Securities Industry Association

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

**Re: Regulations G, T and U; Docket No. R-0923**

Dear Mr. Wiles:

The Securities Industry Association ("SIA") is writing in response to the request by the Board of Governors of the Federal Reserve System (the "Board") for comments on proposed revisions to Regulation T as well as Regulations G and U. SIA strongly supports the Board's determination to continue its comprehensive review of its margin rules and welcomes the opportunity to provide comments to the Board on this important subject.

SIA also commends the Board for determining to provide important regulatory relief for broker-dealers by adopting amendments to Regulation T while continuing its general review of the margin regulations. The amendments adopted by the Board represent an important step in the process of revising the Board's margin regulations to reflect current market realities and to remove a number of significant barriers to the competitiveness of U.S. broker-dealers. In this regard, SIA also appreciates the close consideration given by the Board and its staff to the comments submitted by numerous securities market participants, including SIA and its members, in response to the Board's request for comments on the amendments to Regulation T proposed by the Board last year.

SIA's comments are divided into four parts. Part One briefly reviews certain key developments in the securities markets and in broker-dealers' approach to risk management that are of relevance to the Board's proposed amendments. Part One also provides an executive summary of SIA's comments with references to those pages in the letter where a fuller discussion of SIA's views may be found. Part Two generally follows the Board's subject divisions in the Proposing Release and sets forth SIA's views on the proposed amendments to Regulation T, as well as Regulations G and U, with respect to which the Board has solicited comment. To simplify the presentation, the discussion in this Part includes SIA's comments on all issues relating to a particular subject even if some of those issues are not specifically mentioned in the discussion of that subject in the Proposing Release. Part Three addresses other topics not discussed by the Board in the Proposing Release, which should be considered as requests for further amendments to or clarifications of Regulations G, T, U or X, as applicable. Part Four recommends a number of technical or conforming changes to be made to Regulation T.

For the convenience of the Board and its staff, we have provided a table of contents for the main body of this letter.

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- **I. Introduction and Executive Summary**

**A. Significant Recent Developments.**

**1. Evolution of the Marketplace.**

As noted by the Board in the Proposing and Adopting Releases, the securities markets and the securities industry have undergone profound changes in recent years. SIA's prior comment letters sought to identify in detail a number of the more significant features of these changes, which as described by the Board include "the erosion of barriers between broker-dealers and other lenders, the globalization of securities markets, the increasing overlap in the businesses of various lenders, and the constant development of new mechanisms for extending securities credit." SIA greatly appreciates the Board's recognition of the importance of these market developments and of the need to adopt significant amendments to Regulation T to bring the regulation of broker-dealers' securities credit activities more closely into line with the fundamental economic characteristics of the modern financial markets.

The burdens placed on broker-dealers as a result of these market developments assume a number of forms. Perhaps most significantly, Regulation T has substantially impaired the ability of U.S. broker-dealers to compete with other providers of securities credit. U.S. securities firms face ever-increasing competition from banks and other lenders of securities credit within the United States. At the same time, competition from sophisticated foreign securities firms, operating both within the United States and abroad, has increased sharply with the rapid internationalization of the securities markets. As a general matter, these domestic and foreign providers of securities credit are not subject to regulatory margin requirements comparable to Regulation T.

This regulatory disparity profoundly affects the ability of broker-dealers to serve an increasingly important segment of investors -- sophisticated institutions -- whose securities credit needs are frequently not easily accommodated under Regulation T and whose ability to satisfy those needs through non-broker-dealers is unprecedented. In view of these competitive pressures on U.S. broker-dealers, SIA welcomes the recent amendments to Regulation T adopted by the Board which have provided important competitive relief for broker-dealers in a number of areas. SIA strongly urges the Board, in reviewing both its proposed amendments and the additional amendments to Regulation T proposed by SIA below, to adopt a broad policy of parity of regulatory treatment between U.S. broker-dealers and other providers of securities credit.

Equally significant, the frequently inflexible and antiquated requirements of Regulation T have imposed a number of unnecessary costs on broker-dealers. For example, as described more fully below, the margin requirements imposed by Regulation T on a number of securities transactions are frequently excessive. In other instances, the appropriate treatment under Regulation T of new (and, in some cases, well-established) transactions is unclear -- creating unnecessary compliance costs for broker-dealers and inhibiting their ability to participate in the development of new products. Although the amendments adopted or proposed by the Board will remove a number of these burdens, SIA urges the Board to consider the need to revise Regulation T more broadly to provide broker-dealers with greater flexibility to accommodate new types of securities transactions on a competitive basis. SIA notes that this need has become more significant in view of ongoing efforts to reform self-regulatory organization ("SRO") margin requirements and other SRO and Securities and Exchange Commission ("SEC") rules, which in turn have highlighted additional areas in which amendments to Regulation T are necessary. SIA also hopes the Board will take this opportunity to eliminate uncertainty in the interpretation of its rules and has attempted to identify below the most important areas in which clarification regarding the application of Regulation T is necessary.

