

HAYNES BOONE

# Understanding Regulation U

Craig Unterberg, Partner

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*Note: This material does not constitute a legal opinion or advice related to any of the subjects or topics mentioned herein. It is only an informative overview of the legal framework of Regulation U.*

# LEGISLATIVE HISTORY ON REGULATION U

## Background

- As a result of the stock market crash of 1929, the Board of Governors of the Federal Reserve System (the “**FRB**”) was given the authority and the duty under Section 7 of the Securities Exchange Act of 1934 to regulate margin lending.

## Purpose

- Regulation U was adopted for the purpose of preventing an excessive amount of margin stock secured credit being obtained for the purpose of purchase or carrying of securities. By limiting this type of credit, the margin regulations are intended to, among other things, moderate the amount of (i) credit going into the securities markets in order free up credit for other aspects of the economy and (ii) potential disruptions in the securities markets due to margin loans.

# BASIC OVERVIEW OF REGULATION U

## Regulation U

- Governs credits extended by U.S. banks and other non-broker-dealer lenders secured directly or indirectly by “margin stock”.
- The advance limits under Regulation U apply when such credit is also “purpose credit”.
- If a lender is subject to Regulation U, then Regulation U applies regardless of the jurisdiction of the borrower.

Note: “Margin Stock” is defined further on Slide 11.

## Regulation T

- Applicable to credit extended by broker-dealers.

## Regulation X

- Governs U.S. persons (and foreign persons controlled by or acting on behalf of or in conjunction with U.S. persons) who obtain credit either:
  - within the U.S. to purchase or carry any “Margin Stock”; or
  - outside the U.S. to purchase or carry U.S. securities (in such cases, Regulation X applies the substantive limitations of Reg. T or U, as applicable, through the borrower).

# BASIC OVERVIEW OF REGULATION U

- The general purpose of Regulation U is to regulate extensions of credit (“**loans**”) by certain types of lenders, including banks, that are:
  1. Made “for the purpose, whether immediate, incidental or ultimately, of buying or carrying margin stock” (“**purpose loans**” or a “**purpose credit**”); and
  2. Secured directly or indirectly by margin stock.
  
- Note: “Purpose Credit” is defined further on Slide 13.

# BASIC OVERVIEW OF REGULATION U

## Credit Extension Limitations

To the extent a credit governed by Regulation U is both:

- a purpose credit; and
- secured by margin stock.

Then the credit extended (*i.e., the amount of the loan*) may not exceed the “maximum loan value” of the margin stock and the non-margin stock assets securing the credit.\*

## Maximum Loan Values

- The “***maximum loan value***” of margin stock is currently set at 50% of the margin stock’s “current market value.”
- The maximum loan value of all other collateral is its “*good faith*” loan value.

Note: puts, calls and options that are not margin stock do not have any good faith loan value.

\*There are certain exemptions from this collateral requirement under Regulation U based on the type of loan or the status of the customer (e.g., special purpose loans and loans to exempt customers).

# BASIC OVERVIEW OF REGULATION U

- Regulation U does not contain a maintenance test, so Regulation U does not require a lender to make margin calls. Margin calls are set by a lender's own credit requirements.
- Regulation U does require re-testing in certain limited situations. For example, Regulation U requires a lender to re-test the value of the collateral when there is a withdrawal or substitution. (See slide 18)

# ELEMENTS OF REGULATION U

## Scope

What lenders are within the scope of Regulation U?

- U.S. bank lenders.
- U.S. non-bank lenders other than broker-dealers.

What lenders are outside the scope of Regulation U?

- U.S. broker-dealers (covered under Regulation T).
- Foreign banking institutions (subject to certain exceptions).
- Foreign non-bank lenders.

Note: the determination of whether a lender is considered a “foreign lender” under the margin regulations requires a detailed analysis of the facts.



# ELEMENTS OF REGULATION U

## Scope (continued)

What customers are within the scope of Regulation U?

- Most borrowers (including individuals) will qualify as customers under Regulation U. There are few exceptions to this general rule.
- Primary exceptions are for (i) certain “**Clearing Agencies**” (see *Regulation U Section 2201.1(b)(2)* for exact criteria) and (ii) “**Exempted Borrowers**” which means a member of national security exchange or registered broker or dealer with a substantial amount of business with non-brokers or dealers (see *Regulation U Section 221.2* for exact definition/criteria and *Regulation U Section 221.3(e)*.)

# ELEMENTS OF REGULATION U

## **Scope (continued)**

What does it mean to extend or maintain credit?

### **Extending Credit:**

- Traditional loan
- Non-traditional credit
- Guaranty
- Reverse Repurchase Agreement
- Case by case review for potential re-characterization

### **Maintaining Credit:**

- Maintaining purpose credit previously extended by another lender or the same lender.

# ELEMENTS OF REGULATION U

## Margin Stock

What is Margin Stock?

