



FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

November 16, 1994

DALLAS, TEXAS
75265-5906

Notice 94-111

TO: The Chief Executive Officer of each
member bank and others concerned in
the Eleventh Federal Reserve District

SUBJECT

**Final Amendments to Regulation T
(Credit By Brokers and Dealers)**

DETAILS

The Board of Governors of the Federal Reserve System has published final amendments to Regulation T (Credit by Brokers and Dealers) regarding payment for securities purchases and the status of government securities transactions.

One amendment specifies that customers must meet initial margin calls or make full cash payment for securities purchased at a broker-dealer within two business days of the standard settlement period. When a standard settlement period of three days adopted by the Securities and Exchange Commission goes into effect in June 1995, Regulation T will be in conformity.

Related amendments raise the de minimis amount below which liquidation of unpaid transactions is not required from \$500 to \$1000, require brokers seeking extensions of the payment periods to obtain them from their designated examining authority, and clarify that the time periods provided for certain securities with extended settlement periods are the time periods used to calculate when restrictions in the cash account are applied. The other amendments address transactions involving U.S. government securities.

The amendments become effective November 25, 1994.

ATTACHMENT

A copy of the Board's notice as it appears on pages 53565-68, Vol. 59, No. 205, of the Federal Register dated October 25, 1994, is attached.

MORE INFORMATION

For more information, please contact Eugene Coy at (214) 922-6201. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

ACTION: Final rule.

SUMMARY: The Board is adopting amendments to Regulation T. The amendments are part of the Board's review of Regulation T and respond to rulemaking by the Securities and Exchange Commission (SEC) concerning settlement of securities transactions and Congressional action concerning government securities. The proposed amendments were published for public comment in the *Federal Register* on July 1, 1994. The amendments address two general areas: payment periods for securities purchases and transactions in government securities. The amendments concerning payment periods will reduce by two days the amount of time customers have to meet initial margin calls or make full cash payment for securities at the same time the SEC reduces the standard settlement period by two days, require broker-dealers seeking an extension of this time period to obtain the extension from their designated examining authority if the balance due is \$1000 or more, and revise regulatory language in the cash account so that the time periods within which extensions must be obtained and when the "90-day freeze" may be lifted are consistent for certain transactions in which settlement exceeds the standard settlement period. The amendments concerning transactions in government securities will exempt from Regulation T those broker-dealers registered with the SEC solely as government securities brokers or dealers and create a new account for customers of general broker-dealers that permits transactions in government securities to be effected without regard to other provisions of the regulation.

EFFECTIVE DATE: November 25, 1994.

FOR FURTHER INFORMATION CONTACT: Scott Holz, Senior Attorney or Angela Desmond, Senior Attorney, Division of Banking Supervision and Regulation (202) 452-2781; for the hearing impaired only, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202) 452-3544.

SUPPLEMENTARY INFORMATION: The proposed amendments are part of the Board's general review of Regulation T (Docket R-0772) and were published for public comment on July 1, 1994 (59 FR 33923). Twenty-two comments have been received. The comments on the proposed amendments concerning transactions in government securities were supported by all commenters, although some asked for additional amendments. The comments concerning the proposed reduction in payment periods were mixed, with some

commenters in favor, some opposed, and some requesting a delay in the amendments' effectiveness. The related payment period issues were generally supported by the commenters, with the exception of the requirement that extensions be obtained solely from the broker-dealer's examining authority and the use of language that will automatically reduce the payment periods if the standard settlement cycle is reduced. Comments on these issues were also mixed.

The Board is adopting the proposed amendments substantially as proposed. Technical changes have been made in the regulatory language and structure to respond to comments and clarify the intent of the amendments. The two general areas are discussed below.

I. Payment Periods

A. T+3 and Shortening of Payment Periods

1. Introduction. On October 6, 1993, the SEC adopted Rule 15c6-1,¹ which establishes a standard three business day settlement cycle for most securities transactions in the United States, effective June 1, 1995. Regular settlement is presently effected in five business days. This new standard is often referred to as "T+3," meaning regular settlement will occur three business days after trade date. Regulation T contains a seven day time period within which brokers must obtain cash or margin deposits from their customers. The seven day payment period in Regulation T is based on the current five day settlement period.

The Board proposed shortening the payment period in Regulation T by the same amount of time that SEC Rule 15c6-1 shortens the standard settlement cycle. Instead of changing the phrase "seven business days" to "five business days," the proposal defined a new term, "payment period," to represent the number of days in the standard settlement cycle plus two business days. This formulation allows the regulation to be amended immediately without changing the current payment period. Once SEC Rule 15c6-1 becomes effective next June, the regulation will automatically require payment within five business days. Although the definition of payment period refers to settlement date, Regulation T remains a trade date based regulation. The use of the phrase "payment period" is meant to be an alternate way of requiring payment within seven business days until June 1995 and five business days thereafter, unless the SEC acts to further

¹ 17 CFR 240.15c6-1; 58 FR 52891 (October 13, 1993).

