

# NASD Notice to Members 98-43

## Federal Reserve System Amends Regulations T, U, And X

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### Executive Summary

Effective April 1, 1998, the Board of Governors (Board) of the Federal Reserve System (FED) adopted several amendments to Regulation (Reg) T, as well as Regs U and X. In addition, it is eliminating Reg G, which had applied to credit extended by "other lenders" (*i.e.*, other than banks and broker/dealers). These changes were made to reflect changes to the FED's statutory authority under the Securities Exchange Act of 1934, as amended by the National Securities Markets Improvement Act of 1996 (NSMIA). The FED retains the authority to adopt rules and regulations regarding the extension of credit where securities (other than exempt securities) are used as collateral.

Reg T is the regulation that governs the extension of credit by and to broker/dealers. Unless indicated otherwise, all changes to Reg T referenced in this *Notice* were effective April 1, 1998. *However, compliance with the revised Reg T is optional until July 1, 1998.*

Prior to April 1, 1998, Reg U applied to extensions of credit by banks only. As of April 1, 1998, Reg U was amended to now include banks and all other U.S. lenders (except broker/dealers). Consequently, Reg G has been eliminated.

Members are urged to review the FED's release in its entirety for a complete discussion of these changes. The release was published in the *Federal Register*, see 63 FR 2806 (January 16, 1998).

Questions concerning this *Notice* may be directed to Samuel Luque, Associate Director, Compliance, NASD Regulation, Inc., at (202) 728-8472, or Susan DeMando, Regional Compliance Supervisor, NASD Regulation<sup>SM</sup>, at (202) 728-8411.

### Highlights Of Changes

Listed below are highlights of the changes caused by NSMIA and their impact on Regs T, U, and X.

### Changes To The Securities Exchange Act Of 1934 As A Result Of NSMIA

- NSMIA repealed section 8(a) of the Securities Exchange Act of 1934 (the '34 Act), which had required broker/dealers obtaining credit against exchange-traded securities to borrow only from other broker/dealers, banks that were members of the FED, or banks that agreed to abide by certain restrictions applicable to member banks. *Broker/dealers can now borrow money from any lender.* (To reflect this change, the FED deleted Section 15 of Reg T.)
- NSMIA also amended section 7 of the '34 Act to grant two distinct statutory exemptions applicable to broker/dealers as borrowers. That is, these borrowings are exempt from the FED's rules under NSMIA. Therefore, a lender who would normally be required to comply with either Reg T or Reg U when lending to broker/dealers who can qualify for one of the two exemptions, is *free to lend on any terms.*
- The *transactional exemption* is applicable to credit extended to a broker/dealer to the extent that credit is used to finance the broker/dealer's activities as a market maker or an underwriter.
- The *status exemption* is applicable to all borrowings by a broker/dealer where a substantial portion of its business consists of transactions with persons other than broker/dealers, *i.e.*, exempted borrowers. (To reflect this change, Reg T and Reg U have been amended to add a definition for exempted borrower. See the section on Reg T below.)

