FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **10569** August 25, 1992]

REGULATION T — CREDIT BY BROKERS AND DEALERS

Comments Invited by October 16, 1992

To All Banks, Brokers and Dealers, and Persons Extending Securities Credit in the Second Federal Reserve District:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued an advance notice of proposed rulemaking and requested public comment in connection with a review of Regulation T (Credit by Brokers and Dealers). This action is part of the Board's program to review periodically all regulations and will help determine whether any provisions of the regulation are in need of updating and whether any substantive changes are necessary because of new products or developments in the securities markets.

Comments should be received by October 16, 1992.

Regulation T was completely rewritten in 1983 after several years of review and comment. The completely revised and simplified regulation appears in general to have met the Board's statutory obligations under the Securities Exchange Act of 1934 with greatly reduced burden.

In conjunction with the present review, Board staff received suggestions from the staff of the Securities and Exchange Commission, officials from the stock and option exchanges, and representatives of the Securities Industry Association. These sources helped Board staff develop a list of issues that could be addressed during this review of the provisions of Regulation T.

Comment also is invited on all areas of the regulation.

Printed on the following pages is the text of the Board's proposal, which has been reprinted from the *Federal Register* of August 18. Comments thereon should be submitted by October 16 and may be sent to the Board as indicated in the notice, or to our Compliance Examinations Department.

E. Gerald Corrigan,
President.

FEDERAL RESERVE SYSTEM

12 CFR Part 220

[Regulation T; Docket No. R-0772]

Securities Credit Transactions; Review of Regulation T, "Credit by Brokers and Dealers"

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Advance notice of proposed rulemaking and request for comment.

SUMMARY: As part of a program of continually reviewing regulations, the Board proposes to amend Regulation T to recognize the current financial environment, classify new products and transactions, and clarify the reach of existing definitions. Comment is invited on all areas of Regulation T.

Regulation T was completely rewritten in 1983 after several years of review and comments. The completely revised and simplified regulation appears in general to have met the Board's statutory obligations under the Securities Exchange Act of 1934 with a greatly reduced burden. The Board has amended Regulation T several times since 1983 to increase the types of securities that can be purchased on credit and/or used as collateral in a margin account and to allow broker-dealers to help customers exercise employee stock options. In 1990 the Board adopted a series of amendments to accommodate transactions in foreign securities. The continuing introduction of new products and types of transactions and the expansion of global markets, however, creates the need for a more broadly based review. In addition, over the past several years, Board staff has issued numerous opinions concerning the provisions of Regulation T. Some of these opinions may be codified in the regulation as a result of this review. After the review of Regulation T is completed, the Board may propose related changes to its other margin regulations, Regulations G, U, and X.

DATES: Comments should be received on or before October 16, 1992.

ADDRESSES: Comments, which should refer to Docket No. R-0772, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Comments addressed to Mr. Wiles may also be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room B-1122 between 9:00 a.m. and 5:00 p.m., except as provided in § 261.8 of the Board's Rules Regarding the Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Laura Homer, Assistant Director, or Scott Holz, Senior Attorney (202/452/2781), Division of Banking Supervision and Regulation , Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202) 452-3544, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, D.C.

SUPPLEMENTARY INFORMATION: Comment is invited on all areas of Regulation T. Some of the areas already identified for review are listed below in alphabetical order.

Arranging

In 1990, the Board adopted a number of amendments to Regulation T to accommodate transactions in foreign securities. The "arranging" provision found in § 220.13 was amended at that time to allow broker-dealers to arrange for a customer to obtain credit from a foreign lender on foreign securities without regard to the broker-dealer's ability to extend the credit itself. In adopting the amendment, the Board declined to add language suggested by some commenters to allow broker-dealers to arrange (1) short sales in foreign markets, and (2) loans of foreign securities. The Board indicated that these proposed enlargements would be addressed after some experience was gained with the amendments adopted at that time. The Securities Industry Association has recently raised the issue again. Comment is requested on the advisability of such amendments, subject to the considerations explained below.

