AT CIRCULAR NO. 10634

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045-0001

AREA CODE 212 720-5268

WILLIAM L. RUTLEDGE
SENIOR VICE PRESIDENT

April 16, 1993

TO THE CHIEF EXECUTIVE OFFICERS OF
ALL STATE MEMBER BANKS, BANK HOLDING COMPANIES,
AND U. S. BRANCHES AND AGENCIES OF FOREIGN BANKS
IN THE SECOND FEDERAL RESERVE DISTRICT

SUBJECT: VIOLATIONS OF FEDERAL RESERVE MARGIN REGULATIONS IN CUSTODIAL AGENCY ACCOUNTS RESULTING FROM "FREE-RIDING" SCHEMES

State member banks, bank holding companies, and U.S. branches and agencies of foreign banks should be aware of recent targeted examinations and investigations by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, that have found banks in violation of Regulation U (12 CFR 221) (Credit by Banks for the Purpose of Purchasing or Carrying Margin Stocks) in connection with extensions of credit by bank trust departments, using bank or other fiduciary funds, to individuals involved in illegal "day trading" or "free-riding" schemes. These activities also involved the aiding and abetting of violations of two other securities credit regulations: Regulation T (12 CFR 220) (Credit by Brokers and Dealers) and Regulation X (12 CFR 224) (Borrowers of Securities Credit). Day trading and free-riding schemes involve the purchase and sale of stock on the same day (or within a very short period of time) and the funding of the purchase by the sales' proceeds.

Because of the illegal activities described below, banks have been exposed to disciplinary proceedings, as well as to substantial credit risk. To date, several banks have sustained monetary losses in their trust departments as a result of their involvement in these schemes.

In the late 1980's, the SEC started to uncover illegal free-riding schemes and addressed them through injunctive actions filed against broker-dealers and banks in Federal district court. In one case, SEC v. Hansen, et al., 726 F. Supp. 74 (S.D.N.Y. 1989), a bank was found to have violated Regulation U by knowingly participating in a free-riding scheme. This was the first case in which the SEC sued a bank for illegal securities clearance activities associated with a free-riding scheme. It appears that over the past several months these illegal schemes have resurfaced. Investigations and examinations by SEC and Federal Reserve staffs have detected similar violations by State member and national banks' trust departments, leading to follow-up enforcement actions.

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Thus, increased vigilance by banking organizations that conduct trust-related activities is called for to ensure they take all steps necessary to prevent their customers from involving them in the customers' attempts at free-riding.

Summary of Illegal Activities

The free-riding conduct in question typically involves individuals trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free-ride--that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Often, free-riding schemes involve initial public offerings because broker-dealers are prohibited from financing these new issues. If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment or received-versus-payment (DVP) transaction, a bank or other financial institution that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of credit that is subject to Regulation U.

The typical device used by the perpetrators of a free-riding scheme is for a new customer to open a custodial agency account into which a number of broker-dealers will deliver securities or funds on a DVP basis. Although a deposit may be made into the custodial agency account, the amount of trading is greatly in excess of the original deposit causing the bank to extend its own credit to meet the payment and delivery obligations of the account. Thus, while the financial institution may be generating fees based on the activity of these accounts, it is subjecting itself to substantial losses should the market prices for the purchased securities fall or failed transactions otherwise occur. In addition, other liabilities under Federal banking and securities laws may be involved.

Application of Securities Credit Regulations

Regulation U. Because there is no exemption in Regulation U for trust activities in a bank or other financial institution,[1] any extension of credit in the course of settling

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[1] The definition of the term "bank" for purposes of the regulation specifically includes institutions "exercising fiduciary powers." See 12 CFR 221.2(b), 15 U.S.C. 78c(a)(6), and Federal Reserve Regulatory Service at 5-795 (1946).

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customer securities transactions must comply with all of the provisions of Regulation U.[2] This includes the requirement that all extensions of credit that are secured by marginable stock be within the 50 percent margin limit set by Regulation U.

To avoid violations of the Board's securities credit regulations, the customer's account must hold sufficient funds on the settlement date to pay for each transaction and the funds may not include the proceeds of their sale. If a financial institution is relying on the proceeds of the sale of securities as its source of payment for accepting delivery of the securities, Board staff, the SEC, and the courts have viewed the institution as extending credit secured by the securities to the customer. Because Regulation U limits the amount of credit that can be extended in these cases to 50 percent of the securities' current market value if the securities qualify as margin stock and, generally, in a free-riding scheme a customer's account does not have funds to pay for all such purchases or a customer instructs the institution to pay for the purchase of securities with the proceeds from the sale of those securities, a banking organization that has extended credit in a free-riding scheme has violated Regulation U.

