



Securities Industry Association

120 Broadway, New York, NY 10271-0080, (212) 608-1500, Fax (212) 608-1604
1401 Eye Street, NW, Washington, DC 20005-2225, (202) 296-9410, Fax (202) 296-9775
info@sia.com, <http://www.sia.com>

January 31, 1997

Mr. William W. Wiles
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue,
N.W. Washington, D.C. 20551

Re: Regulations G, T and U, Docket No. R-0944

Dear Mr. Wiles:

The Securities Industry Association ("SIA") and PSA The Bond Market Trade Association ("PSA") (collectively sometimes referred to below as the "Trade Associations") are writing in response to the request by the Board of Governors of the Federal Reserve System (the "Board") for comments on proposed revisions to Regulations G, T and U. SIA and PSA appreciate the Board's efforts to review its margin regulations in light of the amendments to Section 7 and the repeal of Section 8(a) of the Securities Exchange Act of 1934 (the "Exchange Act") effected by the National Securities Markets Improvement Act of 1996 (the "Markets Improvement Act") and welcome the opportunity to provide comments to the Board in connection with this project.

The Trade Associations support the amendments to Regulations G, T and U proposed by the Board to implement the repeal of Section 8(a) of the Exchange Act. In addition, they recommend that the Board implement the new exemptions under Sections 7(c) and (d) of the Exchange Act by excluding from the scope provisions of each of the Regulations credit extended, maintained or arranged to or for a member of a national securities exchange or a registered broker-dealer (i) a substantial portion of whose business consists of transactions with persons other than broker-dealers or (ii) to finance its activities as a market maker or an underwriter (such members or registered broker-dealers, when obtaining such credit, "Qualifying Broker-Dealers"). The Trade Associations further recommend the adoption of appropriate safe harbor provisions identifying those broker-dealers who are Qualifying Broker-Dealers because a substantial portion of their business consists of transactions with customers. As discussed in greater detail below, such safe harbor provisions should, in the Trade Associations' view, be based on (i) a minimum number of customer accounts, (ii) a minimum dollar amount of revenues from customer business or (iii) a minimum percentage amount of revenues from customer business. SIA and PSA also request that the Board amend its margin regulations to clarify that lenders may extend credit without regard to those regulations where they accept in good faith a representation from a borrower that it is a Qualifying Broker-Dealer.

With regard to other broker-dealer financing provisions under the Board's regulations affected by the Markets Improvement Act, the Trade Associations favor retaining the omnibus account and the broker-dealer credit account in Regulation T, deleting the market functions account in Regulation T (subject to clarification by the Board that all transactions currently permitted in that account are now exempt from Regulation T) and amending Regulations G, T and U to expand the categories of special purpose credit that may be extended to broker-dealers. They also request confirmation from the Board that loans of securities by (and borrowings of securities from) a Qualifying Broker-Dealer are outside the scope of the Board's margin regulations, including the requirements of Section 220.16 of Regulation T. SIA and PSA also request that the Board amend Regulation X to exempt foreign affiliates of Qualifying Broker-Dealers.

Comments on Specific Amendments Proposed by the Board

The Trade Associations endorse the Board's proposal to delete Section 220.15 of Regulation T and Section 221.4 of Regulation U in their entirety. As the Board notes in the Proposing Release, these two sections implemented the provisions of former Section 8(a) of the Exchange Act and are no longer necessary as a result of its repeal. SIA and PSA also support the Board's proposed conforming amendment to Section 221.5 of Regulation U, which would eliminate the requirement that nonmember banks making special purpose loans to broker-dealers have an agreement in force with the Federal Reserve, and the proposed conforming amendment to Section 207.4 of Regulation G deleting the general prohibition on extensions of credit to broker-dealers secured by margin stock.

SIA and PSA also generally support the Board's proposed discontinuation of Federal Reserve Form T-1, T-2, which was required (under former Section 8(a) of the Exchange Act) to be filed by nonmember U.S. and foreign banks extending credit to U.S. broker-dealers. The Trade Associations note, however, that Form T-2 is currently used to determine the foreign banks whose letters of credit are permissible collateral for securities borrowing and lending transactions under Section 220.16 of Regulation T. Although it would be possible for the Board to continue to use Form T-2 solely for purposes of Section 220.16, the Trade Associations urge the Board to discontinue that Form altogether and adopt a new standard for identifying which letters of credit issued by foreign banks qualify as collateral under Section 220.16. With the elimination of Section 8(a) of the Exchange Act and the Board's proposed deletion of Section 220.15 of Regulation T, the continued use of Form T-2 solely for purposes of Section 220.16 could detract from the ability of broker-dealers to collateralize securities borrowings with letters of credit issued in a foreign currency -- since foreign banks, an obvious source of such letters of credit, are less likely to file Form T-2 merely to permit their letters of credit to qualify under Section 220.16.

