## INDIRECTLY SECURED - DRAGNET PROVISION

*"If a bank has specifically contracted with a borrower for a continuing security interest in all stock held for any indebtedness of the borrower, all such indebtedness will be deemed indirectly secured by that stock. A Form U-1 is required for each credit extended while such a dragnet provision is in effect. STAFF OP. of Sept. 9, 1975.*

*Authority: 12 CFR 2221.3(c) (revised 1983; now 12 CFR 221.2(g)).*

*As of March 31, 1982, only credit secured by margin stock is subject to Regulation U (§221.3(a))."*

## INDIRECTLY SECURED - REVOLVING CREDIT AGREEMENT

*"Under a revolving credit agreement, the borrower may use the proceeds of loans for various corporate purposes, including the purchase of margin stock. Although no direct security is granted to the banks, the credit agreement contains various provisions restricting the borrower's right to sell, pledge, or otherwise dispose of its assets, including any margin stock owned by it. Thus, it was believed that the loans made pursuant to the credit agreement would be indirectly secured by margin stock for the purpose of Regulation U unless section 221.2(g)(2)(i) applied. The question was raised whether the satisfaction of section 221.2(g)(2)(i) maybe determined at the time of entering into the credit agreement.*

*If on the date the credit agreement is entered into the total credit being provided will be treated as if it will be used to purchase margin stock on that date and the margin stock already owned by the borrower on that date and any margin stock to be acquired would be less than 25 percent of the value of its total assets, the loans would not be indirectly secured for Regulation U purposes.*

*In the case of any subsequent borrowing under the credit agreement, if the 25 percent test cannot be met as a result of changed in the value of the borrower's assets, the newly extended credit would be indirectly secured. That new credit would have to be combined with the previously extended credit and treated as a single credit, but only for purposes of the withdrawal and substitution provision of Regulation U (§221.3(f)). STAFF OP. of Nov. 9, 1983.*

*Authority: 12 CFR 221.2(g), 221.3(d)(3), and 221.3(f)."*

## INDIRECTLY SECURED - CORPORATION LOAN; NEGATIVE COVENANT ON BORROWER'S ASSETS

*"The term "indirectly secured" does not apply to a situation in which "not more than 25 percent of the value . . . of the assets subject to the arrangement is represented by margin stock" (§221.1(g)(2)(i)). This exemption typically involves a corporate loan, with the lending bank placing a negative covenant on all of the borrower's assets, which are in large part represented by plant and equipment. It was not designed to cover a situation in which all of the assets of the borrower are margin stock, as is the case with a holding company or shell corporation prior to the effectuation of a merger. Over the course of the years, many corporations own or intend to own in addition to plant and equipment, some margin stock. The bank lending to such a corporation may wish to use a general negative covenant in the loan agreement. Without the exception provided in Regulation U, even a de minimus holding of margin stock would make the loan a regulated loan. The exception from the coverage of the term "indirectly secured" is not available when the only assets of the borrower are margin stock. STAFF OP. of June 15, 1984.*

*Authority: 12 CFR 221.2(g)(2)(i)."*

## INDIRECTLY SECURED - COVENANT

*"A group of banks proposes to make some loans to a parent company and one of its subsidiaries that will effectively be jointly and severally liable for the loans. The loans will be treated as purpose credit but will not be directly secured by any collateral. The banks have asked the borrowers to maintain a portfolio of liquid assets with an aggregate value in excess of the sum of the bank loans and all other debt of the borrowers. This portfolio will consist of margin stock and other marketable securities such as government securities, corporate bonds, money market instruments, commercial paper, and certificates of deposit. The banks are not concerned about the mix of this portfolio.*

*Ideally, the bank would like a negative pledge on the borrower's assets. However, more than 25 percent of these assets currently consist of margin stock. A negative pledge would therefore bring the loan within the definition of "indirectly secured" in Regulation U. Although the borrowers appear to have enough collateral to comply with the margin requirements of Regulation U, the fact that the borrowers will be free to change the mix of assets in the portfolio makes compliance with the withdrawal-and-substitution provision of the regulation impractical.*

*As an alternative, the banks would like to require the borrowers to agree that, if they pledge all or any part of the portfolio to another creditor, they will grant to the banks "a pari passu security interest in the [liquid] assets so pledged securing the claims of the other creditor and those of the banks equally and ratably." The banks should be able to state in good faith that they are not relying upon the margin stock as collateral.*

*The covenant described does not make the loan "indirectly secured" by margin stock within the meaning of Regulation U. The banks note that their overriding objective is to ensure that sufficient liquidity will be available for the borrowers to meet their obligations to the banks and any other creditors. The banks merely wish to ensure that no other creditor receives a preferential interest in the portfolio. This appears to be a prudent requirement. If the borrowers later pledge some margin stock to another creditor and the covenant therefore gives the banks a equal and ratable lien, the loans would be come subject to Regulation U on a prospective basis. STAFF OP. of April 20, 1993. Authority: 12 CFR 221.2(g)."*

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