Although the proscriptions of Regulation U apply only to transactions in margin stock, free-riding in nonmargin stocks in custodial agency accounts could, as described below, result in aiding and abetting violations by the banking organization of Regulations T and X and other securities laws, and raise financial safety and soundness issues.

Regulation T and X. Because the custodial agency accounts described above are used to settle transactions effected by the customer at broker-dealers, a banking organization that opens this type of account should have some general understanding of how Regulation T restricts the customer's use of the account at the institution. Regulation T requires the use of a cash account for customer purchases or sales on a DVP basis. Section 220.8(a) of Regulation T specifies that cash account transactions are predicated on the customer's agreement that he or she will make full cash payment for securities before selling them and does not intend to sell them before making such payment. Therefore, free-

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[2] When used in discussing a bank's trust department, or any other type of financial institution exercising fiduciary powers, the term "extension of credit" includes overdrafts in settling customer's accounts that may be covered by advances from the banking organization, from other fiduciary customers, or from a combination of both.

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riding is prohibited in a cash account. A customer who instructs his or her agent bank or other financial institution to pay for a security in reliance on the proceeds of its sale in a DVP transaction is causing, or aiding or abetting, the broker-dealer to violate the credit restrictions of Regulation T. Regulation X, which generally prohibits borrowers from willfully causing credit to be extended in contravention of Regulations T or U, also applies to the customer in such cases.

As described above, banking organizations involved in free-riding schemes may be aiding and abetting violations of Regulation T by the broker-dealers delivering securities or funds to the institutions' customers' accounts. As long as the bank uses its funds to complete a customer's transactions, the broker-dealers may not discover that they are selling securities to the customer in violation of their obligations under Regulation T. A similar aiding and abetting violation of Regulation X could occur with respect to violations by the customers who have used the financial institution to induce their broker-dealers to violate Regulation T.

New Customer Inquiries and Warning Signals

Banking organizations that conduct trust-related activities should make sure that they follow appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. They should address, among other things, ways a bank can protect against free-riding schemes. One of the ways banks can protect themselves is to obtain adequate background and credit information from new clients, including whether the customer intends to obtain bank credit to use the account for transactions as if it were a margin account at a broker-dealer. This type of activity requires more extensive monitoring than the typical DVP account in which no credit is extended. It would be prudent to inquire why a new customer is not utilizing the margin account services of its broker-dealers. Regulation U Form FR U-1 must be obtained and constantly updated if the account is to be used as a margin account.

It also would be advisable for the bank or bank holding company subsidiary to obtain from the customer a list of broker-dealers that will be sending securities to or receiving funds from the account on a DVP basis. If it appears that a number of broker-dealers may be used on a DVP basis, the bank should obtain an undertaking from the customer, as part of the new account agreement, that all transactions with the broker-dealer will be in conformance with Regulations T and X and that the customer is aware that a cash account security is not to be sold until it is paid for. Similarly, in obtaining instructions for settling DVP

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transactions for a customer, the bank should clarify that it will not pay for the purchase of securities with the proceeds from the sale of those securities.

State member banks, bank holding companies, and U.S. branches and agencies of foreign banks exercising trust powers should also ensure that they monitor such accounts closely for an initial period to detect patterns typical of free-riding, including intraday overdrafts, and ensure that sufficient funds or margin collateral are on deposit at all times. Frequent transactions in securities being offered in an initial public offering may suggest an avoidance of Regulations T and X. In the event it appears that a customer is attempting to free-ride, a banking organization should immediately alert the broker-dealers involved and take steps to minimize its own credit risk and legal liability.

At a minimum, you should also evaluate a trust institution's ability to ensure that it does not extend more credit on behalf of the banking organization to a customer than is permitted under Regulation U. Any overdraft related to a purchase or sale of margin stock is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Board staff has published a number of opinions discussing the application of Regulation U to various transactions related to free-riding in the Federal Reserve Regulatory Service. See, for example, Federal Reserve Regulatory Service, at 5-942.2 (1992); 5-942.18 (1990); and 5-942.15 (1989).