The Trade Associations suggest, in lieu of reliance on Form T-2, that the Board revise Section 220.16 to include as permissible collateral under that provision any letter of credit issued by a foreign bank that satisfies an appropriate financial adequacy requirement. An appropriate standard might include, for example, an investment grade rating applicable to the issuer of the letter of credit. Under this approach, where a broker-dealer would be permitted to give "good faith" loan value to the debt securities of a foreign bank (because such securities are rated investment grade and qualify as "OTC margin bonds"), it also would be permitted to give or take a letter of credit issued by that bank in any currency as collateral for a securities loan. The

Trade Associations also believe that other standards, such as compliance with applicable international capital adequacy requirements as applied by home country authorities, may be appropriate for identifying those foreign banks whose letters of credit are permissible collateral under Section 220.16.

Comments on Issues Raised by the Board

A. Mechanism for Implementing the New Section 7 Exclusions: Amendment of "Scope" Provisions or "Customer" Definitions?

The Board has sought comment on whether the new exclusions arising from the amendments to Section 7 of the Exchange Act should be implemented under Regulations G, T and U by amending the scope provisions or the definitions of "customer" under each Regulation. The Trade Associations recommend that the Board implement the new Section 7 exclusions by amending the scope provisions of each Regulation. This approach would be consistent with Congress' determination to draft the amendments to Section 7 in a manner that removed the Board's authority to regulate extensions of credit to or for Qualifying Broker-Dealers (except where a finding has been made by the Board that such regulation is "necessary or appropriate in the public interest or for the protection of investors").

In addition, at a technical level, amendment of the definition of "customer" (without amendment of the scope provisions) could create a number of potential ambiguities under other provisions of each Regulation. Several provisions of Regulations G, T and U are framed as general prohibitions on certain types of transactions and do not specifically refer to credit extended to "customers." Other provisions, as currently drafted, provide special rules for extending credit to "brokers and dealers" or "creditors" and make no reference to "customer" transactions. If the scope provisions of each Regulation are not amended, therefore, all provisions of the Regulations would have to be meticulously reviewed, and several key sections would have to be significantly reworked, to implement accurately the statutory amendments. Such revisions could, in the worst case, engender substantial uncertainty about the correct interpretation of the revised sections and result in the inconsistent application of differently worded provisions. A general exclusion from the scope of each Regulation, by contrast, would minimize changes to the current text of each Regulation while ensuring a wholesale exclusion from the margin requirements for credit extended to Qualifying Broker-Dealers.

B. Regulatory Standard Identifying Broker-Dealers With a Substantial Customer Business

SIA and PSA support the establishment of regulatory standards that will assist in identifying those registered broker-dealers "a substantial portion of whose business consists of transactions with customers" (the "substantial customer business requirement"). In light of the highly factual nature of the substantial customer business requirement, however, the Trade Associations favor the adoption of standards in the form of non-exclusive regulatory safe harbor provisions rather than in the form of inflexible definitional rules that attempt to provide an exhaustive description of which firms satisfy the requirement.

1. Need for a Safe Harbor Provision

The adoption of standards defining the scope of the substantial customer business requirement

would significantly advance the statutory objective of enhancing the financing opportunities available to Qualifying Broker-Dealers. Lenders generally expect borrowers and their counsel to provide a high degree of certainty regarding the legality of financing transactions. In the context of newly-enacted legislation that contains a fact-based standard, the existence of regulatory guidelines defining categories of eligible broker-dealer borrowers can greatly assist in providing this certainty to lenders. Moreover, in the absence of such guidelines, some borrowers eligible for the exemptions afforded under the Markets Improvement Act may needlessly incur a financing premium because of lenders' concerns regarding the scope of the new provisions of the statute.

The Trade Associations consider it critical, however, that any regulatory guidance take the form of a safe harbor provision rather than an exclusive definitional provision. In light of the broad variety of factual considerations that may bear on the question of whether a "substantial portion" of a broker-dealer's business is with customers, the formulation and implementation of an exhaustive definitional standard would be exceptionally difficult. Moreover, any exclusive definitional standard might inappropriately burden broker-dealers falling outside the definition whose activities would merit exemption if examined on a case-by-case basis for compliance with the substantial customer business requirement.

2. Standards for Meeting the Substantial Customer Business Requirement

As a policy matter, the Trade Associations understand that the statutory exception from the margin requirements was limited to broker-dealers "a substantial portion of whose business consists of transactions with persons other than brokers or dealers" to prevent certain entities engaged largely in proprietary trading activities from registering as broker-dealers with the Securities and Exchange Commission (the "SEC") solely to take advantage of the exception. Consistent with this anti-evasion philosophy, the Trade Associations favor the adoption of safe harbor thresholds for a "customer" business that are not excessively onerous to satisfy or monitor for a Qualifying Broker-Dealer, but that clearly exceed the levels that a trading entity is likely to be willing or able to achieve merely to obtain the benefits of the legislation. In addition, in view of the breadth and diversity of forms which broker-dealers' customer businesses may take, the criteria established by the Board should include alternative non-exclusive measures of a broker-dealer's "customer" business rather than a single "one-size-fits-all" test.