FEDERAL RESERVE SYSTEM

12 CFR Part 220

[Regulation T; Docket No. 0840]

Credit by Brokers and Dealers

AGENCY: Board of Governors of the Federal Reserve System.

change the standard settlement cycle. Future changes by the SEC would be automatically incorporated in the Board's rule without the necessity of further amendment.

2. Issues raised by commenters. Comments on the proposal to shorten the payment periods in conjunction with the SEC's shortening of the standard settlement cycle were focused on three issues: whether the payment periods should be shortened, whether the proposed language clearly accomplishes this goal, and whether future reductions in the standard settlement period should be automatically accommodated or reviewed by the Board.

a. Shortening the payment period by two days. The Board is adopting the proposed amendments, subject to the clarification discussed in section b below. Many of the commenters who oppose shortening the payment periods had written to the SEC last year to oppose its T+3 proposal. The Board and the SEC both have responsibilities in the area of settlement and clearance. Shortening the Regulation T payment periods is consistent with (if not required by) the SEC's adoption of a three day settlement cycle. A failure to adjust the payment periods would lessen the overall benefits to be realized from the transition to T+3 and increase risk to the broker-dealer community since they will have to settle trades amongst themselves in the shortened time frame while allowing their customers' behavior and payment patterns to remain unchanged. Increased risk to broker-dealers also affects customers with cash and securities at those firms. Adoption of the proposed amendments by the Board does not reduce the two-day period currently provided to resolve payment problems, but merely clarifies that two days beyond the usual settlement date should be sufficient to resolve any mistakes in the payment process.

Some of the commenters opposed to shortening the payment periods in conjunction with the shortening of the standard settlement cycle believe that the mail system does not permit funds to be delivered within this time frame. However, the increased use of fax machines and money market mutual funds provide alternate ways for customers to make prompt payment for their securities purchases. Although the Board shares the concerns expressed about investors who rely on the mail to pay for securities, it believes that most investors will be able to adjust to the shortened periods. Indeed, the Bachmann Task Force on Clearance and Settlement Reform in U.S. Securities

Markets, which recommended to the SEC that the standard settlement cycle be reduced to T+3, stated that it "believes that current customer behavior practices should not be an obstacle to shortened settlement provided there is strong leadership from within the industry and educational efforts to address customer and account executive concerns."² Many of the commenters stressed the fact that the brokerage industry is already educating customers about the approach of T+3 settlement and the changes this will entail. The Board is of the view that the successful implementation of T+3 includes a reduction in the Regulation T payment periods. It is expected that broker-dealers will be working with customers who may have difficulty making prompt payment. A delay in the effectiveness of shortening the payment periods would not necessarily improve the educational process, which is already well underway at most firms, and might serve as an excuse for others to delay their educational efforts.

b. Uniform payment period. The proposed term "payment period" was defined as the two business days beyond "the standard securities settlement cycle in the United States." This phrase was meant to refer to the current five day settlement cycle for most securities transactions until SEC Rule 15c6-1 becomes effective next June, at which time the Board's regulation would be referring to the three day period established in the SEC rule. Additional language has been added to the definition of payment period to clarify this point. Some commenters believed the reference to a "standard settlement cycle" depends on the type of security being purchased, so that trades involving standardized options or government securities, both of which settle the day after trade date, would have to be paid for by the third business day after trade date. Although broker-dealers can require payment for transactions by settlement date of the particular trade, Regulation T establishes a standard period within which customers must make payment even though certain securities settle in less than the current five day period. It was not the intent of the Board to change this general policy.

c. Impact of further reductions in settlement periods. As noted in the request for public comment, one of the reasons for using the phrase "payment period" instead of a fixed number of days was to ensure that future reductions in the settlement cycle would be automatically reflected in

Regulation T, without the need for further amendments. Commenters were evenly split on whether the Board should be forced to review the Regulation T payment periods whenever the standard settlement cycle is altered. The proposed language has been retained. In light of the fact that investors are expected to pay for securities on settlement date, tying the payment period to the standard settlement cycle merely codifies the Board's current position that two business days should be sufficient to insure that a failure to receive the customer's payment is not due to an error or other exceptional circumstance.