## Reg T

- A broker/dealer must meet the test(s) for an exempted borrower on average for a 12-month period. A broker/dealer can qualify as an exempted borrower if it can meet one of these three alternative tests:
  1. The broker/dealer has 1,000 active accounts for persons other than brokers, dealers, or persons associated with a broker/dealer; or
  2. The broker/dealer has \$10 million in annual gross revenues from transactions with such persons; or
  3. The broker/dealer derives 10 percent of its annual gross revenues from transactions with such persons.
- Prior to April 1, 1998, Reg T provided a margin account and eight special purpose accounts in which to record all financial relations between a customer and a creditor. As of April 1, 1998, Reg T provides a margin account and four special purpose accounts: the cash account, the special memorandum account, the broker/dealer credit account, and a new account called the "good faith account."
- The good faith account incorporates the old "nonpurpose," "arbitrage," and "government securities" accounts, and can be used to extend good faith credit against all non-equity securities. Specifically, the good faith account may be used for:
  1. The purchase and sale of non-equity securities on a credit or cash basis; or
  2. Repurchase and reverse repurchase agreements on non-equity securities; or
  3. The purchase and sale of options on non-equity securities.
- A broker/dealer does not need a permitted purpose in order to borrow or lend non-equity securities in the good faith account.
- Bankers' acceptances, certificates of deposit, and commercial paper are acceptable collateral in the good faith account.
- The good faith account has no specific payment/margin requirements and does not require sell-out. In theory, transactions in the good faith account may liquidate to a deficit. However, broker/dealers must comply with National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 2520 and/or New York Stock Exchange Rule 431 on margin requirements.
- The loan value in the good faith account cannot be used to effect transactions in equity securities in the cash or margin accounts. These three accounts *must* be treated separately.
- The special memorandum account (SMA) is being retained. There are no changes to it at this time. The SMA will continue to be available for use in conjunction with a margin account, but is not available for use with a good faith account.
- Broker/dealers may continue to arrange for credit that they can not extend themselves provided that the credit is not otherwise prohibited by the FED, *i.e.*, that it does not violate Reg U or Reg X.
- The only securities that have no loan value under Reg T are nonmargin nonexempt equity securities. The FED defers to the Securities and Exchange Commission (SEC) on the exact parameters of the definition of equity security.
- The FED is rescinding its interpretation that options are not convertible securities and amending the Supplement of Reg T to allow a listed call option to serve as partial margin for short sales of the underlying security.
- The definition of "foreign margin stock" is being amended to include both the securities on the FED's List of Foreign Margin Stocks (Foreign List) and those deemed to have a "ready market" for capital purposes, as determined by the SEC and as appear on the Financial Times/Standard & Poor's World Actuaries Indices (FT/S&P Indices).
- The FED is retaining its Foreign List to identify those foreign securities that it finds meet its eligibility and continued listing requirements. The list will not duplicate those securities that meet the ready-market test and appear on the FT/S&P Indices.
- Reg T now excludes from its scope financial relations between a foreign branch of a U.S. broker/dealer and a foreign person involving foreign securities.
- FED changes clarify that creditors may also extend credit denominated in any freely convertible foreign currency in the good faith account and the broker/dealer credit account as well as the margin account.
- When a customer sells or delivers out securities in the cash account that have not been paid for, the 90-day freeze need not be applied until the permissible payment period has passed.
- Effective January 1, 1999, all issues listed on The Nasdaq Stock Market<sup>SM</sup> (Nasdaq National Market<sup>®</sup> and The Nasdaq SmallCap

Market<sup>SM</sup>) will be marginable. The FED will cease publication of its quarterly OTC list after the list is published in November 1998.

## Reg U

- Reg U is expanded to include banks and other lenders; and Reg G is eliminated.
- The definition of "margin stock" in Reg U is amended to exclude stocks trading in the SmallCap tier of The Nasdaq Stock Market, as the Board will no longer choose which Nasdaq<sup>®</sup> stocks qualify as a margin stock for purposes of Reg U. This eliminates the need for the FED's quarterly OTC list for banks and other nonbroker lenders. Information on Nasdaq securities is available on the Nasdaq Web Site at [www.nasdaq.com](http://www.nasdaq.com).
- Reg U is amended to give good faith loan value to money market mutual funds, as was done in Reg T in 1995.
- Lenders other than broker/dealers may extend 50 percent loan value against listed options. Unlisted options continue to have no loan value when used as part of a mixed collateral loan.
- The FED is amending the revolving credit provisions in Reg U to require a lender to call for additional collateral when the lender is relying on margin stock that is insufficient to cover an extension of purpose credit.
- The FED is deleting the mixed collateral provision in Reg U. Banks must still make a good faith determination that nonmargin stock collateral, if any, has sufficient good

faith loan value to make up the difference between the regulatory loan value of margin stock and the amount of credit extended for a purpose loan.

## Reg X

- Reg X applies the Board's margin regulations to U.S. persons and related parties who obtain credit *outside* the U.S. to purchase or carry U.S. securities. Borrowers must conform the credit they receive with Reg T if the credit is obtained from a foreign branch of a broker/dealer or with Reg U if the credit is obtained from a foreign branch of a bank or from any non-bank lender.

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