To achieve these objectives, the Trade Associations have sought to identify standards that the Board could adopt in establishing a safe harbor. Specifically, they would support adoption of a safe harbor that encompasses a registered broker-dealer meeting any of the following requirements:

- **The broker-dealer currently maintains 1,000 or more active securities accounts of "customers," as defined below (*i.e.*, accounts in which one or more *bona fide* transactions have been effected within the preceding twelve months);**
- The broker-dealer receives at least \$5,000,000 in gross revenue in a calendar year from transactions with or on behalf of customers; or
- Not less than 10% of the gross revenue received by such broker-dealer for a six-month period (calculated semiannually) is derived from transactions with or on behalf of customers.

For purposes of each of these tests, the term "customer" would be limited exclusively to persons who are neither broker-dealers nor affiliates of the Qualifying Broker-Dealer.

Each of these tests, discussed in turn below, is designed to exclude any meaningful risk of evasion by trading entities seeking to avoid otherwise applicable margin rules by registering as a broker-dealer, while at the same time providing a practicable list of clear standards upon which qualifying firms may rely.

(a) Customer Accounts Test.

The first test focuses on the number of active customer accounts carried by a broker-dealer. In the Trade Association's view, this test would provide a particularly straightforward mechanism for large, customer-oriented firms to determine that they meet the substantial customer business requirement. The test does not require any complex analysis of the source of particular revenues or business; instead, it relies on the application of a clear -- but very high -- minimum threshold that could not readily be satisfied by a firm seeking merely to evade the margin rules. Notably, the test counts only *active* accounts of *unaffiliated* persons -- rendering it exceptionally difficult for anyone other than a *bona fide* customer-oriented firm to meet its requirements. While the Board may determine, in considering this question, that the proposed minimum threshold of 1,000 accounts should be raised or lowered, the Trade Associations consider it essential that the Board adopt a safe harbor test that looks to a minimum number of customer accounts given the significant practical advantages of clarity and ease of measurement such a test would offer to broker-dealers legitimately seeking to benefit from the Markets Improvement Act.

(b) Dollar Minimum Customer Revenue Test.

The second test seeks to assess whether a broker-dealer can demonstrate that it derives a sufficient minimum level of revenue from customer-related business, measured in absolute terms, to qualify for the substantial customer business requirement. As with the customer accounts test, this gross revenue test would measure only revenue from transactions with or on behalf of *unaffiliated* persons that are *not* broker-dealers.

Establishing a safe harbor based on a dollar minimum of a firm's gross revenue from customer-related business will accommodate large firms that conduct substantial customer business but that may, because they lack wide-ranging retail activities, find it difficult to meet a standard based on a minimum number of active customer accounts. At the same time, by

establishing a sufficiently high dollar threshold, the Board can ensure that the safe harbor will only be available to broker-dealers that have made a substantial commitment to engaging in customer business and that have not registered merely to take advantage of the new margin treatment offered by the Markets Improvement Act. The Trade Associations recommend a minimum customer-related revenue threshold of \$5,000,000, but note that lower or higher thresholds -- ranging from \$1,000,000 to \$10,000,000 -- might reasonably be considered appropriate for purposes of identifying a substantial customer business.

For the purpose of this test, the Trade Associations recommend that "gross revenue" be defined to include, at a minimum:

- (i) Net commissions on securities brokerage and markups on trades as principal;
- (ii) Net underwriting and distribution profits;
- (iii) Interest income on customers' securities accounts (including comparable income from reverse repurchase transactions);
- (iv) Investment advisory, account supervision and similar fees;
- (v) Fees for proxy solicitation, tenders and exchanges;
- (vi) Service charges or other surcharges; and
- (vii) Fees or net income from transactions as a market maker in puts, calls and other options.

This definition of "gross revenue" builds upon the provisions of Section 16(9) of the Securities Investor Protection Act of 1970 ("SIPA"), as amended, that define the term "gross revenues from the securities business." The SIPA definition has been modified to exclude sources of income (such as gains from trading on securities positions) that do not appear appropriate for purposes of assessing whether a firm meets the requirements established under the Markets Improvement Act.

(c) Minimum Percentage of Customer Revenue Test.