B. Granting of Extensions of Time by a Broker-dealer's Examining Authority

If a customer has not made full cash payment or met an initial margin call within the payment period, the broker-dealer must liquidate the customer's position. However, if exceptional circumstances exist, the broker-dealer can obtain an extension for its customer. Regulation T currently permits any self-regulatory organization (SRO) to grant these extensions. A New York Stock Exchange (NYSE) rule recently approved by the SEC requires broker-dealers for whom the NYSE is the designated examining authority (DEA) to obtain these extensions only from the NYSE.³ Although the Board could leave Regulation T unchanged and most broker-dealers would still be required to go to their DEA instead of any SRO, the Board proposed amending Regulation T to require that extensions be granted only by a broker-dealer's DEA. This decision was based on analysis of the comments received by the Board in response to its advance notice of proposed rulemaking concerning the current review of Regulation T and the SEC's consideration of the NYSE rule filing. No new information was presented in this area. The Board is therefore adopting the requirement that extensions be granted by a broker-dealer's DEA.

C. Technical Amendments Concerning Foreign Securities

The Board proposed technical amendments to the cash account to clear up confusion resulting from its 1990 amendment allowing payment for foreign securities to be tied to the appropriate foreign settlement period. The amendments would clarify that this longer period is also used to determine when extensions of time must be

³ NYSE Rule 434; SEC approval: 59 FR 26826 (May 24, 1994); Securities Exchange Act Release 34073 (May 17, 1994).

² 57 FR 27819 (June 22, 1992).

obtained and when the "90-day freeze" may be lifted for foreign securities. Two securities trade associations point out that the cash account establishes three other situations in which settlement regularly exceeds the standard settlement cycle: unissued securities, "when-issued" securities, and refunded securities.⁴ These commenters suggest the proposed language be revised to consistently refer to the various time periods in determining when extensions are required and when the "90-day freeze" may be lifted. These amendments have been redrafted to accommodate this suggestion.

D. De Minimis Amount

The required liquidation of customer purchases for which payment has not been received within the required time currently does not apply to amounts of \$500 or less. The Board proposed doubling this amount to \$1000 in light of the ten years that had passed since the amount was last increased. This increase was supported by a wide variety of commenters. The increase to \$1000 will still reduce the regulatory burden on broker-dealers and their examining authorities by reducing the number of extensions that must be requested and processed.

II. Government Securities

Two amendments were proposed to exempt most transactions in * * * government securities from Regulation T. The first exempts those brokers and dealers who effect customer transactions only in government securities (Section 15C Brokers). The second amendment effectively exempts transactions involving government securities for customers of general securities broker-dealers by allowing the transactions to be effected in a new government securities account. All of the commenters supported these two proposed amendments.

A. Exemption from Regulation T for Brokers and Dealers Whose Activities are Limited to Government Securities

The scope of Regulation T, as stated in section 220.1(b)(1), is "all financial relations between a customer and a creditor." In order to exempt Section 15C brokers from Regulation T, the Board proposed excluding them from the definition of creditor in section 220.2(b) of the regulation. The Public Securities Association (PSA) and the Securities Industry Association (SIA) suggest that the exclusion be moved to the scope section, so that Section 15C brokers would still be defined as

"creditors" when they are not dealing with "customers." For example, the commenters point out that the term "creditor" is used in the broker-dealer credit account to describe permissible transactions between broker-dealers. In light of these comments, the exclusion has been moved to the scope section of Regulation T.

B. Government Securities Account

The second amendment proposed in the area of government securities was the creation of a new government securities account. This account would allow general broker-dealers to effect customer transactions that could be effected by Section 15C Brokers without regard to other restrictions in Regulation T.

In addition to general support of the proposal, commenters focused on two areas: the regulatory language used to describe the account and whether additional securities and other financial instruments should be included in its scope.

1. Description. The government securities account was proposed for "transactions involving government securities, provided the transaction would be permissible for a broker or dealer registered under section 15C of the act." The PSA and the SIA both suggest deletion of the reference to Section 15C Brokers because they believe it is confusing and unnecessary. They argue that section 15C does not establish permissible and impermissible classes of transactions in government securities. However, section 15C(b)(7) of the Act prohibits government securities brokers and dealers from effecting "any transaction * * * in any government security in contravention of any rule under this section." The regulatory language for the government securities account has been redrafted to clarify that it is available for transactions involving government securities as long as the transaction is not prohibited under section 15C or any of the rules thereunder.

2. Scope. The PSA, SIA, SIA-Credit Division and one broker-dealer suggest that all exempted securities, including municipal securities, be included in the new account. A second broker-dealer would include foreign sovereign debt that meets the margin requirements of Regulation T. In addition, three of these commenters believe that all nonconvertible debt securities that meet the margin requirements of Regulation T should be eligible for the account and one of these commenters would like "money market instruments" such as certificates of deposit, bankers acceptances and commercial paper to be

covered by the new account. All of these suggestions will be considered in the course of Board's review of Regulation T, with an opportunity for public comment. As explained in the request for public comment on the proposed government securities account, the rationale for the new account stems from the unique regulatory scheme established for U.S. government securities and brokers and dealers in that market.