SEC and Federal Reserve Sanctions and Enforcement Actions

As noted earlier, the SEC has exercised its broad authority to enforce the Board's securities credit regulations. This has included the initiation of several enforcement actions in Federal district court against banks involved in activities similar to those outlined above. In each case, the SEC obtained permanent injunctions against future violations from the banks involved. The SEC also required the banks to establish credit compliance committees to formulate written policies and procedures concerning the extension of purpose credit in their securities clearance business, establish training programs for bank personnel responsible for the conduct of their securities clearance business and submit to outside audits to ascertain whether the banks met their undertakings under the injunctions.

It should be noted that under recently revised section 21 of the Securities Exchange Act of 1934, the SEC may, and has stated an intention to, seek civil money penalties in addition to Federal district court injunctive actions. Civil penalties and aiding and abetting liability may be assessed by the SEC against a banking

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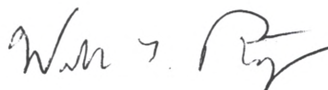
organization if the customer or its broker-dealer is found in violation of Regulations X or T, if the financial institution has knowledge of the facts and assists the scheme--that is, by extending credit to finance the free-riding.

In addition, we may institute enforcement proceedings against banking organizations supervised by the Federal Reserve and their institution-affiliated parties involved in these activities, including cease and desist, civil money penalty assessment, and removal and permanent prohibition actions.

In the event you have any questions concerning this matter, please contact Scott Holz, Senior Attorney, or Angela Desmond, Senior Attorney, at (202) 452-2781, at the Board of Governors of the Federal Reserve System in Washington, D.C., or K. Walter Winkhart, Supervising Examiner, Specialized Examinations Department, at the Federal Reserve Bank of New York at (212) 720-5893.

Very truly yours,



William L. Rutledge
Senior Vice President

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NEW YORK, N.Y. 10045-0001

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ROBERTA J. PUSCHEL
EXECUTIVE VICE PRESIDENT

April 27, 1993

TO: CHIEF EXECUTIVE OFFICERS OF FOREIGN BANKING ORGANIZATIONS THAT HAVE A PRESENCE IN THE U.S. AND THAT FILE THE Y-7 REPORT WITH THE FEDERAL RESERVE BANK OF NEW YORK

SUBJECT: VIOLATIONS OF FEDERAL RESERVE MARGIN REGULATIONS IN CUSTODIAL AGENCY ACCOUNTS RESULTING FROM "FREE-RIDING" SCHEMES

On April 16, 1993 the Federal Reserve Bank of New York mailed the attached letter regarding violations of Federal Reserve margin regulations in custodial agency accounts to state member commercial banks, bank holding companies and agencies and branches of foreign banks in the Second Federal Reserve District. The concerns discussed in that letter are relevant for all U.S. offices of foreign banking organizations, including bank and nonbank subsidiaries, as well as branches and agencies of foreign banks. I am writing to you to call to your attention the requirements of, and the possible consequences of failure to abide by, the relevant regulations.

Recent targeted examinations and investigations conducted by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, have found banks in violation of Regulation U (12 CFR 221) (Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock) in connection with extensions of credit by bank trust departments to individuals involved in illegal "day trading" or "free-riding" schemes. These activities may have also involved violations of two other securities credit regulations: Regulation T (12 CFR 220) (Credit by Brokers and Dealers) and Regulation X (12 CFR 224) (Borrowers of Securities Credit).

Of note, banks that have been cited for such illegal activities have been subject to disciplinary proceedings and exposed to substantial credit risk. To date, several banks have sustained monetary losses in their trust departments as a result of their involvement in these schemes.

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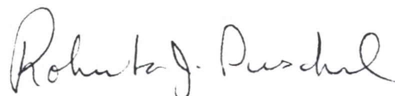
Since this matter extends to all offices of your organization operating in the U.S., including branches and agencies, and banking and nonbanking subsidiaries, we would like your assistance in assuring that all of your banking and nonbanking operations in the U.S. are cognizant of the regulations.

If you have any questions related to this matter, please contact Scott Holz, Senior Attorney, or Angela Desmond, Senior Attorney, at (202) 452-2781, at the Board of Governors of the Federal Reserve System in Washington, D.C., or K. Walter Winkhart, Supervising Examiner, Specialized Examinations Department, at the Federal Reserve Bank of New York at (212) 720-5893.

Sincerely,



Roberta J. Puschel
Executive Vice President

Attachment

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