The third test considers the relative size of a broker-dealer's customer-related securities business as compared to its overall securities business, as measured over a six-month period. The minimum percentage test is designed to embrace smaller broker-dealers with neither a sufficiently large client base nor sufficient volume to satisfy either of the first two proposed tests and yet who, by virtue of the relative size of their customer-related securities business, should qualify for the statutory exclusion. A requirement based on a sufficiently large percentage of the broker-dealer's gross revenue (defined as described in Subsection (b) above) would effectively deter large private trading entities from maintaining ancillary customer businesses simply to take advantage of the statutory exemption. In this connection, the Trade Associations propose a percentage test of 10%, but recognize that other percentages ranging from 5% to 25% could be considered appropriate in meeting the statutory requirement of a "substantial" customer business.

SIA and PSA recommend that a broker-dealer's gross revenues and customer-related revenues be measured over a six-month period for the purpose of determining whether it satisfies the percentage test. A six-month window would provide adequate assurance that a broker-dealer's

customer-related revenues, calculated as a percentage of its gross revenues, will not be manipulated through short-term trading patterns entered into solely for the purpose of satisfying the percentage test. Any longer period, however, might unfairly delay the ability of start-up firms to obtain financing even where their revenues derive exclusively from transactions with customers.

The Trade Associations also recommend that the safe harbor adopted by the Board permit broker-dealers to determine their compliance with the percentage test on a semiannual basis (*i.e.*, by measuring the relationship between their customer-related revenues and their gross revenues only once every six months). Requiring broker-dealers to recalculate the ratio of their customer-related revenues to their gross revenues each time they finance their securities inventories would impose an unnecessarily onerous operational burden on broker-dealers and significantly undermine the benefits of the safe harbor. Moreover, there would not appear to be any significant opportunity for manipulation where broker-dealers are permitted to rely on revenue computations made once every six months -- particularly where those revenue computations reflect a minimum measurement period of half a year.

3. Good Faith Reliance on a Representation by the Borrower Regarding its Status as a Qualifying Broker-Dealer

The Trade Associations strongly urge the Board to amend Regulations G, T and U to clarify that a lender may extend credit to a registered broker-dealer without regard to those Regulations where the lender accepts, in good faith, a representation from such broker-dealer that it is a Qualifying Broker-Dealer.

Whether a registered broker-dealer is a Qualifying Broker-Dealer whose borrowings are exempt under the Markets Improvement Act will depend on specific facts about that broker-dealer's business activities and the purposes for which it is borrowing -- facts that are readily available only to the broker-dealer receiving credit, not the lender. Although the adoption by the Board of a safe harbor defining a "substantial customer business" will greatly assist broker-dealers in determining their own status as borrowers, lenders generally will not have ready access to the information (*e.g.*, number and activity of customer accounts, sources of revenue) necessary to apply any such safe harbor with certainty. Moreover, in the case of a broker-dealer acting as a market maker or underwriter, only the broker-dealer will be in a position to determine whether the credit obtained will actually be used to finance these activities (*i.e.*, exempt credit) or to finance other business activities (*i.e.*, potentially non-exempt credit). It would therefore be both impractical and unfair to impose on lenders an obligation to determine independently a broker-dealer's status, as a borrower, under the Markets Improvement Act.

Permitting a lender, acting in good faith, to rely on a representation of a broker-dealer as to its status as a borrower would be consistent with the current treatment of non-purpose credit under Regulations G, T and U. Lenders subject to these Regulations may accept, in good faith, a representation from the borrower that the credit is not "purpose credit" within the meaning of the applicable Regulation and therefore is not subject to the Board's margin requirements. These provisions reflect a reasonable accommodation between the need to confirm that a borrower is not obtaining credit in a manner that circumvents the Board's margin requirements and the practical considerations that limit the ability of lenders to obtain, otherwise than from the borrower, information necessary to determine that the credit is permissible.

C. Application of Regulations G, T and U to Borrowings By Non-Qualifying Broker-Dealers

The Board has solicited general comments on the desirability of amending or deleting, in light of the Markets Improvement Act, various provisions of Regulations G, T and U that currently govern special types of securities credit extended to broker-dealers. As noted above, SIA and PSA support the Board's proposal explicitly to exempt from its margin regulations *all* extensions of credit to Qualifying Broker-Dealers, preferably by excluding Qualifying Broker-Dealers from the scope of such regulations. Under this approach, the specific margin requirements of Regulations G, T and U would continue to apply *only* to extensions of credit to broker-dealers whose borrowings are *not* exempted under the Markets Improvement Act (*i.e.*, "Non-Qualifying Broker-Dealers").