*Regulation U Section 221.2 (Definition of Margin Stock)*

- Equity security registered or having unlisted trading privileges on a national securities exchange; or
- Any OTC security designated as qualified for trading in the National Market System under a designated plan approved by the SEC (NMS Security); or
- Debt security convertible into a margin stock or carrying a warrant or right to subscribe to or purchase a margin stock; or
- Warrant or right to subscribe to or purchase a margin stock; or
- Security issued by an investment company registered under Section 8 of the Investment Company Act of 1940, other than (i) a company licensed under the Small Business Investment Act of 1958, as amended; (ii) a company which has at least 95% of its assets continuously invested in exempted securities; (iii) a company which issues face-amount certificates, but only with respect of such securities; or (iv) a company which is considered a money market fund under SEC Rule 2a-7.

# ELEMENTS OF REGULATION U

## “Margin Stock” does not include:

- Securities quoted in the “pink sheets” or the “over-the-counter bulletin board” (that do not otherwise qualify as margin stock); or
- Foreign securities (that do not otherwise qualify as margin stock); or
  - Note: The FRB staff has stated that publicly traded American Depositary Receipts should be treated as “*margin stock*” for purposes of Regulation U as well as the underlying foreign securities of such ADRs.
- Nonconvertible debt securities; or
- OTC options (i.e., not listed options); or
- OTC convertible equity.

Note: See FRB opinions on a bifurcated treatment of convertible equity.

# ELEMENTS OF REGULATION U

## **Purpose Credit**

What is purpose credit?

## **Purpose credit**

Purpose credit under Regulation U is “*any credit extended for the purpose, whether immediate, incidental or ultimate, of buying or carrying margin stock.*”

## **Carrying Margin Stock**

Carrying credit under Regulation U is “*credit that enables a customer to maintain, reduce, or retire indebtedness originally incurred to purchase a security that is currently margin stock.*”

# ELEMENTS OF REGULATION U

## **Purpose Credit (continued)**

### **Specific Issues on Analyzing Purpose Credit:**

- Customer's Line of Business
- Retirement of Shares
- "But For" Test
- Short Sales
- Status of Stock
- Temporary Use of Proceeds

# ELEMENTS OF REGULATION U

## Secured by Margin Stock

What does it mean to be secured by margin stock?

## Directly or Indirectly Secured

An extension of credit will be deemed to be secured by margin stock for purposes of Regulation U if the credit is either *directly* or *indirectly* secured by margin stock.

- Subject to certain exceptions, a loan may be deemed indirectly secured by margin stock if the loan documentation restricts the use of an obligor's margin stock.
- Regulation U treats indirectly secured credits the same as directly secured credits.

# ELEMENTS OF REGULATION U

## **Secured by Margin Stock (continued)**

Examples of common provisions and situations that could cause a credit to be indirectly secured by margin stock:

- Negative pledges;
- Cross-defaults/cross-collateralization;
- Scope of customer's trading/investment activities;
- Certain liquidity maintenance requirements; and
- Certain assets with a value derived from margin stock.

Note: A case by case basis analysis is required due to the vast number of opinions on indirectly secured situations and the broad scope of certain opinions.



# ELEMENTS OF REGULATION U

## Secured by Margin Stock (continued)

### Safe Harbors for Indirectly Secured

- The FRB has adopted safe harbors so that the definition of “indirectly secured” excludes certain arrangements in which the margin stock is not a substantial portion of the restricted assets.
- The primary safe harbor is a percentage test that creates a materiality standard for indirect security by stating that if, after applying the proceeds of the credit, not more than 25% of the value of the restricted assets are margin stock, then such restrictions (*e.g.*, negative covenants) should not make the loan indirectly secured.

# FORMAL RULES OF REGULATION U

## **Withdrawal and Substitution Rule**

The withdrawal and substitution rule requires a lender to re-test the collateral when the collateral is either withdrawn or substituted.

### **Specific rules for two scenarios:**

1. If the loan does not exceed the Maximum Loan Value of the collateral, then a withdrawal or substitution is only permitted if it would not cause such loan to exceed the Maximum Collateral Value of the remaining collateral.
2. If a loan exceeds the Maximum Loan Value of the collateral, then a withdrawal and substitution is only permitted if it would not increase the amount that such loan exceeds the Maximum Collateral Value of the remaining collateral.

# FORMAL RULES OF REGULATION U

## Single Credit Rule

What happens when a lender makes multiple loans to a customer and at least one of the loans is a purpose credit?

- If a lender makes a purpose loan and then later makes an additional purpose loan to the same customer, all the purpose loans need to be aggregated into one purpose credit.
  - *Exception:* Syndicated loans do not need to be aggregated with unrelated purpose credit.
- If a lender makes a margin stock secured purpose loan and later wants to make an unsecured purpose loan to the same customer, the second loan would be prohibited unless there is sufficient collateral to cover both advances.
- If a lender makes an unsecured purpose loan and later makes a margin stock secured purpose loan to the same customer, then all the purpose loans (secured and unsecured) would need to be aggregated when evaluating a withdrawal or substitution.