The Board has long taken the position that an investor with a given amount of money should not be able to effect a greater amount of short selling than long buying. There is some concern about encouraging customers of U.S. broker-dealers to sell short in countries that do not have such a requirement. Also, some countries allow short sales to be effected without disclosure of the parties and without identifying whether the sale is short or long. Comments should, therefore, address the possible effect that allowing broker-dealers to arrange for foreign short sales could have on short sales in the United States.

In addition, comment is invited on the appropriateness of allowing broker-dealers to arrange for the borrowing and lending of foreign securities without regard to the limitations found in § 220.16 of Regulation T, the section which covers broker-dealers when they lend or borrow securities directly. As discussed immediately below, the Board is also inviting comment on that section. If that section is amended to allow broker-dealers greater freedom when borrowing and lending securities, an amendment to the arranging section may not be needed. Comments should address situations in which it is appropriate to allow broker-dealers to arrange transactions of this type which they cannot effect themselves.

Borrowing and Lending of Securities

Section 220.16 of Regulation T restricts the ability of broker-dealers to borrow and lend securities in two ways: (1) A loan of securities must be for a permitted purpose, i.e., to complete a short sale or failure to receive securities, and (2) a loan of securities must be at least 100 percent collateralized with specific types of collateral. Board staff is unaware of other valid purposes for borrowing and lending securities. If commenters believe other purposes should be permitted, they should identify appropriate situations.

Comment is invited on additional types of appropriate collateral. Originally, all loans of securities had to be collateralized by cash. Treasury securities were the first noncash instruments allowed as collateral for these loans. The Board expanded the list of acceptable collateral in 1982 to include securities issued or guaranteed by United States agencies and certain bank letters of credit, certificates of deposit, and bankers acceptances. Since that time, Board staff has indicated it believes that marginable foreign sovereign debt securities should be allowed as collateral for loans of securities denominated in that foreign currency.

One of the reasons for restricting the ability of broker-dealers to borrow and lend securities is the possible evasion of the margin requirements by someone

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who obtains 100 percent credit on a security through characterization of the transaction as a stock loan. Permissible collateral for broker-dealers who borrow securities from their customers is also covered in Securities and Exchange Commission (SEC) Rule 15c3-3 (17 CFR 240.15c3-3), the SEC's customer protection rule. The Board intends to coordinate its approach in this area with that of the SEC as closely as possible, while taking into account the different reasons for the two rules.

As noted above in the section on arranging, it has been suggested that broker-dealers should be able to arrange for the borrowing and lending of foreign securities without regard to the purpose of the transaction or the collateral securing it. Interested commenters should identify those situations in which it would be appropriate to allow broker-dealers to arrange these transactions outside of the parameters of § 220.16 of Regulation T.

Section 220.16 as currently written clearly applies to exempted securities. Comment is invited on the need for continuing regulation of borrowing and lending of U.S. government securities in Regulation T. At least one primary dealer has argued that government securities dealers cannot easily document that their securities borrowing and lending is for a permitted purpose, although short sales and fails are the primary reasons for such transactions (see staff opinion in the Federal Reserve Regulatory Service at 5-615.19). In addition, the enactment of the Government Securities Act of 1986 has imposed new regulation in this market, raising the question of whether Regulation T requirements are still appropriate.

Borrowing by Creditors

Section 8(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78h(a)) restricts the ability of broker-dealers to borrow using exchange-traded securities as collateral. Under this section, the only lenders to whom a broker-dealer can pledge exchange-traded securities are banks that are members of the Federal Reserve System; nonmember banks (including foreign banks with U.S. branches and agencies) that have agreed to be bound by the provisions in the Federal Reserve Act, the Banking Act of 1933, and the Securities Exchange Act of 1934 covering securities loans; and other broker-dealers as specified in Regulation T. The requirements of section 8(a) can be found in § 220.15 of Regulation T and § 221.4 of Regulation U (12 CFR 221.4). In addition, § 207.4 of Regulation G (12 CFR 207.4) mirrors the statutory limitation by prohibiting lenders who are neither banks nor broker-dealers from lending to broker-dealers on the collateral of margin stock, unless the loan is to meet emergency needs arising from exceptional circumstances.