The Trade Associations' comments regarding the application of Regulations G, T and U to borrowings by Non-Qualifying Broker-Dealers, set forth in detail below, are based on three policy rationales. First, the Board should preserve all special exemptions from the otherwise applicable margin requirements of these Regulations that are currently available for extensions of credit to Non-Qualifying Broker-Dealers. There is no reason to believe that Congress, in exempting borrowings by Qualifying Broker-Dealers from the Board's margin requirements, intended to deprive Non-Qualifying Broker-Dealers of any special exceptions for which their borrowings may currently qualify under the Board's margin rules. Moreover, a number of the special provisions under the Board's margin rules for loans to broker-dealers reflect the beneficial functions which broker-dealers fulfill as market intermediaries and as sources of credit in the securities markets. To the extent that Non-Qualifying Broker-Dealers engage in these beneficial activities, the Board's margin rules should continue to permit them to finance such activities on a preferential basis.

Second, the Trade Associations urge the Board generally to provide for parallel treatment under each of its margin regulations for all borrowings by Non-Qualifying Broker-Dealers. As noted in the Proposing Release, many of the current distinctions between the Board's margin regulations with respect to loans to broker-dealers reflect prohibitions that existed under former Section 8(a) of the Exchange Act. In light of the repeal of these prohibitions, the Board should conform its margin regulations to permit Non-Qualifying Broker-Dealers to borrow from all lenders on functionally equivalent terms.

Third, SIA and PSA recommend that the Board expand the types of securities positions of Non-Qualifying Broker-Dealers that may be financed on a "good faith" basis under Regulations G, T and U. In particular, the Trade Associations urge the Board to reconsider the need to create exceptions to its margin requirements for financings of hedged or limited risk positions, including in particular convertible arbitrage transactions.

Based on these considerations, the Trade Associations' specific recommendations regarding the existing broker-dealer credit provisions of Regulations G, T and U are as follows.

1. Regulation T Accounts

(a) Omnibus Account and Broker-Dealer Credit Account. SIA and PSA recommend that the Board retain the omnibus account (Section 220.10) and the broker-dealer credit account

(Section 220.11) under Regulation T. The omnibus account currently permits a creditor to extend credit to a registered broker-dealer to finance the securities positions of the customers of such registered broker-dealer. Although many of the registered broker-dealers currently eligible to finance their customers' securities transactions through the omnibus account will be Qualifying Broker-Dealers exempted from the margin requirements of Regulation T, certain of these broker-dealers may be Non-Qualifying Broker-Dealers because they do not satisfy the substantial customer business requirement. It would not serve the purposes of the Markets Improvement Act to deprive such Non-Qualifying Broker-Dealers of the more favorable financing they currently may obtain from Regulation T creditors under this account.

Similarly, the broker-dealer credit account currently permits creditors to extend certain types of securities credit to Non-Qualifying Broker-Dealers on terms more favorable than would be permitted under the margin account. There is no clear policy rationale for depriving creditors and Non-Qualifying Broker-Dealers of the benefits of the broker-dealer credit account. Moreover, as noted by the Board, this account currently accommodates certain transactions with persons who are not Qualifying Broker-Dealers because they are unregistered broker-dealers or non-broker-dealers. For example, the provisions of the broker-dealer credit account were recently amended to accommodate prime brokerage transactions and to allow certain foreign broker-dealers to purchase and sell securities on a delivery-versus-payment (DVP) basis (without application of the 90-day freeze and letter of free funds requirements imposed on DVP transactions in the cash account). Eliminating this account would frustrate the policy objectives which the Board achieved by permitting creditors to engage in these specified financing transactions with unregistered broker-dealers and non-broker-dealers, without achieving any offsetting policy advantage.

(b) Market Functions Account. SIA and PSA recommend that the Board eliminate the market functions account (Section 220.12 of Regulation T) and clarify that all transactions currently permitted in that account (by interpretation or otherwise) are now exempt from the Board's margin requirements. As noted by the Board, the broker-dealers to whom creditors may extend financing under the market functions account -- *i.e.*, specialists, dealers engaged in an underwriting or distribution of securities, OTC and third marketmakers and odd-lot dealers -- generally appear to be Qualifying Broker-Dealers because they are borrowing to finance market making or underwriting activities. The exclusion of Qualifying Broker-Dealers from the scope of Regulation T would therefore make most provisions of the market functions account redundant.

The Trade Associations request, however, that the Board clarify that *all* transactions which currently may be financed by a creditor on a "good faith" margin basis under Section 220.12 (*e.g.*, specialist transactions) would be excluded from the scope of Regulation T as qualifying market making or underwriting activities. For example, Section 220.12(b)(2) currently permits credit to be extended on a "good faith" basis not only with respect to transactions by a specialist in the security in which the specialist makes a market, but also with respect to any "permitted offset positions" (as defined in Section 220.3). From a risk management perspective, specialists' transactions in permitted offset positions are an integral component of their ability to make a market in designated securities. In view of this special role which permitted offsets play in market making -- a role currently recognized by Regulation T as well as Regulation U -- the Board should explicitly clarify that for purposes of Regulation T a specialist's transactions in permitted offset positions are covered by the exclusion under the Markets Improvement Act for

broker-dealers' market making activities.

