FEDERAL RESERVE SYSTEM

12 CFR Parts 207, 220 and 221
[Regulations G, T and U; Docket No. R-0944]
Securities Credit Transactions; Borrowing by Brokers and Dealers

AGENCY: Board of Governors of the Federal Reserve System

ACTION: Proposed rule.

SUMMARY: On October 11, 1996, the President signed the National Securities Markets Improvement Act of 1996 (the Markets Improvement Act). Under the Markets Improvement Act, the Board no longer has the authority to regulate certain loans to registered broker-dealers unless it finds that such rules are necessary or appropriate in the public interest or for the protection of investors. The Markets Improvement Act also repeals section 8(a) of the Securities Exchange Act of 1934 (the Exchange Act), which limited the sources of credit for broker-dealers who pledge exchange-traded equity securities to certain banks and other broker-dealers. The Board is soliciting comment on amendments to its margin regulations (Regulations G, T and U) to implement the statutory amendments in the Markets Improvement Act and further the policies behind their adoption.

DATE: Comments should be received by December 31, 1996.

ADDRESSES: Comments should refer to Docket No. R-0944 and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Comments also may be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, N.W. between Constitution Avenue and C Street, N.W. at any time. Comments received will be available for inspection in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding availability of information.

FOR FURTHER INFORMATION CONTACT: Oliver Ireland, Associate General Counsel (202) 452-3625; Gregory Baer, Managing Senior Counsel (202) 452-3236; or Scott Holz, Senior Attorney (202) 452-2966, Legal Division; for

the hearing impaired only, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202) 452-3544.

SUPPLEMENTARY INFORMATION:

The Markets Improvement Act (Pub. L. 104-290) affects the Board's margin authority in two ways. First, the Markets Improvement Act amended section 7 of the Exchange Act (15 U.S.C. 78g) to exclude certain loans to broker-dealers from the Board's margin authority. The Board is nevertheless authorized to adopt rules and regulations covering these loans if the Board finds such rules are "necessary or appropriate in the public interest or for the protection of investors." Second, the Markets Improvement Act repealed section 8(a) of the Exchange Act (15 U.S.C. 78h(a)), which limits the sources of funding for broker-dealers who pledge exchange-traded equity securities to other broker-dealers and certain banks. In a separate document published elsewhere in today's Federal Register, the Board is issuing an interpretation of Regulations G, T and U to clarify their applicability in light of the statutory amendments in the Market Improvement Act.

The Board is seeking comment on appropriate amendments to Regulations G, T and U to reflect the changes contained in the Markets Improvement Act and to further the policies behind these changes. To reflect the repeal of section 8(a) of the Exchange Act, the Board is proposing to delete the provisions of its regulations which repeat the former statutory restriction on sources of broker-dealer funding. Two regulatory sections would be removed in their entirety. These sections, § 220.15 of Regulation T and § 221.4 of Regulation U, restate the requirements of former section 8(a) of the Exchange Act and identify the FR T-1, T-2 as the form to be used by nonmember banks wishing to extend credit to brokers and dealers. Regulation U would also be amended by revising § 221.5 (special purpose loans to brokers and dealers) to eliminate the requirement that nonmember banks making such loans have an agreement in force with the Federal Reserve pursuant to section 8(a) of the Exchange Act. Use of the FR T-1, T-2 would be discontinued, as would the Board's "K.22" publication, which lists those nonmember banks with section 8(a) agreements in force. Finally, § 207.4 of Regulation G would be revised to delete the general prohibition that lenders not extend credit to broker-dealers secured by margin stock.