Some broker-dealers have expressed the opinion that the statutory limitation on the types of lenders to whom they can pledge exchange-traded securities is overly restrictive and anti-competitive. The Board does not have the authority to expand the eligible types of lenders for loans that are not to meet "emergency needs." Comment is invited on whether the Board should recommend legislative changes to permit additional types of entities, such as insurance companies, to lend to broker-dealers on the collateral of exchange-traded securities.

Cash Account

Since the last revision of Regulation T in 1983, Board staff has received many inquiries concerning the ability to use a cash account for transactions not specifically authorized in § 220.8, the section governing cash accounts. Investors and some self regulatory organizations (SROs) have indicated that certain institutional customers are precluded, either under state law or corporate charter, from opening a margin account or leaving cash and securities at a broker-dealer. These customers sometimes wish to engage in a variety of transactions, generally involving options, where their risk is limited to an amount deposited in a cash account or evidenced by an escrow receipt. Situations which Board staff could not conclude were covered by the language of § 220.8 have sometimes been referred to the SEC for a possible "no-action" position (see staff opinion in the Federal Reserve Regulatory Service at 5-666.251). Comment is invited on possible revisions to the cash account provisions to accommodate transactions in which combinations of securities limit the customer's exposure and cash or securities in the account cover that exposure.

Another area in which Board staff has received numerous inquiries about the cash account concerns transactions in exempted securities. These questions generally concern net settlement of multiple transactions or repurchase/reverse repurchase agreements.

Transactions in a cash account are settled individually to prevent "free-riding," the purchase of a security by a customer who does not have the ability to pay for it followed by the sale of the same security so that the purchase can be paid for with the proceeds of its sale. In order to reduce the number and size of large-dollar wire transfers, however, Board staff has not objected to net settlement in the cash account of transactions in exempted securities for institutional customers whose business is conducted on a delivery-versus-payment basis through a depository environment.

An SRO has noted that institutions sometimes purchase U.S. government securities in a cash account and finance their purchase through a repurchase agreement. This type of transaction appears to be more appropriate for the margin account given the current language of the cash account, but some customers may be unable to use a margin account. Comment is invited on the appropriate treatment of transactions in exempted securities in a cash account. Repurchase transactions are also discussed generally in a separate section below.

Cross-Margining

Financial futures and options on financial futures are often based on the same securities index as index options traded on a national securities exchange. Although one may be a "commodity" and the other a "security," the products are related. The concept of "cross-margining" includes the recognition that positions in financial futures can be used to hedge positions in securities index options and vice versa. While most would agree that cross-margining should be encouraged, there is a statutory limitation in this area. Section 7(c) of the Securities Exchange Act of 1934 generally prohibits broker-dealers from extending credit to purchase or carry securities unless the loan is collateralized by securities in accordance with Board rules. This statutory prohibition has prevented Board staff from opining that commodities can serve as margin for related securities positions under Regulation T. In lieu of an opinion, Board staff has indicated that it does not object to the issuance of an SEC "no-action" position permitting cross-margining for specialists in certain circumstances. Comment is solicited on methods of accommodating cross-margining.

"Customer" Status of Certain Broker-Dealers

Broker-dealers who use another broker-dealer to clear and carry their proprietary trades are treated as

customers of the clearing broker-dealer. It has been suggested that "customer" status for these broker-dealers is unnecessary as they are also subject to the SEC's net capital rule (17 CFR 240.15c3-1). However, this may present equitable problems if the SEC's net capital rule requires less capital for broker-dealers with no public customers than the amount of margin required for a non-broker-dealer with the same positions.

If broker-dealers continue to be treated as customers of their clearing broker-dealers for proprietary positions, should the provision in Regulation T covering joint and common back offices (§ 220.11(a)(2)) be amended? This provision allows broker-dealers who do not clear and carry their own transactions to avoid being treated as customers of their clearing firms if the non-clearing broker-dealer has an ownership interest in the clearing firm. When the Board adopted this provision, it declined to define an appropriate ratio between the non-clearing broker-dealer's interest in the clearing firm and the amount of transactions it needs cleared. However, several SROs have expressed concern that this section of Regulation T is being abused by non-clearing broker-dealers who make a minimal investment in a clearing firm. If this section of the regulation is being used by broker-dealers to avoid other provisions of Regulation T, comment is invited on how those sections can be amended to reduce the incentive to abuse the section on joint and common back offices.