2. Other Amendments to Regulations G, T and U

As noted above, SIA and PSA urge the Board to preserve the current authority of non-broker-dealers subject to Regulations G and U to extend financing to Non-Qualifying Broker-Dealers on a "good faith" margin basis. In particular, banks should continue to be permitted to extend to Non-Qualifying Broker-Dealers at least those types of special purpose credit currently identified under Section 221.5, and other lenders should continue to be permitted to extend to Non-Qualifying Broker-Dealers at least those types of special purpose credit currently identified under Section 207.4 of Regulation G.

In addition, the Trade Associations recommend that the Board conform Regulations G, T and U to provide comparable treatment for credit extended by any lender to Non-Qualifying Broker-Dealers. For example, Non-Qualifying Broker-Dealers should be permitted to obtain the same types of "good faith" credit from non-banks (including broker-dealers) as they may currently obtain from banks under Section 221.5 of Regulation U. The special purpose loans identified in Section 221.5 are generally intended to promote liquidity and efficiency in the market or to facilitate the financing of customer positions by broker-dealers. In view of the elimination of Section 8(a) of the Exchange Act -- which limited the types of lenders from whom broker-dealers could obtain certain securities credit -- there is no clear policy reason for continuing to distinguish between the types of securities credit that may be extended to broker-dealers by banks, on the one hand, and by broker-dealers and other lenders, on the other.

SIA and PSA believe that, with respect to Regulations G and U, such functional equivalence could be achieved either by amending these regulations or by merging them. If the Board determines to merge Regulations G and U, however, the Trade Associations request that the new regulation include the more expansive list of special purpose loans under Section 221.5 of Regulation U (rather than the more restrictive list of special purpose loans identified in Section 201.4 of Regulation G). In addition, SIA and PSA recommend that any combination of the Regulations be implemented so as not to impose new substantive or procedural requirements on any non-broker-dealer lenders. Thus, for example, a combined regulation should not make the registration requirements currently set forth in Section 207.3(a) of Regulation G applicable to banks.

3. Expansion of Permitted Hedged Positions

In connection with the Board's review of extensions of credit to Non-Qualifying Broker-Dealers, SIA and PSA urge that the Board expand the types of fully hedged or limited risk transactions eligible for "good faith" financing under Regulations G, T and U. As currently drafted, the Board's margin rules recognize only certain limited categories of offsetting risk positions for purposes of determining applicable margin requirements; any combination of fully hedged or limited risk strategies which are not specifically recognized by the Board are treated as entirely separate positions for margin purposes. For example, convertible arbitrage transactions -- *i.e.*, the purchase of a convertible debt security or convertible preferred stock combined with the offsetting sale of the underlying stock -- are generally eligible for "good faith" margin under Regulations T and U (but not Regulation G) only if they are effected for the purpose of taking

advantage of a concurrent disparity in the prices of the convertible security and the underlying security. Convertible arbitrages entered into for any other *bona fide*, non-speculative purpose are subject to the Board's margin requirements, even though they do not pose any greater risk for the customer than those arbitrage transactions satisfying the strict requirements established by the Board. Moreover, the risk-reducing benefits of other types of fully hedged positions -- which do not involve the types of speculation or leverage that the Board's margin rules were designed to address -- currently do not qualify for reduced margin, regardless of the purpose for which they are effected.

The Trade Associations urge the Board to amend Regulations G, T and U to recognize and facilitate the risk-reducing benefits of transactions that involve offsetting risk positions, including in particular convertible arbitrage transactions entered into for any purpose. Such amendments should cover, at a minimum, extensions of credit to Non-Qualifying Broker-Dealers (e.g., under Section 221.5(c)(5) of Regulation U), although the policy rationale for requiring reduced margin would apply with equal force to financings of the hedged positions of non-broker-dealer counterparties.

D. Permitted Purpose Requirement

The Trade Associations request the Board's confirmation that loans of securities by (or borrowings of securities from) Qualifying Broker-Dealers are no longer subject to the Board's margin requirements, including the permitted purpose and collateral requirements of Section 220.16 of Regulation T. As indicated in the Proposing Release, the regulation of securities lending transactions under Regulation T generally has been based on the view that the borrower of securities is extending credit to the lender of securities (since securities loans "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"). To limit the circumstances in which a lender of securities obtains credit in excess of the margin requirements otherwise applicable to the securities being loaned, Section 220.16 permits a broker-dealer to engage in such transactions only where the borrowing is necessary to satisfy a delivery obligation (*i.e.*, covering a short or a fail or in similar circumstances) with respect to the security.

