Understanding Regulation U

What every deal lawyer needs to know about the margin regulations

November 17, 2011

Craig Unterberg

David Aman

haynesboone

CLEARY GOTTLIEB
Federal Margin Regulations—Background

- Authorized under Section 7 of the Exchange Act.
- Promulgated and interpreted by the Board of Governors of the Federal Reserve System (the “Fed”).
- Enforced by the Securities and Exchange Commission (the “SEC”).
- “For the purpose of preventing the excessive use of credit for the purchase or carrying of securities” in order to
  - Limit the amount of credit diverted into securities speculation and away from other uses; and
  - Limit the disruptive effects of excessive credit on the securities markets.
The Federal Margin Regulations

• Regulation U
  – Credit extended by U.S. banks and other non-broker-dealer lenders that is secured directly or indirectly by “margin stock”.
  – Substantive limits apply when such credit is “purpose credit”.

• Regulation T
  – Credit extended by broker-dealers.
  – Substantive limits apply when such credit is “purpose credit”.

• Regulation X
  – U.S. persons (and foreign persons controlled by or acting on behalf of or in conjunction with U.S. persons) who obtain credit either
    • outside the U.S. to purchase or carry U.S. securities, or
    • within the U.S. to purchase or carry any securities.

• Applies substantive limitations of Reg. T or U.
The Basic Limitation of Regulation U

Any extension of credit* ...

– By a bank or other non-broker-dealer lender (a “Reg. U Lender”);
– Secured directly or indirectly by margin stock; and
– For the immediate, incidental or ultimate purpose of buying or carrying margin stock (“purpose credit”);

... is limited to the “maximum loan value” of the collateral for the extension of credit.

* This general limitation is subject to certain exceptions based on the type of borrower (e.g., banks, broker-dealers and ESOPs) or loan (e.g., DVP transactions and emergency credit.)
Extension of Credit

“Extensions of credit” regulated by Reg. U include:

• loans, including margin loans, bank credit facilities and loan commitments;
• purchase of debt securities, other than in a bona fide public offering;
• deferred payment or delivery transactions, installment sales (including deep-in-the-money options or warrants);
• guarantees and letters of credit;
• reverse repos; and
• certain joint venture or partnership arrangements.
Regulation U Lenders

• Within the scope of Reg. U
  – U.S. bank lenders.
  – U.S. non-bank lenders other than broker-dealers.

• Outside the scope of Reg. U
  – Foreign lenders (i.e., lenders without a “principal office” in a U.S. Federal Reserve District).
Margin Stock

“Margin stock” includes:

• Equity securities listed or having unlisted trading privileges on a national securities exchange.
  – Foreign securities underlying exchange-listed ADRs are margin stock because they are technically listed on the exchange.
  – Listed options.

• Debt securities convertible into margin stock or carrying warrants or rights to subscribe to or purchase margin stock.

• Warrants or rights to subscribe to or purchase margin stock.

• Securities issued by registered investment companies (e.g. mutual funds),
  – Except for licensed small business investment companies, certain exempted securities investment companies, face amount certificates, and money market funds.
Margin Stock

“Margin stock” does not include:

• Equity securities convertible into margin stock (that do not otherwise qualify as margin stock);
• Securities quoted in the “pink sheets” or the “over-the-counter bulletin board” (that don’t otherwise qualify as margin stock);
• Foreign securities (that don’t otherwise qualify as margin stock);
  – A listing on a non-U.S. securities exchange does not cause a security to be margin stock, although foreign-listed equities are margin stock if they are also listed on a U.S. exchange.
  – ADRs quoted in the pink sheets or OTCBB do not cause the underlying foreign equity securities to be margin stock.
• Nonconvertible debt securities; or
• Over-the-counter options.
“Secured directly or indirectly”

What does it mean to be secured “directly or indirectly by margin stock?"

• Credit is directly secured by margin stock when margin stock (even one share) is affirmatively pledged to secure the credit.
• In general, credit is indirectly secured by margin stock if there is an understanding between the borrower and lender:
  – Designed to make the margin stock more available to the lender in the case of default than to the borrower’s other creditors; or
  – Which restricts the borrower’s ability to pledge, sale, or otherwise dispose of margin stock.