Questions have also arisen on the treatment of foreign broker-dealers. Some parts of Regulation T apply to brokerdealers generally, such as the section on borrowing and lending securities (§ 220.16). Other parts apply only to broker-dealers registered with the SEC, such as omnibus accounts (§ 220.10). Should Regulation T take greater account of foreign broker-dealers? If so, how can the phrase "foreign broker-dealer" be defined? Also, should affiliated foreign broker-dealers be treated differently from non-affiliated foreign broker-dealers?

Derivative Securities

Margin requirements for securities positions are found in the Regulation T supplement, § 220.18. Margin depends on the type of security involved: margin equity security, margin debt security, exempted security, short options position, etc. Different margins are required for long purchases and short sales. Following the introduction of standardized, exchange-traded options in 1973, the Board amended Regulation T frequently to accommodate new options products and transactions. In 1985, the Board simplified its rules in this area by defining margin for the writing of options by reference to the maintenance rules of the exchange that trades the option. In the past few years, a variety of new products have been developed, such as index participations and capped options, that do not fit easily into one of the categories in the supplement. Board staff has tried to respond to inquiries on new products on an ad hoc basis. Comment is invited on possible generic approaches to categorizing the margin treatment of the continuing list of new products, especially those with characteristics of more than one type of security.

There appears to be an increasing number of transactions involving nonstandardized, over-the-counter options. The margin for these options is the amount required by the maintenance margin rules of the broker-dealer's SRO. Margin must be collected for nonstandardized options that are "issued, endorsed, or guaranteed" by the broker-dealer. Board staff has recently been asked about over-the-counter options that are not issued, endorsed, or guaranteed by a broker-dealer. The argument has been made that a broker-dealer who buys such an option from its customer is merely purchasing a security and no margin need be charged to the customer because the broker-dealer does not have a continuing obligation vis-a-vis the customer. One of the reasons broker-dealers traditionally endorse or guarantee OTC options is to make them transferable. Although OTC options that are not endorsed or guaranteed by a broker-dealer may not be transferable, there is nothing to stop a broker-dealer from writing a similar option to offset the option purchased from the customer. This is in many ways the equivalent of endorsing a customer option for sale to another investor. Comment is requested on the appropriate treatment of OTC options, whether or not endorsed or guaranteed by a broker-dealer.

Extensions of Time

Most customer purchases in a margin or cash account must be paid for within seven business days of trade date or the broker-dealer is required to cancel or otherwise liquidate the transaction. Under §§ 220.4(c)(3) and 220.8(d), a broker-dealer may obtain an extension of this time period from an SRO. One SRO has asked the SEC to approve a rule requiring broker-dealers to obtain extensions of time from their designated examining authority. Staff of the SEC is currently studying this issue and exploring the possibility of requiring the SRO that grants the extension to do compliance examinations. Others have suggested that broker-dealers should be able to grant extensions of time without approval from any SRO. There is some concern that this would allow broker-dealers to grant more favorable extensions to certain customers. In addition, the Board believes settlement and payment should occur as soon as possible. The Group of Thirty, a private sector group concerned with international financial issues, has recommended a world-wide standard of settlement on the third day after trade date. The Board may consider shortening the time for customer payment once the settlement period is shortened from the current five days. Comment is invited on the current need for changes to rules regarding extensions of time for customer payment.

Hedges, Offsets, and Cover in Lieu of Margin

Under § 220.18(c), the short sale of a nonexempted security requires a margin of 150 percent of the security's current market value. One hundred percent is met by the proceeds of the short sale and the customer must post an additional 50 percent margin. The additional 50 percent is not required if the account also holds securities "exchangeable or convertible within 90 calendar days without restriction other than the payment of money." Concerns have been raised about the equity of using a corporate warrant as a hedge for a short sale of the underlying stock because the warrant is not of comparable value to the underlying security. In addition, the continuing proliferation of derivative securities has led to the suggestion that like, but not identical, products should be recognized as hedges. Comment is invited on this area. Commenters who believe the relationship between like products should be recognized should describe how close a correlation between the products should be required for the hedge to be recognized.

