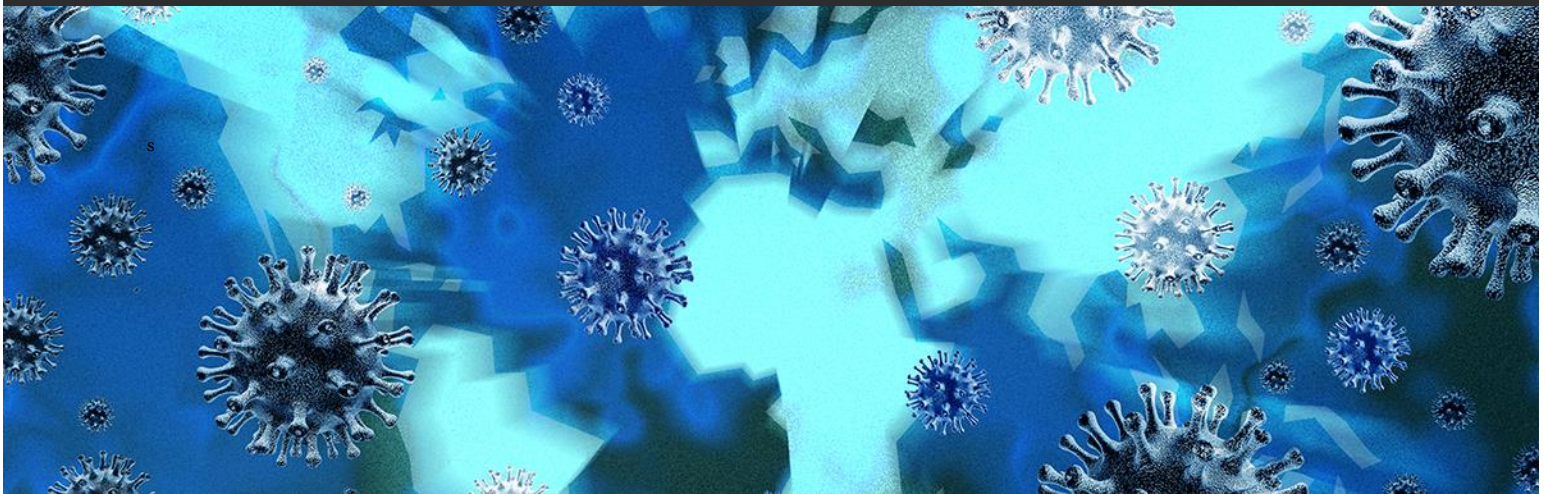


**Alert | Health Emergency Preparedness Task Force:  
Coronavirus Disease 2019**



April 1, 2020

## **Securities-Based Loans During the COVID-19 Market Correction**

From 2009 to early 2020, the U.S. stock market enjoyed its longest ever bull market. This prolonged run, in tandem with historically low interest rates, produced a favorable environment for investors to borrow against securities holdings for a wide range of purposes. Securities-based loans can provide a number of attractive features, such as potentially lower rates, greater flexibility, more convenience and less paperwork (i.e., real estate appraisals, liens against purchased property, etc.). However, now that the COVID-19 pandemic has brought a swift end to the bull market with unprecedented volatility, the decline in value of the underlying securities that serve as collateral for these loans may trigger calls for additional collateral or forced liquidations.

Securities-based lending is governed by Regulation T (12 CFR Part 220) when credit is extended by broker-dealers and Regulation U (12 CFR Part 221) when credit is extended by banks and other financial institutions. These regulations contain a number of requirements relating to opening and maintaining securities-based loans. Under both regulations, loans can be “purpose credit,” in which at least some portion of the loan proceeds will be used to purchase securities, or “non-purpose credit,” in which the borrower cannot use the loan for purpose of investing in securities. *See* 12 CFR 220.2 and 220.6(e); 12 CFR 221.2. All loans are presumed to be purpose credit unless specific forms are executed by the customer, and purpose credit is generally subject to more stringent regulations. Issues presented by purpose loans in broker-dealer margin accounts are covered in a GT Alert, [Dangerous Waters: The Pitfalls of Margin Calls](#).

With both the Dow Jones and S&P 500 indices recently down as much as 35% from their highs, securities-based lenders have seen collateral drop to the point that it may no longer support certain loans. The loan agreements governing such loans provide lenders with broad discretion and flexibility in demanding additional collateral or otherwise protecting their interests, including the ability to force liquidations of pledged collateral. Nevertheless, this may be the first time many securities-based borrowers have encountered such a market decline, and some may be unprepared to promptly deposit more assets or face forced liquidation of securities.

Although lenders have the legal right to demand additional collateral or force the sale of securities, these actions may also give rise to potential litigation risk. Creative claimants' attorneys often rely on fiduciary duty standards and covenants of good faith and fair dealing to attack firms that have made forced sales of securities to satisfy loan-related calls. Where broker-dealers lend, attorneys may cite FINRA Rule 2110, requiring "high standards of commercial honor and just and equitable principles of trade" in an effort to overcome contractual rights relating to calls. Section 1-304 of the Uniform Commercial Code establishes an obligation of good faith. These claims, particularly when asserted in FINRA arbitration where claimants' attorneys often urge arbitrators to follow loose equitable principles, may possibly gain traction notwithstanding the law or contract where a lender has not been clear and consistent in its policies and communications regarding calls.

When addressing calls in the current market, lenders may consider taking steps to ensure that their client-facing representatives know that conditions can change quickly and the lender may exercise its right to force liquidations at any time. Lenders may wish to consider instructing their representatives not to tell borrowers anything that conflicts with their broad contractual rights (particularly when discussing deadlines to meet a call). Lenders may also consider the ramifications of giving certain borrowers special treatment (call extensions or additional release on collateral), which could later become the subject of discovery and testimony in litigation.

For more information and updates on the developing COVID-19 situation, visit [GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019](#).

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