

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10721]
July 15, 1994]

CREDIT BY BROKERS AND DEALERS

Proposed Amendments to Regulation T

Comments Invited by August 15, 1994

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

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

The Federal Reserve Board has requested public comment on proposed amendments to Regulation T (Credit by Brokers and Dealers) regarding settlement of securities purchases and the status of government securities transactions.

Comments should be received by August 15, 1994.

One proposal 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.

Related amendments would 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 foreign settlement periods are used to calculate when restrictions in the cash account are applied to foreign securities.

Other amendments would exempt certain brokers and transactions involving U.S. government securities from the regulation.

Printed on the following pages is the text of the proposal, which was published in the *Federal Register* of July 1. Comments thereon should be submitted by August 15, 1994, and may be sent to the Board of Governors, as specified in the Board's notice, or to our Compliance Examinations Department.

WILLIAM J. McDONOUGH,
President.

10/721

FEDERAL RESERVE SYSTEM**12 CFR Part 220****[Regulation T; Docket No. R-0840]****Credit by Brokers and Dealers****AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Proposed rule.

SUMMARY: As part of its review of Regulation T, the Board is proposing three substantive amendments to two areas of the regulation. One proposal 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 and includes related technical amendments. The other amendments would exempt certain brokers and transactions involving U.S. government securities from the regulation.

DATES: Comments should be received on or before August 15, 1994.

ADDRESSES: Comments, which should refer to Docket R-0840, may be mailed to Mr. William 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 a.m. and 5 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: 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: On August 18, 1992, the Board published an advance notice of proposed rulemaking (Advance Notice) requesting public comment in connection with a general review of Regulation T.¹ The review is not yet complete, but the Board believes that certain developments since the publication of the Advance Notice warrant the publication of three proposed amendments in two areas.

I. Three Day Settlement (T+3).

In light of the adoption by the Securities and Exchange Commission (SEC) of a rule shortening the standard settlement period for securities transactions from five to three business days (T+3), the Board proposes to shorten the time periods specified in Regulation T for customers to meet margin calls or make full cash payment by a corresponding two days. Related amendments would 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 ("DEA"), and clarify that foreign settlement periods are used to calculate when restrictions in the cash account are applied to foreign securities.

Regulation T has always required cash payment for securities purchases within seven business days of trade date. The seven day period was initially chosen for the cash account because it was felt that a customer should have no obligation to pay for securities before they were delivered. The two days permitted beyond settlement date provide a short period of time for resolution of problems before the broker is required to act under Regulation T, i.e. either obtain an extension on the customer's behalf (if it is determined that a valid reason exists) or sell out the customer's position.

The Board's Advance Notice was issued before the SEC proposed its rule adopting a T+3 settlement period. The Advance Notice mentioned the Group of Thirty's recommendation of a world-wide settlement standard of T+3 and said the Board "may consider shortening the time for customer payment once the settlement period is shortened from the current five days." The Board supported the SEC when it proposed requiring T+3 settlement, calling the proposal "an important and achievable step" to reduce potential systemic disturbances to financial markets and to the economy. The SEC

also received several comment letters stating that the implementation of T+3 settlement will require the Federal Reserve to address the possible shortening of its Regulation T payment periods. Those letters were forwarded to Board staff for consideration in the context of the ongoing Regulation T review.

The Board proposes to reword Regulation T to specifically incorporate the standard settlement cycle and the current two day cushion. Instead of requiring payment within "seven business days," the regulation would require payment within "one payment period," with "payment period" being defined as the standard settlement period in the United States plus two business days. This will not change the operation of the rule at this time, but once the new language is put into place the conversion to T+3 next year will automatically result in a reduction in the amount of time brokers can give their customers to pay for securities or meet initial margin calls. Future changes in settlement periods by the SEC will similarly be automatically reflected in the Board's rule without the necessity of further amendment.

The payment periods in Regulation T can be extended for exceptional circumstances if the broker applies to a self-regulatory organization (SRO) for an extension. In 1988, the New York Stock Exchange (NYSE) sought SEC approval of a rule that would require a broker seeking a Regulation T extension to obtain the extension from the NYSE if the NYSE is the broker's DEA. The proposal was noted by the Board in the Advance Notice, as was a suggestion by the Credit Division of the Securities Industry Association that brokers be permitted to grant customer extensions without approval of an SRO. The SEC approved the NYSE rule filing in May 1994.² In its approval order, the SEC stated that it does not agree with assertions that the objectives of the Securities Exchange Act of 1934 (the "Act") could be better met by implementing a uniform system of sharing extension information. As to the other objections raised by commenters (and also raised with the Board pursuant to the Advance Notice), the SEC found that "the regulatory benefits from the NYSE rule outweigh any competitive concerns raised by the commenters." Finally, the SEC said it does not agree with those commenters who argue that broker-dealers should not be required to submit requests for extensions of time to either their DEA or

¹ Docket No. R-0772, 57 FR 37109, August 18, 1992.