With the passage of the Markets Improvement Act, loans of securities by a Qualifying Broker-Dealer should be viewed (if analyzed, consistent with the Board's traditional interpretations, as extensions of credit to the Qualifying Broker-Dealer) as outside the scope of the Board's margin regulations. Because a Qualifying Broker-Dealer may *borrow funds* from any person against any security without restriction under the Board's margin rules, a *loan of securities* by a Qualifying Broker-Dealer (if characterized as an extension of credit to the Qualifying Broker-Dealer) should no longer be subject to any of the Board's margin requirements, including the permitted purpose and collateral requirements of Regulation T. The Board therefore should clarify that its margin regulations, including in particular Section 220.16 of Regulation T, no longer apply either to a Qualifying Broker-Dealer that lends securities to any person *or* to any person who *borrow*s securities from a Qualifying Broker-Dealer.

Comments on Other Topics Not Specifically Addressed by the Board

A. Regulation X

SIA and PSA strongly urge the Board to amend Regulation X to ensure that Congressional policy in the Markets Improvement Act is reflected consistently across the Board's margin regulations. In particular, the Trade Associations request that the Board exempt foreign affiliates of Qualifying Broker-Dealers from the scope of Regulation X.

Regulation X currently prohibits "U.S. persons" and "foreign persons controlled by or acting on behalf of or in conjunction with United States persons" from obtaining credit from outside the United States to purchase or carry U.S. securities unless such credit conforms to Regulation T (if the credit is obtained from a foreign branch of a U.S. broker-dealer), Regulation U (if the credit is obtained from a foreign branch of a U.S. bank) or Regulation G (if the credit is obtained from any other lender outside the United States). Because foreign affiliates of Qualifying Broker-Dealers may be "foreign persons controlled by a United States person" for purposes of Regulation X or otherwise subject to its restrictions, the ability of such affiliates to obtain credit may be limited by Regulation X -- even though the credit is obtained outside the United States. For example, a non-U.S. affiliate of a U.S. broker-dealer may be limited in its ability to finance any inventory it maintains in U.S. "margin stock" (since Regulation X would impose a 50% margin requirement on any such financings).

The continued application of Regulation X to foreign affiliates of Qualifying Broker-Dealers would frustrate the policy objectives of the Markets Improvement Act, which clearly were intended to eliminate restrictions on the ability of Qualifying Broker-Dealers to fund their securities activities, whether conducted in the United States or abroad. The Board's margin regulations should not be applied in a manner that would limit the funding activities of a Qualifying Broker-Dealer in foreign securities markets merely because business or regulatory considerations dictate that such activities be conducted through separately organized affiliates of the Qualifying Broker-Dealer.

The application of different margin requirements to domestic and foreign operations of the same Qualifying Broker-Dealer simply does not make sense in light of the basic premise of Regulation X -- *i.e.*, no Qualifying Broker-Dealer will establish a foreign affiliate to obtain better credit *outside* the United States now that it can obtain exempt credit *within* the United States. Indeed, the fundamental objectives of Regulation X -- ensuring that consistent rules apply to borrowings by U.S. persons and foreign affiliates controlled by U.S. persons, regardless of whether effected in the United States or abroad -- would seem to mandate parallel treatment of foreign affiliates of Qualifying Broker-Dealers. Moreover, the exclusion of foreign affiliates of Qualifying Broker-Dealers from Regulation X would not enable such foreign affiliates to obtain credit on better terms than U.S. persons within the United States -- since Regulations G, T and U would directly limit any extensions of credit to the foreign affiliate by a U.S. lender.

Furthermore, extraterritorial application of the Board's margin regulations to foreign affiliates of U.S. broker-dealers substantially impairs the competitiveness of such foreign affiliates in foreign securities markets, since they are not permitted to obtain securities credit on terms as favorable as those available to foreign broker-dealers operating in the same markets (including foreign broker-dealers with U.S. offices that are Qualifying Broker-Dealers). The Board has recently proposed certain amendments to its margin regulations that would enhance the ability of U.S. broker-dealers to compete as *providers* of securities credit in foreign markets. Eliminating restrictions on *borrowings* by foreign affiliates of U.S. broker-dealers would promote the same policy of eliminating barriers to the international competitiveness of U.S. securities firms. The

need for such action by the Board has become particularly acute, moreover, since the adoption of the Markets Improvement Act has created an asymmetry in the regulation of the funding activities of U.S. and foreign securities firms: borrowings by foreign firms' U.S. affiliates which qualify for the Section 7 exclusions are now exempted from the Board's margin requirements, while substantially identical borrowings by U.S. firms' foreign affiliates remain subject to the Board's margin requirements. SIA and PSA urge the Board to level the playing field for all broker-dealers and their affiliates by excluding foreign affiliates of Qualifying Broker-Dealers from the scope of Regulation X.