**2. <u>Risk Management and Portfolio Margining</u>.**

In SIA's view, the Board's margin regulations do not adequately reflect in their methodology the evolution in modern finance theory and management that has not only coincided with, but has played a major role in, the rapid expansion of the securities markets and the development of a broad variety of securities credit transactions. In particular, since the basic structure of the Board's current margin regulations was adopted, broker-dealers and increasing numbers of their customers have substantially revised their approach to analyzing the risks of their securities positions, including securities credit transactions.

Based on a number of well-established principles of modern financial theory and statistical analysis, the paradigm of risk measurement and management has shifted away from the "position-by-position" approach embodied in the current structure of Regulation T -- in which the risk of each securities position is analyzed and margined separately -- to a "portfolio-based" approach in which risk is measured on an aggregate basis with respect to all securities and related positions in a given portfolio. Although portfolio-based approaches to risk measurement and management may be implemented through a variety of analytical models and operational techniques, an essential feature of any such approach is the recognition of the offsetting nature of the risks arising from various securities and commodities transactions and the corresponding opportunities for actively managing and reducing those risks.

As currently drafted, Regulation T lacks sufficient flexibility and sophistication to accommodate portfolio-based approaches to the measurement and management of risk. With increasing frequency, this has created an impediment to broker-dealers' ability to compete in the global marketplace, particularly with respect to the more sophisticated institutional investors who employ modern portfolio management theories to their own investment strategies. For example, the frequent failure of Regulation T to recognize the offsetting nature of various securities and commodities positions results in "double charging" (*i.e.,* imposing separate margin requirements on) positions which, from a risk perspective, effectively cancel each other. Such "double charging" has the perverse result of discouraging customers from assuming offsetting positions that would reduce their overall risk exposure.

As a matter of regulatory policy, moreover, the imposition of collateral requirements on specific transactions or positions is a crude device for regulating credit exposures. Recent research suggests that a portfolio approach to risk produces a far more efficient measurement than the strategy-based approach embodied in Regulation T. For example, a recent paper by economists at the Board demonstrates that the SPAN margining system used by the Chicago Mercantile Exchange achieves virtually the same protection against loss from market movements in options positions as does Regulation T, but with substantially lower margin requirements.

Similar conclusions regarding the efficacy of portfolio margining were reached in a study comparing three different regulatory methods of determining capital adequacy requirements for the equity portfolios of market makers in London. The three approaches were a strategy-based or "comprehensive" approach, a "building block" approach that has been utilized by some banking regulators, and a "simplified portfolio" approach used by the Securities and Futures Authority in the U.K. The study concluded that the portfolio approach worked best, while the comprehensive approach was by far the least satisfactory, since under the latter methodology there was no correlation between the relative riskiness of the portfolio and the amount of capital required. A study undertaken by senior staff of the New York Federal Reserve Bank was similarly critical of non-portfolio approaches. The study, which focused on the market and credit risks of option contracts and reviewed several different methods of measuring the risk of such instruments, determined that the portfolio-based "value-at-risk" approaches were far more accurate than strategy-based rules.

SIA therefore considers it essential that the Board revise Regulation T to adopt margin requirements consistent with the evolution of portfolio risk management. As discussed more fully below, SIA strongly supports the Board's efforts to review the current position-based and account-based margin requirements of Regulation T, its proposed amendments to facilitate portfolio margining within the non-equity account, and its proposed amendments to enhance the ability of customers to "cross-margin" their securities positions with positions in the nonsecurities credit account. SIA notes, however, that there are a number of additional ways in which portfolio margining may be facilitated under Regulation T to include a broader range of securities, particularly equity securities, and transactions. In addition, many of SIA's recommendations below would substantially enhance broker-dealers' ability to facilitate portfolio-based risk management by their customers -- such as the proposed amendments to the arbitrage account. In connection with the Board's review of all the comments set forth below, therefore, SIA urges the Board to give broad recognition in Regulation T to the principles of portfolio-based risk management.

**B. Executive Summary.**

The following is an executive summary of SIA's comments set forth in greater detail in Parts Two, Three and Four below.