² 59 FR 26826, May 24, 1994; Securities Exchange Act Release 34073, May 17, 1994.

any SRO. The Board believes, along with the SEC, that a good case has been made to restore to the broker's DEA sole responsibility for granting and monitoring extensions of time and the language proposed by the Board today reflects this conclusion.

II. Government Securities

In light of the recent enactment of the Government Securities Act Amendments of 1993, the Board proposes to exempt most transactions involving government securities from the restrictions of Regulation T. This would be accomplished with two separate but related actions. First, Regulation T would exclude government securities brokers and dealers who register with the SEC under section 15C of the Securities Exchange Act of 1934 (the "Act") from the definition of "creditor" in Regulation T. Second, general broker-dealers effecting customer transactions that could be effected by a section 15C broker-dealer would be able to record the transactions in a new government securities account in which the other restrictions in Regulation T would not apply.

Before the enactment of the Government Securities Act of 1986, brokers-dealers who limited themselves to transactions in government securities were not subject to a comprehensive regulatory scheme and were not required to be registered with the SEC. Although such brokers were within the definition of "creditor," there was no practical way to enforce Regulation T for them. The Government Securities Act of 1986 required SEC registration of all nonbank government securities brokers and dealers under a new section 15C of the Act. The Government Securities Act of 1986 also added the term "government securities" to the Act.

The Advance Notice invited comment on two areas involving government securities: repurchase agreements ("Repos") and the borrowing and lending of securities. The Advance Notice explained that the Board has not specified the exact treatment of repurchase agreements while noting that repos of government securities do not raise credit issues under Regulation T because the good faith loan value of such securities is often close to 100 percent of their current market value. Many of the commenters suggested that the Board create a new account for exempted securities that could be used for transactions such as Repos and forward transactions. Most of the commenters supported exempting government securities from § 220.16 of Regulation T. This would allow loans of government securities without the

current requirement that a broker document that the reason for the borrowing stems from a short sale or failure to receive securities required for delivery.

Under today's proposal, whenever a general broker-dealer effects a transaction for a customer that could be effected by a section 15C broker, the transaction could be recorded in a new government securities account. The account would allow these transactions to be effected without regard to other restrictions in Regulation T. The account would be permissive; brokers could continue to let customers who wish to use the cash or margin account for transactions involving government securities do so. It would allow institutional customers who cannot or will not use a margin account to engage in government securities transactions not specifically authorized in the cash account. For example, the government securities account could be used to effect purchases of government securities on credit or for cash as well as repurchase and reverse repurchase agreements. Borrowing and lending of government securities could also be effected in the proposed account without being subject to the "permitted purpose" requirement in § 220.16 of Regulation T that requires brokers to limit and document the reasons for their securities borrowings. The account would also permit net settlement of offsetting purchases and sales of government securities. Government securities purchased or deposited in a margin account would still be subject to the current Regulation T rules and would therefore still be available to finance the purchase of other securities in a margin account.

The Board is not proposing to include additional types of exempted securities, such as municipal securities, in the proposed government securities account. Government securities constitute an unusually deep and liquid market and are subject to a unique scheme of regulation, as evidenced by the Government Securities Act of 1986.

Regulatory Flexibility Act

The Board believes there will be no significant economic impact on a substantial number of small entities if this proposal is adopted. Comments are invited on this statement.

Paperwork Reduction Act

No additional reporting requirements or modification to existing reporting requirements are proposed.

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, the Board proposes to amend 12 CFR Part 220 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.

§ 220.1 [Amended]

2. In § 220.1 the word "seven" in the first sentence of paragraph (b)(1) is revised to read "eight".

3. Section 220.2 is amended as follows:

a. A new sentence is added to the end of paragraph (b).

b. Paragraph (h) is revised.

c. Paragraphs (w) through (aa) are redesignated as paragraphs (x) through (bb) and new paragraph (w) is added.

The additions and revisions read as follows:

§ 220.2 Definitions.

* * * * *

(b) * * * *Creditor* does not include a broker or dealer registered only under section 15C of the act.

* * * * *

(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 plus two 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 one payment period of the trade date, or in the case of the purchase of a foreign security, within the period specified in paragraph (b)(1)(ii) 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.

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 would be permissible for a broker or dealer registered under section 15C of the act.

By order of the Board of Governors of the Federal Reserve System, June 27, 1994.

William W. Wiles,

Secretary of the Board.

[FR Doc. 94-16033 Filed 6-30-94; 8:45 am]

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