To address the amendments to section 7 of the Exchange Act, the Board is specifically seeking comment on whether the exclusion of loans to specified types of broker-dealers from these regulations should be accomplished by amending the "scope" provision in the first section of each regulation[1/] or by amending the definition of "customer" in the second section of each regulation.[2/] The Board is also seeking comment on whether it needs to provide a test to identify brokers or dealers or members of a national securities exchange "a substantial portion of whose business consists of transactions with persons other than brokers or dealers" and, if such a test is necessary, what an appropriate test would be. The Board believes an appropriate test should be able to be readily administered by both regulators and market participants while not being more restrictive than the Congressional intent behind the Markets Improvement Act. The Board seeks comment on whether a test based on volume, revenue, transactions or some other measure can achieve these goals. In addition, the Board is seeking comment on potential changes specific to the various regulations.

Regulation T

Regulation T contains nine accounts in which to record financial transactions between broker-dealers and their customers. Three of these accounts, the omnibus account, the broker-dealer credit account and the market functions account allow favorable treatment for certain transactions that are generally limited to broker-dealers.

Under the Markets Improvement Act, most of the transactions eligible for execution in the market functions account are excluded from the Board's general margin authority because they involve market making and underwriting. The omnibus account is used by broker-dealers who seek to finance the credit they extend to their public customers and these transactions are excluded from the Board's general margin authority under the Markets Improvement Act if the borrowing broker-dealer has a substantial public customer business. The Board is seeking comment on whether there is any continuing need for these accounts.

[1/] 12 CFR 207.1 (Regulation G), 12 CFR 220.1 (Regulation T), and 12 CFR 221.1 (Regulation U).

[2/] 12 CFR 207.2 (Regulation G), 12 CFR 220.2 (Regulation T), and 12 CFR 221.2 (Regulation U).

The broker-dealer credit account contains several permissible transactions, some of which are not limited to members of a national securities exchange or registered brokers and dealers.[3/] In addition to these transactions, broker-dealers who do not meet the test that a "substantial portion" of their business involves public customers may continue to be subject to Board rules for certain borowings unless the Board exempts them. The Board is seeking comment on whether these broker-dealers should continue to be covered by Board rules, and if so, whether there is a continuing need for the broker-dealer credit account. The Board is also seeking comment on whether transactions currently permitted in the broker-dealer credit account that do not require the customer to be a member of a national securities exchange or a registered broker-dealer should continue to be allowed under Regulation T and if so, how this should be accomplished.

Regulation T covers the borrowing and lending of securities in § 220.16 to accommodate short sales and fails to receive while preventing circumvention of the margin requirements. Because these transactions are traditionally collateralized with cash or other collateral equal to at least the market value of the security being lent, the lender of the securities can be viewed as receiving 100 percent credit against the security being lent. If both parties to a securities lending transaction are broker-dealers with a substantial public customer business, it appears that § 220.16 is no longer applicable. The Board is soliciting comment on how to amend the rules regarding the borrowing and lending of securities to reflect the Market Improvement Act.

Regulations G and U

The current structure of the Board's margin regulations is based in part on the requirements of the recently-repealed section 8(a) of the Exchange Act. Section 8(a) sought to limit sources of funding for broker-dealers to certain banks and other broker-dealers. Both of these types of lenders were themselves subject to Federal Reserve regulation when they extended securities credit. The

---

[3/] Section 220.11(a)(1) of Regulation T was recently amended to allow unregistered foreign broker-dealers to purchase and sell securities on a delivery-versus-payment (DVP) basis without application of 90-day freeze and letter of free funds requirements imposed on DVP transactions in the cash pursuant to § 220.8(c). At the same time, § 220.11(a)(5) was added to cover transactions with customers that are part of a "prime-broker" arrangement effected in accordance with SEC guidelines. "Prime-broker" arrangements involve two or more broker-dealers effecting and financing transactions for a nonbroker-dealers customer.

repeal of section 8(a) of the Exchange Act raises fundamental questions about the appropriate coverage of Regulations G and U.