# FORMAL RULES OF REGULATION U

## Single Credit Rule (continued)

If a lender makes a nonpurpose loan and then makes a purpose loan secured by margin stock to the same customer and wants to utilize the single credit rule, then:

1. The two loans should be treated as separate loans;
2. The collateral from the purpose credit may not be relied upon as collateral for the nonpurpose credit; and
3. The margin stock collateral generally should be allocated first to the purpose credit and then to the nonpurpose credit.
  - *Alternative:* The lender may elect to treat both loans as purpose credit and combine the collateral.

# FORMAL RULES OF REGULATION U

## Exempted Transactions

***“Special Purpose Credit”*** (See Regulation U Section 221.5):

1. Regulation U contains exemptions for “special purpose credits” extended to broker-dealers. These credits can be extended on a good faith basis (i.e., margin stock is not required to be discounted to 50%) and the single credit rule does not apply.
2. A lender needs to obtain a good faith certifications from the broker-dealer that the credit is a special purpose loan.
3. If purpose of credit ceases to be a special purposes credit based on a notice from the borrower or lender, then the credit will cease to be exempt.

# FORMAL RULES OF REGULATION U

## Exempted Transactions

*“Special Purpose Credit” (See Regulation U Section 221.5):*

These exemptions for loans to broker-dealers apply to:

- Hypothecation Loans
- Temporary Advances and DVP Transactions
- Securities in Transit
- Intraday Credit
- Arbitrage Credit
- Market Maker and Underwriter Credit
- Clearing Broker-Dealers
- Emergency Loans
- Capital Contribution/Subordinated Loans

# FORMAL RULES OF REGULATION U

## Exempted Transactions

### *Exempted Transaction for Banks*

1. A bank lender can extend purpose credit without regard to Regulation U if the credit is extended in certain specific circumstances.
2. For a complete list of these exempted transaction see *Regulation U Section 221.6*.

Note: These exemptions only apply to banks.

# FORMAL RULES OF REGULATION U

## **Lender Protection Clause**

*Regulation U Section 221.3(j) states that “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.”*

Note: There are specific FRB opinions on the applicability of this clause.



# FORMAL RULES OF REGULATION U

## Filing Rules

### Bank Lenders:

- Bank lenders must have a Form U-1 executed by the customer when the loan is greater than \$100,000 is secured by margin stock.

Note: there are multiple FRB opinions on revolving loans and Form U-1s.

### Non-Bank Lenders:

- Non-bank lenders who extend or maintain credit secured by margin stock are required to register with the FRB on Form G-1 if they reach certain thresholds.
- Non-bank lenders use a Form G-3 instead of a Form U-1.

# FORMAL RULES OF REGULATION U

## **Lender's Obligations**

The FRB opinions impose a duty on the lender to be, among other things, aware of the circumstances surrounding a loan and to make inquiries before accepting a purpose statement.

# POTENTIAL CONSEQUENCES IF A LENDER VIOLATES REGULATION U

- Commission Enforcement
- Criminal Prosecution Against Lender and Officers of Lender
- Avoidance under *Exchange Act Section 29(b)*
- Civil Liability



**CRAIG UNTERBERG**, Partner | NY Office Managing Partner  
[craig.unterberg@haynesboone.com](mailto:craig.unterberg@haynesboone.com) | +1 212 659 4987

A member of our Executive Committee and the New York Office Managing Partner, Craig Unterberg has handled an industry-leading number of margin stock, NAV facilities, and structured equity transactions on behalf of financial institutions, private equity funds, and hedge funds. He heads up the firm's New York-based Margin Lending and Structured Equity Practice Group and is a go-to lawyer for his clients on Regulation U and other regulatory matters.

A market leader in handling complex onshore and offshore margin and fund financing facilities, Craig advises on a range of derivative, prime brokerage, private equity, and hedge fund financing transactions for both buy- and sell-side counterparties. Chambers USA (Chambers and Partners) cites a client who states that Craig "is always constructive and communicates well... [H]e has been invaluable to us in assessing possible courses of action and providing advice that is practical and business-savvy."

Craig's practice group is ranked by Chambers USA (Chambers and Partners) for its work on financial services regulatory matters. Clients rave that the group is "best-in-class," and "excellent in their drafting skills, precedent database, market knowledge, and overall execution." Another Chambers source reports that the team "is very responsive and takes a collaborative approach in representing us. They are good at understanding and efficiently implementing our objectives."

As the former head of our Finance Practice Group, Craig also represents borrowers and lenders in the leveraged lending, asset-based, and M&A financing spaces. Clients also look to Craig to handle loan restructurings and DIP facilities. He regularly leads national presentations on margin loans, intercreditor agreements, forbearance agreements, and bankruptcy matters relating to lending transactions.

Craig has received wide recognition from industry publications, including being named a 2019 "Trailblazer" by New York Law Journal (ALM Media Properties, LLC), an honor bestowed on select "innovators and thought leaders" who have made "significant marks" on the legal industry. He is a member of the Community Assistance Panel for Marines stationed on Camp Lejeune and is the immediate past president of the American Jewish Committee's NY Region.

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