

CADWALADER

Reg. T, U, X and You

April 5, 2024



By Joe Zeidner
Partner | Fund Finance

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.

Fitch Posts Update on PE CFO Performance

April 5, 2024

Conservative structures that prioritize debt repayment and limit leverage supported consistent performance for Fitch rated PE CFOs in recent months despite a decline in distributions. Overcollateralization and improving liquidity ratios (distributions to capital calls) are expected to support deal performance in 2024. The full report is available via subscription [here](#).

Save the Date: 2024 Cadwalader Finance Forum

April 5, 2024



Save the Date: October 23

[#financeforum2024](#)

We're thrilled to announce the 8th Annual Cadwalader Finance Forum will take place on Wednesday, October 23, in Charlotte.

This premier event brings together industry leaders and experts for a day of networking and insightful discussions on the latest market trends and opportunities across various sectors including commercial real estate, fund finance, leveraged finance, middle market lending, private credit, securitization and structured finance.

Stay tuned for a detailed schedule featuring fantastic speakers, substantive panels and our keynote speaker, a high-profile founder and president of an award-winning direct lender. We look forward to welcoming you in October!

Register [now](#).

WFF EMEA: Register Now for Our Inaugural Irish Networking Event

April 5, 2024



Register now for the Women in Fund Finance Inaugural Industry Gathering on Wednesday, April 17, 2024!

Women in Fund Finance EMEA and Maples Group are pleased to invite you to the first WFF Industry Gathering in Ireland. The evening will include networking drinks and canapes, and keynote address from Joan Kehoe, CEO and Founder of alchelyst.

This event is open to all genders and for members and prospective members of Women in Fund Finance, the Fund Finance Association, Diversity in Fund Finance and NextGen. We hope you will be able to join for what promises to be a wonderful evening!

Location: Museum of Literature Ireland, 86 St. Stephen's Green, Dublin 2, DX02 XY 43, Ireland

Date: Wednesday, 17th April, 2024

Time: 6:00PM - 9:00PM GMT

Register [now!](#)

Fund Finance Hiring

April 5, 2024

Fund Finance Hiring

Here is who's hiring in Fund Finance:

PNC Bank is looking to hire a Capital Markets Associate Director – Originations (F) within PNC's Corporate Banking Organization. Candidates can be based in New York, NY, Philadelphia, PA, or Charlotte, NC. A description of the role, and additional details are available [here](#).

JPMorgan is currently seeking a Private Banking Lending Attorney - Vice President, Assistant General Counsel in their Chicago office. Candidates can learn more and apply [here](#).

First Citizens Bank is currently hiring for a SVB - Associate 1 - Structured Fund Solutions in New York, New York. Learn more about the role and apply [here](#).

Fund Fanatics Features Neil Keegan

April 5, 2024



Join Scott Aleali, Head of Private Equity Finance at Citizens Bank, and Jeff Maier, Senior Managing Director - Private Equity Finance at Citizens Bank, with special guest Neil Keegan, Co-Managing Partner and CEO of [Marlinspike](#), for the latest episode of Fund Fanatics!

Neil is a former Family Office CEO/CIO and spent six years on active duty as a Surface Warfare Officer in the United States Navy.

See the episode [HERE](#)

- What you need to know about our defense industrial base
- Valuable fundraising practices for Emerging Managers
- Examples of portfolio companies leveraging AI
- Lessons learned from serving in the US Navy
- Tips for the Washington Commanders to return to glory and an NFL draft prediction for the #2 overall pick

What We're Reading

April 5, 2024

Secondaries. The share of secondary sales done at a discount to NAV increased in 2023 according to [Jefferies data cited](#) in the Financial Times. Overallocations to PE, better returns in fixed income, and cash outflow needs for investors such as pension funds, are driving record volumes in secondaries. Jefferies reported \$112 billion in secondaries transactions last year.

GP stakes. Hunter Point closed its HPC Fund I at \$3.3 billion in commitments, making it the largest ever debut GP stakes fund, [according to Private Equity News](#).

Private credit. Total returns in private credit are expected to rank among the top across asset classes over the next twelve months, according to a recent survey of insurance companies recently conducted by Goldman Sachs Asset Management. Despite concerns about the credit cycle, 52% of respondents reported plans to increase allocations to private credit. Crypto and real estate equity ranked lowest in terms of expected returns.

CRE. Lending against office makes sense for private funds, especially when opportunities arise to provide acquisition financing at below the land value. That's the takeaway from a [recent CoStar note](#) highlighting Northwind's \$65 million loan that financed the acquisition of Harbourside 5, a 65% vacant office tower in Jersey City.

2023 recap. McKinsey published its [annual private market overview](#) highlighting key trends that shaped the year.

FDIC Proposes Bank Merger Policy Revisions: Our Key Takeaways

April 5, 2024

On March 21, the Federal Deposit Insurance Corporation published for comment a proposal to revise its Statement of Policy on Bank Merger Transactions. In a recent [Client & Friends Memo](#) authored by Andrew Karp and Chris Van Heerden, we focus on how if adopted as proposed, the proposal would modify the Statement of Policy substantially, effectively creating an entirely new policy.

Read more [here](#).

WFF Americas: Ladies Poker Night

April 5, 2024



Deloitte.



FitchRatings

Please join The Fund Finance Association for the first Women In Fund Finance Ladies Poker Night at the Hearst Tower in New York City, cohosted by Fitch Ratings, Deloitte and WFF.

Whether you are new to Poker or a seasoned pro, FFA looks forward to an evening of hands-on poker training by Tumbling Dice to learn the game or help sharpen your skills. All experience levels are welcome.

Date: Tuesday, April 30th, 2024

Time: 6:30pm - 8:30pm EDT (Check-in starts at 6:30)

Location: Hearst Tower, 44th floor, 300 West 57th Street, NYC.

Drinks & light refreshments will be provided. Space is limited, [RSVP](#) by April 15th to reserve your spot.