**Comments on Amendments Proposed by the Board and Related Topics.**

**Loan Value for Non-Equity Securities.**

1. "Good Faith" Loan Value for all "Non-Equity Securities." SIA supports granting "good faith" loan value to all "non-equity securities." SIA does not favor the adoption of a special definition of "equity-linked" debt securities that would be ineligible for "good faith" loan value. (pp. 15-17)

2. Definition of "OTC Margin Bond." If the Board determines not to grant "good faith" loan value to all "non-equity securities," SIA recommends that the Board: (i) amend the definition of "OTC margin bond" to include certain debt securities exempt from registration under Sections 3(a)(2), 3(a)(5), 3(a)(9) and 3(a)(10) of the Securities Act of 1933 (the "Securities Act") and Section 1145 of the U.S. Bankruptcy Code; and (ii) clarify that the reports under the Securities Exchange Act of 1934 (the "Exchange Act") referred to in the definition of "OTC margin bond" need to be filed only to the extent that the issuer is required to make such filings under applicable securities laws. (pp. 17-18)

3. Non-Convertible Preferred Securities. SIA requests that the Board amend Regulation T so that non-convertible preferred securities will be treated in the same manner (including for purposes of calculating their loan value) as comparable debt securities. (pp. 18-19)

Establishment of Non-Equity Account. SIA supports the Board's proposal to create a new "non-equity account." However, SIA strongly opposes the proposed requirement that "[n]o transaction or withdrawal shall be allowed if it would cause the account to liquidate to a deficit." SIA recommends that creditors be permitted to effect transactions in the "non-equity account" on a "good faith" basis. (pp. 19-25)

**Portfolio Margining.**

1. Amendment to Definition of "Good Faith Margin." SIA supports the Board's proposed amendment to the definition of "good faith margin" to eliminate the requirement that such margin be calculated "for a specified security position. . . without regard to the customer's other assets or securities positions held in connection with unrelated transactions." SIA also recommends that this revised definition be applied to all Regulation T accounts, not only to the proposed "non-equity account." (pp. 25-26)

2. Separation of Accounts. SIA supports the Board's proposal to explicitly allow commodities and foreign exchange positions in the nonsecurities credit account to be considered in calculating the margin for any securities transaction in the proposed "non-equity account" or the margin account. SIA also supports the elimination of the general prohibition in Section 220.3(b) on meeting the requirements of one account by considering items in another account. (pp. 26-27)

In addition, SIA proposes that the Board facilitate the process of developing appropriate portfolio margining requirements by amending Regulation T to permit a creditor, in lieu of satisfying the account structure and requirements of Regulation T, to comply with any portfolio margining requirements that may be established by the creditor's SRO. (p. 27)

SIA also recommends that the special memorandum account be retained even if the Board amends Section 220.3(b) to permit any excess margin in one account to be used to meet a margin deficiency in another account. (pp. 27-28)

**Borrowing and Lending of Securities by Broker-Dealers.**

1. Permissible Categories of Collateral. SIA supports the Board's proposal to expand the list of permissible collateral under Section 220.16 to include any security or other asset, valued at its market value. In SIA's view, the Board should, at a minimum, permit any marginable security to serve as collateral, valued at its regulatory loan value. SIA also believes that the collateral requirements of Section 220.16 could be eliminated entirely. (pp. 28-29)

If the Board continues to limit the types of collateral permissible under Section 220.16, SIA proposes that the Board (i) confirm that formal or informal interpretations and no-action positions adopted by the SEC or its staff with respect to Rule 15c3-3 are subsumed within the cross-reference to that rule in Section 220.16, and (ii) expand the list of banks whose letters of credit are permissible collateral under Section 220.16 by eliminating the Form T-2 filing and related requirements with respect to certain foreign banks and certain foreign branches of U.S. banks. (pp. 29-30)

2. Borrowing and Lending of Foreign Securities. SIA proposes that the Board revise Section 220.16(b) to permit a creditor to lend any foreign securities under that Section, not just "non-U.S. traded foreign securities." Alternatively, SIA proposes that the Board prohibit loans of U.S.-traded foreign securities to foreign persons only where the securities are to be used to cover a short sale in the United States. (pp. 30-32)

SIA also proposes that the Board clarify that for purposes of Section 220.16(b) the term "foreign person" includes foreign branches of U.S. banks. (pp. 32-33)