The concept of “indirect security” is fact specific and has been the subject of numerous interpretations by the Fed and its staff. Therefore, a case-by-case review is necessary to determine whether a credit is indirectly secured by margin stock.
Examples of Indirect Security

• Negative covenants restricting the pledge, sale or other disposition of margin stock.
• Cross-defauls to other agreements with such restrictions.
• Credit to an investment company is presumed to be indirectly secured by margin stock where margin stock is more than 25% of its assets.
Indirect Security Safe Harbors

An arrangement restricting the pledge, sale or other disposition of margin stock (or making such pledge, sale or disposition grounds for accelerating the credit) will not cause the credit to be indirectly secured by margin stock if:

- After applying the proceeds of the credit, not more than 25 percent of the value of the assets subject to the arrangement is represented by margin stock;
- 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;
- 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
- The lender, in good faith, has not relied upon the margin stock as collateral in extending or maintaining the particular credit.
Shell Corporations

• A shell corporation is a takeover vehicle that has virtually no business operations, no significant business function other than to acquire and hold the shares of a target company, and substantially no assets or cash flow to support the credit other than the target margin stock.

• A shell corporation’s unsecured debt is presumed to be indirectly secured by margin stock, except where there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral.
  – The shell’s debt is guaranteed by a company with substantial non-margin stock assets or cash flow.
  – Where the merger will take place promptly and it is reasonable to assume that the lenders are looking to the target company’s assets for repayment.
    • A merger agreement has been executed at the time the commitment is made to purchase the debt securities or in any event before loan funds are advanced.
    • The financing is contingent on the shell’s acquisition of the minimum number of shares necessary to effect a merger without the approval of either the shareholders or directors of the target company.
Purpose Credit

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

• Carrying credit under Reg. U “is credit that enables a customer to maintain, reduce, or retire indebtedness originally incurred to purchase a security that is currently margin stock.”
Purpose Credit—Examples

Purpose credit includes:

• Proceeds used to purchase an equity security convertible into margin stock;
• Proceeds temporarily invested in investment company securities;
• Proceeds used to refinance purpose credit;
• Proceeds used to acquire an issuer through the purchase of its margin stock.

The following are presumed to be purpose credit:

• Credit to a borrower in the business of extending purpose credit to others;
• Credit to a borrower (e.g., an investment company or broker-dealer) that ordinarily invests in margin stock.

Purpose credit does not include:

• Loans to cover short sale margin requirements; or
• Purchases of margin stock by the issuer thereof for immediate retirement.
Regulation U Registration

• Any lender with a principal office in a Federal Reserve District
  – other than a bank or broker-dealer who,
  – in the ordinary course of business,
  – extends or maintains credit secured, indirectly or directly, by margin stock
  – over a *de minimis* threshold ($200,000 extended in any calendar quarter
    or $500,000 outstanding at any time in a calendar quarter).
  – Exception – the purchase of 144A debt that is not purpose credit.
• Registered nonbank lenders must file an annual report regarding their
  loans secured by margin stock collateral.
    The report covers the total outstanding amount of such credit, the
    amount extended during the year, whether the loans are purpose or non-
    purpose and whether they’re extended under special provisions relating
    to employee stock plans.
• Deregistration is available to registered nonbank lenders who did not,
  during the preceding 6 calendar months, have more than $200,000 of
  such credit outstanding.
Regulation U Purpose Statements

• Whenever a bank extends credit in excess of $100,000 that is secured directly or indirectly by margin stock, the bank must obtain a purpose statement on Form U-1.
• Whenever a registered nonbank lender extends credit secured directly or indirectly by margin stock, the nonbank lender must obtain a purpose statement on Form G-3.
• In purpose statements on Form U-1 or G-3:
  – The borrower is required to certify
    • whether the credit is purpose credit, and
    • if it’s not purpose credit, the specific purpose of the credit;
      **Note:** “Working capital” or “general corporate purposes” is not sufficient unless accompanied by an example of the use and a statement that none of the proceeds will be used to purchase or carry margin stock.
  – If the credit is purpose credit, the lender is required to
    • record the margin stock securing the credit and its market value, and
    • record any other collateral for the credit and its good faith loan value.
Maximum Loan Value

• Margin stock: 50% of its current market value.
  – If quotations are available, the current market value is the previous business day’s closing sale price;
  – If no closing sale price, the current market value is any reasonable estimate of the market value as of the preceding day’s close of business; or
  – If the credit is used to finance the purchase of a security, its current market value is the total cost of purchase (including commissions).

• OTC options (puts, calls and combinations that do not qualify as margin stock): no loan value.