B. SRO Margin Requirements

SIA and PSA urge the Board to encourage applicable securities self-regulatory organizations ("SROs") to reform their margin rules in a manner that will promote the Congressional policy objectives of the Markets Improvement Act. The margin requirements currently imposed by New York Stock Exchange, Inc. ("NYSE") Rule 431 and National Association of Securities Dealers, Inc. Rule 2520 on most types of credit extended to Qualifying Broker-Dealers in many cases may create significant burdens on the ability of Qualifying Broker-Dealers to finance their securities inventories. Such margin requirements are at odds with the clear intent of the Markets Improvement Act and should be eliminated.

The Trade Associations also note that the NYSE, working in conjunction with other SROs, is conducting a general review of Rule 431 and has established a number of committees to consider and recommend particular revisions to that Rule. The topics under consideration by some of these committees -- such as the feasibility of portfolio margining -- are directly relevant to the implementation and efficacy of the revisions to Regulation T currently being considered by the Board. SIA and PSA commend the NYSE and the other SROs for their efforts to update Rule 431 and urge the Board to continue to support this important undertaking.

* * * *

SIA, PSA and their members appreciate the opportunity to comment on the Proposing Release and would be pleased to discuss any of the comments in this letter with the Board or its staff. If we can be of further assistance to the Board in this regard, please do not hesitate to call Gerard J. Quinn (212-618-0507) of SIA or Paul Saltzman (212-440-9459) or Patricia Brigantic (212-440-9454) of PSA. You are also welcome to contact Giovanni P. Prezioso (202-728-2758) or Robert W. Cook (202-736-2078) of Cleary, Gottlieb, Steen & Hamilton, special counsel to SIA and PSA in this matter, the Co-Chairs of SIA's Ad Hoc Committee on Regulation T, Marcy Engel (212-783-5957) of Salomon Brothers Inc and Anthony J. Leitner (212-902-5730) of Goldman, Sachs & Co., or the Chair of the PSA Working Group on Regulation T, Mindy R. Connelly (212-648-4950) of J.P. Morgan Securities Inc.

Very truly yours,

Marcy Engel

Co-Chairman,
SIA Ad Hoc Committee on Reg T

Anthony J. Leitner

Mindy R. Connelly

Chair, PSA Reg T Working Group
and Member of the Board of Directors

Co-Chairman,
SIA Ad Hoc Committee on Reg T

cc:

Mr. J. Virgil Mattingly, Jr.; Mr. Oliver Ireland; Mr. Gregory A. Baer; Mr. Scott J. Holz (**Board of Governors of the Federal Reserve System**)

Mr. Richard Lindsey; Mr. Robert L.D. Colby; Mr. Michael A. Macchiaroli; Ms. Catherine McGuire (**Securities and Exchange Commission**)

Mr. Raymond J. Hennessy; Mr. Donald van Weezel; Mr. Richard Nowicki; Mr. Albert Lucks (**New York Stock Exchange, Inc.**)

Mr. Richard G. Ketchum; Mr. John E. Pinto; Mr. Thomas R. Cassella; Mr. Samuel Luque (**National Association of Securities Dealers, Inc.**)

ANNEX A

PROPOSED AMENDMENT TO THE SCOPE PROVISIONS OF REGULATIONS G, T AND U

SIA and PSA propose that a new Section 220.1(b)(4) be added to Regulation T, which would read as follows:

(4) (i) This part does not apply to any credit extended, maintained or arranged to or for a member of a national securities exchange or a registered broker or dealer (A) a substantial portion of whose business consists of transactions with persons other than brokers or dealers or (B) to finance its activities as a market maker or an underwriter.

(ii) A "substantial portion" of the business of a member of a national securities exchange or a broker or a dealer shall be deemed to "consist of transactions with persons other than brokers or dealers" if:

(A) The member, broker or dealer maintains 1,000 or more active securities accounts of unaffiliated persons who are not brokers or dealers (*i.e.*, accounts in which one or more *bona fide* transactions have been effected within the preceding twelve months);

(B) The member, broker or dealer receives at least \$5,000,000 in gross revenue in a calendar year from transactions with or on behalf of unaffiliated persons who are not brokers or dealers; or

(C) Not less than 10% of the gross revenue received by such member, broker or dealer for a six-month period (calculated semiannually) is derived from transactions with or on behalf of unaffiliated persons who are not brokers or dealers.

This [clause 4(ii)] establishes a non-exclusive safe harbor and shall not be construed to eliminate or otherwise affect the ability of a [creditor] to determine that a member of a national securities exchange or a registered broker or dealer otherwise qualifies for the exemption in [clause 4(i)].

(iii) A [creditor] may elect to comply with this part by relying in good faith, at the time it extends, maintains or arranges any credit, on a representation from the borrower that the credit is exempt from this part under [clause 4(i)].

Conforming amendments should also be made to Section 207.1 of Regulation G and to Section 221.1 of Regulation U.