Specialists in options are permitted good faith credit in their specialty option and any "permitted offset positions" specified in § 220.12(b). However, permitted offsets are determined by the

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"underlying" security, defined in § 220.2(aa) as "the security that will be delivered upon exercise of an option." This precludes the use of permitted offsets for specialists in cash-settled index options, as no securities are delivered upon exercise. While this can be remedied by changing definitions, comment is invited generally on the area of permitted offsets.

Although margin for the writing of exchange-traded options is generally determined by reference to the rules of the exchange that trades the option, the Federal Reserve still determines what qualifies as cover and positions in lieu of margin for equity securities options. Section 220.5(c) of Regulation T recognizes lesser margin requirements for various option positions such as certain spreads and straddles. These combinations are treated as one position for Regulation T purposes. Board staff has received letters from investors who believe certain new or additional strategies should be recognized, especially multiple combinations of option positions. Comment is invited on improvements and simplifications in this area.

Repurchase and Reverse Repurchase Agreements (See Also Cash Account Above)

It is generally recognized that while repurchase (repo) and reverse repurchase agreements involve the purchase and sale of a security, the transactions can be used as a financing tool. The Board has not specified the exact treatment of these agreements for purposes of Regulation T. Because U.S. government securities are entitled to good faith loan value and are often valued at very close to 100 percent of their current market value, the repo of such a security does not present problems under Regulation T from a credit standpoint. On the other hand, the repo of a margin equity security at greater than 50 percent would be a violation of the margin regulations. Corporate debt securities fall somewhere in between U.S. government securities and corporate equities. Most corporate debt securities are entitled to good faith loan value. However, the combination of credit risk and the maintenance rules of the SROs means that such securities are not generally given as high a loan value as U.S. government securities. Comment is invited on how repurchase agreements can be defined to identify those transactions that may be effected without restriction under the margin regulations. Additional comment is sought concerning which accounts may be used to effect such transactions.

Two-Tiered Market

One of the issues often discussed in the past few years is the ability of so-called sophisticated investors to operate with lesser regulation than so-called average investors. In the margin area, the Board took note of sophisticated investors when it amended, in 1975, the general prohibition on broker-dealers arranging for credit they cannot themselves extend to allow broker-dealers to arrange for credit in private placements. The Board's rationale was that the SEC and the courts have recognized that private placements are made to limited, sophisticated group of persons who will not be lured into the transaction by the availability of credit. At the SRO level, the New York Stock Exchange has established special accounts with less regulation for large institutions. Comment is invited on the desirability of adopting less restrictive rules to apply to specified customers who are sophisticated investors. Comments must necessarily address how such customers can be identified and which restrictions can be eliminated.

When-Distributed Securities

Purchases in the cash account must generally be paid for within seven business days from trade date. A 1943 amendment to Regulation T recognized an exception for "when-distributed" securities. These securities were usually issued by public utility companies undergoing reorganizations. The amendment allows customers a maximum of seven business days from the date when the "when-distributed" security is made available, rather than seven business days from trade date.

In the 1980s, the cash account provision on "whendistributed" securities (§ 220.8(b)(1)(i)(C)) was used in connection with privatizations in the United Kingdom done on an installment basis. While publicly-traded stock is not sold on an installment basis in this country, large issues in the U.K. have used this method. Characterizing these securities as not being distributed until final payment is made therefor allowed U.S. broker-dealers to participate in the offering without being viewed as arranging for impermissible credit in a new issue. Board staff indicated that it would not object to the use of the "when-distributed" exception as an accommodation to a foreign government privatizing its state-owned companies. Questions have recently been raised about the ability of foreign private issuers to use the "when-distributed" language in Regulation T. Comment is invited on this area, including possible amendments that would recognize foreign sovereign and possibly private installment sale offerings without relying on the "when-distributed" exception.

By order of the Board of Governors of the Federal Reserve System, August 13, 1992.

William W. Wiles,

Secretary of the Board.

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