• Nonmargin stock and all other collateral: Good faith loan value.
  – That amount which a lender, exercising sound credit judgment, would lend, without regard to other assets held as collateral in connection with unrelated transactions.
  – It cannot exceed the current market value of the collateral, determined by any reasonable method.

• Unsecured guaranties have no loan value.

• Loan value measured identically for indirect and direct security.

• Collateral cannot be double-counted.
Regulation U—Examples

**Basic Limitation:** In general, any extension of purpose credit by a Reg. U Lender secured directly or indirectly by margin stock is limited to the maximum loan value of the collateral.

1. If a customer pledges to a lender Coca-Cola stock with a current market value of $2 million to buy $2 million of IBM stock, then the lender can loan up to $1 million to that customer for the purchase of the IBM stock. This assumes that the customer is not pledging the IBM stock it purchased.

2. If a customer pledges to a lender Coca-Cola stock with a current market value of $2 million to buy $2 million of IBM stock, which the customer will pledge to the lender after the purchase ($4 million in total collateral) then the lender may loan up to $2 million to that customer for the purchase of the IBM stock.
Maintenance Margin, Withdrawals and Substitutions

• Reg. U only imposes an initial margin requirement, and does not contain a maintenance margin requirement.
• However, a lender may not permit any withdrawal or substitution of cash or collateral that would create or increase an excess of the amount of the credit over the collateral’s maximum loan value (a “margin deficiency”).

Example: If the market value of the Coca-Cola stock drops to $1 million after the extension of credit, the lender does not need to take any action under Reg. U. Reg. U only imposes an initial margin requirement, and does not contain a maintenance margin requirement.
Arranging Credit

• Reg. U Lenders are not permitted to arrange for the extension or maintenance of any purpose credit except upon the same terms and conditions under which the lender itself may maintain or extend credit under Reg. U.
  – “Arranging” has been interpreted very broadly to include “performing some act without which the credit would not be supplied.”
  – “Arranging” includes:
    • Introducing the borrower to the lender; and
    • Acting as a custodian who delivers collateral against receipt of loan proceeds pursuant to a written agreement among borrower, lender and custodian.
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 of the purpose loans must be aggregated into one purpose credit.
  
  —Exception: Syndicated loans need not 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 is 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, all of the purpose loans (secured and unsecured) must be aggregated when evaluating a withdrawal or substitution.

• If a lender makes a nonpurpose loan and then makes a purpose loan secured by margin stock to the same customer, the two loans must be treated as separate loans.
  
  The collateral from the purpose credit may not be relied upon as collateral for the nonpurpose credit and the margin stock collateral generally must be allocated first to the purpose credit and then to the nonpurpose credit.

Alternative: The lender may treat both loans as purpose credit and combine the collateral.
Lender Protection Clause

Reg. U states in Section 221.3(j) 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.”

– Fed Staff opinions concerning the lender protection clause have typically applied the lender protection clause to situations where the subject loan is in default or the applicable customer has filed bankruptcy, such as:
  
  • A work-out plan in which margin stock is exchanged for a collateral debt security may create or increase a margin deficiency, but could be permitted under this clause.
  
  • A refinancing of credit outstanding to a bankrupt counterparty may be permitted when the alternative is foreclosure on the collateral.
Consequences of Violations

Violations of the margin regulations are violations of the Exchange Act. They may expose the violator to:

• SEC enforcement actions, which can result in injunctive relief, civil monetary penalties or cease and desist orders.

• Criminal prosecution
  – Ken Lay (Enron founder) was convicted of bank fraud and making false statements to banks by certifying on Form U-1 that certain loans were not purpose credit and then using the proceeds to buy margin stock. Each of the four counts had a maximum sentence of 30 years.

• Avoidance under Exchange Act Section 29(b).
  – Although there is contrary authority, a number of cases have allowed rescission of bank loans made in violation of the margin regulations, and precluded the banks from recovering the unpaid balance.

• Private rights of action.
Application of Regulation U indirectly through Regulation X

• Regulation X applies to U.S. persons and foreign persons controlled by or acting in conjunction with U.S. persons.
• Reg. X borrowers are prohibited from willfully obtaining credit that violates Reg. T or U.
• Any Reg. X borrower that obtains credit from outside the United States to purchase or carry a U.S. security is required to conform the credit to
  – Reg. T, if the credit is obtained from the foreign branch of a broker-dealer.
  – Reg. U, if the credit is obtained from a foreign bank or any other foreign lender.