In 1968, the Board determined that it was appropriate to extend its margin requirements to cover lenders other than banks and broker-dealers. Rather than extend the provisions of Regulation U to the newly covered lenders, Regulation G was adopted as a separate regulation, in part because section 8(a) of the Exchange Act mandated a distinction between bank and nonbank lenders with respect to loans to broker-dealers. Over the years, the Board has tried to make Regulations G and U more and more similar.[4/]

The Board seeks comment on whether it is still appropriate to distinguish between Regulation G and Regulation U lenders. For example, is it appropriate to retain in Regulation U the concept of special-purpose loans to broker-dealers for those broker-dealers, a substantial portion of whose business does not consist of transactions with public customers, when the broker-dealer is engaged in activities other than market making and underwriting. If so, should these special-purpose loans be part of Regulation G as well. Should Regulation G continue to allow good faith credit to broker-dealers for emergency needs arising from exceptional circumstances, based on a certification from the broker-dealer, and should this treatment be extended to Regulation U. Finally, the Board seeks comment on the advisability of conforming some or all of the provisions of Regulations G and U or combining Regulations G and U into one regulation.

Regulatory Flexibility Act

As discussed in the preamble, the proposed amendments have been developed to implement section 104 of the National Securities Markets Improvement Act (Pub. L. 104-290), which reduced the scope of the Board's statutory authority for margin regulation. The Board is requesting comment to identify potential burden effects of the proposed amendments. After reviewing the comments, the Board should be able to address the impact of the amendments on small broker-dealers.

[4/] Currently, the primary difference between the regulations is that Regulation G prohibits most margin-stock-secured lending to broker-dealers while Regulation U not only permits such lending, but contains numerous exceptions (called special-purpose loans) allowing banks to extend credit to broker-dealers without regard to the margin requirements otherwise applicable.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the rule under the authority delegated to the Board by the Office of Management and Budget.

The collection of information requirements in this regulation are found in 12 CFR 220.15(b). This information collection was mandatory under 15 U.S.C. 78(h), which was repealed by the National Securities Markets Improvement Act of 1996 (Pub. L. 104-290). The respondents are for-profit broker-dealers. The estimated burden per response is 1.0 hour. It is estimated that there is 1 respondent and an average frequency of 1 response per respondent each year. Therefore the total amount of annual burden is estimated to be 1.0 hour. The annual cost burden over the annual hour burden is estimated to be $20. As a result of the Board's proposed action, this collection of information would be discontinued.

Send comments regarding any aspect of this collection of information to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20051; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0191), Washington, DC 20503.

List of Subjects

12 CFR Parts 207, 220 and 221

Banks, banking, Brokers, Credit, Federal Reserve System, Margin, Margin requirements, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Board proposes to amend 12 CFR Parts 207, 220 and 221 as follows:

PART 207 -- SECURITIES CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS (REGULATION G)

1. The authority citation for Part 207 continues to read as follows:

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

2. Section 207.4 is revised to read as follows:

§207.4 Credit to broker-dealers.

A lender may extend or maintain credit secured, directly or indirectly, by any margin stock to a creditor who is subject to part 220 of this chapter. If the credit is extended in good faith reliance upon a certification from the customer that the credit is essential to meet emergency needs arising from exceptional circumstances, any collateral for the credit shall have good faith loan value. In all other cases, collateral shall be valued in accordance with § 207.7 of this part.

PART 220 CREDIT BY BROKERS AND DEALERS (REGULATION T)

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

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

2. Section 220.15 is removed and reserved.

§ 220.15 [Removed and Reserved]

PART 221 CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCKS

1. The authority citation for Part 221 is revised to read as follows:

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

2. Section 221.4 is removed and reserved.

§ 221.4 [Removed and Reserved]

3. Section 221.5 paragraph (a) is revised to read as follows:

§ 221.5 Special-purpose loans to brokers and dealers.

(a) A bank may extend and maintain purpose credit to brokers and dealers without regard to the limitations set forth in §§ 221.3 and 221.8 of this part, if the credit is for any of the specific purposes and meets the conditions set forth in paragraph (c) of this section.

* * * * *

By order of the Board of Governors of the Federal Reserve System, November 19, 1996.

William W. Wiles
Secretary of the Board.