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FUND FINANCE FRIDAY

Reg. T, U, X and You

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Although we all still remember the after effects of the 2007-08 financial crisis, we're actually still feeling the impact of the Great Depression in our loan documents. The Crash of '29 was precipitated in part by margin lending, a popular tool in the early 1900s to enhance infrastructure investments by allowing the purchase of stock with borrowed funds where the stock acted as collateral for the loan. A rush on margin calls as stock prices collapsed wiped out fortunes and eventually led the Federal Reserve Board to issue margin regulations. Better known to fund finance practitioners as Regulations T, U and X, they appear almost universally in our credit agreements and opinions. This article provides an introduction to these regulations and how they may be related to fund finance transactions generally. Although note that certain fund finance transactions require a deeper dive into the margin regulations. Stay tuned!

The Regulations

The purpose of the margin rules is to prevent excessive use of credit to purchase and carry securities. Promulgated under Section 7 of the Securities Exchange Act of 1934, each regulation governs different covered persons. Reg. T applies to securities dealers, brokers and members of national securities exchanges, while Reg. U covers banks and non-bank lenders that extend credit secured by margin stock. Those regulations prohibit covered lenders from providing loans to buy or carry margin stock worth more than the value of the loan if the loan is secured by the margin stock (or specifically a 50% maximum loan to value requirement in the Regulation U context, which is most relevant to our Fund Finance Friday readership, when a margin loan is extended as a "purpose credit"). Reg. X restricts borrowers from being parties to transactions that breach the margin rules.

Margin stock can be equity securities on national exchanges, warrants or rights related to such securities, and certain securities issued by registered investment companies. But importantly for fund finance, it excludes stock of a borrower's wholly owned operating subsidiaries that are not traded publicly. That means the investments of a pure-play private equity fund would often be carved out. Before we examine the use of these regs in credit agreements and opinions, it's

important to evaluate the penalties for noncompliance. Of note, credit that's extended for carrying or purchasing margin stock is termed "purpose credit" under the regulations. Whether a fund finance transaction might violate the margin rules will depend on if the loan is purpose credit and if it is secured either directly or indirectly by margin stock.

The Risks

Violations of Reg. T, U or X can result in significant penalties for lenders, including fines, regulatory sanctions, reputational damage and legal liability. Depending on the severity and frequency of the breach, the Federal Reserve Board may impose various financial penalties. Lenders may also face regulatory sanctions, such as restrictions on their lending activities, suspension or revocation of licenses and heightened scrutiny from their regulators. Lenders seek to ensure compliance with the margin rules to avoid diminishing reputations or hurting the trust they've built with their counterparties. They also look to avoid liability from lawsuits from affected parties that could allege damages resulting from regulatory violations.

The Rules

In fund finance transactions, the parties help ensure compliance with the margin regulations by including coverage of them in credit agreements and opinions. For subscription credit facilities, the collateral does not include margin stock. So long as the fund's business and investments aren't in buying or carrying margin securities, it is relatively simple to have the requisite protective provisions via a representation and warranty by the fund.

If the lender isn't relying on margin stock as any part of the collateral and other valuable assets are pledged as security, this can help the lender demonstrate the facility isn't a margin loan. Even if a credit facility isn't explicitly secured by margin stock, it might still implicate the margin regulations if deemed indirectly secured by margin stock (which could implicate certain negative pledge covenants). However, to address ambiguity as to when a loan is indirectly secured by margin stock, the Federal Reserve has adopted certain safe harbors, including adopting a percentage threshold of 25% to determine if margin stock represents a material portion of the restricted assets (*i.e.*, if the percentage of margin stock is below the materiality threshold, then the restrictions would not result in the loan being deemed indirectly secured by margin stock). For certain types of fund finance transactions, it is common to see representations from the borrower targeted towards compliance with these specific harbors in addition to representations that the loans under the facility are not secured by, and the collateral doesn't contain, any margin stock. The credit agreement may also include clauses allowing the lender to conduct periodic compliance reviews or audits to ensure the borrower's ongoing adherence to Reg. T, U and X.

As far as determining whether a loan will be used for the purpose of buying or carrying margin stock, a fund can represent that it won't use the loan proceeds under the facility to purchase or carry margin stock or for any other reason that would make the facility a purpose credit, which includes paying off any portion of outside debt originally incurred to buy or carry margin securities. Bank lenders must have a Form U-1 executed by a borrower when making a loan greater than $100,000 that is secured by margin stock, which includes a statement of purpose from the borrower regarding the use of the margin loan proceeds.

The opinion letter provided in connection with the fund finance transaction will also give comfort that a lender will stay in regulatory compliance. Generally the lender will request a Reg. T, U and X opinion. It may state that the borrowings under the credit agreement and their use of proceeds as contemplated under the facility do not violate those margin regulations. Certain law firms won't have a separate opinion just for the margin rules but will reference Reg. T, U and X in the general "no violation of laws" opinion.

If the fund does not purchase or carry margin securities, a law firm may base its opinion that the credit facility doesn't violate the margin regulations on the covenants or reps of the fund in the credit agreement. Alternatively, the law firm may request an officer's certificate of the borrower specifying the loan's intended use and that the credit won't be used for margin stock purchases. For credit facilities secured directly or indirectly by margin securities, the law firm can rely for its opinion on the regulatory form required to be delivered by a borrower to the lender that stipulates the purpose of the loan. Such an opinion will give the lender greater legal certainty as to the borrower's agreements related to Reg. T, U and X in the credit agreement.

Conclusion

Reg. T, U and X are meant to maintain the stability and integrity of our financial markets by preventing excessive speculation and risk-taking. Lenders that provide credit facilities to funds need to carefully consider these margin regulations to ensure they are operating within legal boundaries and managing associated risks effectively. Failure to comply with these rules by a lender or borrower can lead to regulatory scrutiny, fines and reputational damage. Fortunately, the related provisions in our credit agreements and opinions are well understood by fund finance attorneys, so the parties can discuss related issues with their counsels to make sure they are staying within the margins of what's required.