Regulatory Flexibility Act

The Board certifies that this final rule will not have a significant economic impact on a substantial number of small entities.

Paperwork Reduction Act

This regulation imposes no additional reporting requirements or modification to existing reporting requirements.

List of Subjects in 12 CFR Part 220

Banks, Banking, Bonds, Brokers, Commodity futures, Credit, Federal Reserve System, Investment companies, Investments, Margin, Margin requirements, National Market System (NMS Security), Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, 12 CFR part 220 is amended as follows:

PART 220—CREDIT BY BROKERS AND DEALERS (REGULATION T)

1. The authority citation for Part 220 is revised to read as follows:

Authority: 15 U.S.C. 78c, 78g, 78h, 78q, and 78w.

2. Section 220.1 is amended as follows:

a. The word "seven" in the first sentence of paragraph (b)(1) is revised to read "eight".

b. A new paragraph (b)(3) is added to read as follows:

§ 220.1 Authority, purpose, and scope.

* * * * *
(b) * * *

(3) This part does not apply to transactions between a customer and a broker or dealer registered only under section 15C of the Act.

3. Section 220.2 is amended as follows:

a. Paragraph (h) is revised.
b. Paragraphs (w) through (aa) are redesignated as paragraphs (x) through (bb) and new paragraph (w) is added.

The revisions and additions read as follows:

§ 220.2 Definitions.

* * * * *

⁴ See § 220.8(b)(1)(i)(B)-(D) of Regulation T

(h) *Examining authority* means:

(1) The national securities exchange or national securities association of which a creditor is a member; or

(2) If a member of more than one self-regulatory organization, the organization designated by the SEC as the examining authority for the creditor.

* * * * *

(w) *Payment period* means the number of business days in the standard securities settlement cycle in the United States, as defined in SEC Rule 15c6-1 (17 CFR 240.15c6-1) under the Act, plus two business days. Until June 1, 1995, payment period means seven business days.

* * * * *

4. In § 220.4, the figure "\$500" in paragraph (d) is revised to read "\$1000" and paragraph (c)(3) is revised to read as follows:

§ 220.4 Margin account.

* * * * *

(c) * * *

(3) *Time limits.* (i) A margin call shall be satisfied within one payment period after the margin deficiency was created or increased.

(ii) The payment period may be extended for one or more limited periods upon application by the creditor to its examining authority unless the examining authority believes that the creditor is not acting in good faith or that the creditor has not sufficiently determined that exceptional circumstances warrant such action. Applications shall be filed and acted upon prior to the end of the payment period or the expiration of any subsequent extension.

* * * * *

5. In § 220.8, the figure "\$500" in paragraph (b)(4) is revised to read "\$1000" and paragraphs (b)(1)(i) introductory text, (b)(1)(ii), (b)(3), (c)(2)(i), and (d) are revised to read as follows:

§ 220.8 Cash account.

* * * * *

(b) * * *

(1) * * *

(i) Within one payment period of the date:

* * * * *

(ii) In the case of the purchase of a foreign security, within one payment period of the trade date or the date on which settlement is required to occur by the rules of the foreign securities market, provided this period does not exceed the maximum time permitted by this part for delivery against payment transactions.

* * * * *

(3) *Shipment of securities, extension.*

If any shipment of securities is incidental to consummation of a transaction, a creditor may extend the payment period by the number of days required for shipment, but by not more than one additional payment period.

* * * * *

(c) * * *

(2) * * *

(i) Within the period specified in paragraph (b)(1) of this section, full payment is received or any check or draft in payment has cleared and the proceeds from the sale are not withdrawn prior to such payment or check clearance; or

* * * * *

(d) *Extension of time periods; transfers.* (1) Unless the creditor's examining authority believes that the creditor is not acting in good faith or that the creditor has not sufficiently determined that exceptional circumstances warrant such action, it may upon application by the creditor:

(i) Extend any period specified in paragraph (b) of this section;

(ii) Authorize transfer to another account of any transaction involving the purchase of a margin or exempted security; or

(iii) Grant a waiver from the 90 day freeze.

(2) Applications shall be filed and acted upon prior to the end of the payment period, or in the case of the purchase of a foreign security within the period specified in paragraph (b)(1)(ii) of this section, or the expiration of any subsequent extension.

§ 220.18 [Redesignated as § 220.19]

6. Section 220.18 is redesignated as § 220.19 and new § 220.18 is added to read as follows:

§ 220.18 Government securities account.

In a government securities account, a creditor may effect and finance transactions involving government securities, provided the transaction is not prohibited by section 15C of the Act or any rule thereunder.

By order of the Board of Governors of the Federal Reserve System, October 18, 1994.

Jennifer J. Johnson,
Deputy Secretary of the Board.

[FR Doc. 94-26357 Filed 10-24-94; 8:45 am]

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