3. Permitted Purpose. SIA requests that the Board (i) clarify that the "standard settlement cycle" for purposes of Section 220.16(a) is at least three business days or, for foreign securities, the period in which settlement is required to occur by the rules of the relevant foreign securities market, and (ii) permit a creditor to borrow up to one standard settlement cycle in advance of trade date where the creditor reasonably anticipates an obligation to deliver securities it does not have (*i.e.,* not just where it anticipates a "short sale"). (pp. 33-34)

SIA also proposes that the Board permit borrowings of securities for the purpose of participating in dividend reinvestment and stock purchase plans. (pp. 34-35)

**Foreign Broker-Dealers.**

1. Extensions of Credit by Foreign Branches of U.S. Broker-Dealers. SIA supports the Board's proposal to exclude foreign branches of U.S. broker-dealers from Regulation T when they extend credit to foreign persons on foreign securities. (p. 35)

2. Omnibus Account Arrangements Involving Foreign Broker-Dealers. SIA proposes that the Board permit creditors to establish omnibus account arrangements for foreign broker-dealers and other foreign persons that would be eligible counterparties for transactions in the broker-dealer credit account (Section 220.11(a)(1)). (p. 35)

**Options.**

1. Options as Cover for a Short Sale. SIA supports the Board's proposal to permit, for purposes of short sale margin requirements, a call option to qualify as a "security exchangeable or convertible. . . into the security sold short," thereby making such call option eligible to serve in lieu of the 50 percent margin requirement otherwise applicable to the short sale. SIA also requests that the Board clarify that a call option may serve as a security which is "exchangeable or convertible" into a security sold short for purposes of a riskless arbitrage transaction effected in the arbitrage account. (p. 36)

2. Options Under Regulation U. SIA supports the Board's proposal to amend Regulation U to permit banks to lend against exchange-traded options to the extent permitted by the rules of the options exchanges. (pp. 36-37)

3. Cash Account Transactions. SIA supports the Board's proposal to shorten the definition of a "covered option transaction" to include (effective June 1, 1997) "any transaction eligible for the cash account under the rules of the registered national securities exchange authorized to trade the option or warrant or the creditor's examining authority in the case of an unregistered option provided that all such rules have been approved or amended by the SEC." (p. 37)

4. Delegation of Authority to SROs. SIA requests that the Board clarify certain technical issues regarding the scope and effective date of the delegation to SROs of margin setting authority with respect to options. (p. 37)

5. Employee Stock Options and Other Benefit Plans. SIA proposes that the Board amend the provisions of Regulation T regarding the financing of a customer's receipt of securities pursuant to an employee benefit plan (Section 220.3(e)(4)) by (i) deleting the requirement that the

employee benefit plan be registered on Form S-8 and (ii) replacing the references to "stock" with the term "security." (pp. 37-38)

**Eligibility of Equity Securities for Credit Under Regulations G, T and U.**

1. Definition of "Foreign Margin Stock." SIA supports the retention of the Board's test under Section 220.17(c)(1)-(5) for "foreign margin stock" in addition to the "ready market" test incorporated by the recent amendments to Section 220.17(c). SIA proposes that the Board amend the definition of "foreign margin stock" to provide that securities deemed to have a ready market for purposes of the SEC's net capital rule would automatically become "foreign margin stock" without the need for broker-dealers to await their publication on the Board's list. (pp. 38-40)

2. Definition of "OTC Margin Stock." SIA supports the Board's proposal to expand the definition of "OTC margin stock" to include any stock traded on a national securities exchange, quoted on NASDAQ, or otherwise having a "ready market" for purposes of the SEC's net capital rule. SIA supports creating a parallel definition of "OTC margin stock" under Regulations G, T and U, but believes other alternatives that provide relief to broker-dealers without increasing regulatory burdens for non-broker-dealers may also be acceptable. (pp. 40-41)

**Comments on Other Topics Not Specifically Addressed by the Board.**

Arbitrage Account. SIA proposes that the Board eliminate or reduce margin requirements on hedged customer positions, including convertible arbitrage transactions, and provide a creditor's SRO with flexibility to determine the types of offsetting transactions for which no margin or reduced margin requirements should apply. SIA also proposes that the Board permit a broker-dealer to provide a customer with "good faith" loan value for a fully-paid long position in a convertible debt security that is hedged by an offsetting short position in the underlying stock. (pp. 41-43)

Definition of "Extension of Credit" Under the Board's Margin Regulations.

1. Purchases of Certain Debt Securities. SIA proposes that the Board clarify that a broker-dealer is not extending credit subject to Regulation T when it purchases a privately-placed debt security for resale under an exemption from Securities Act registration, regardless of whether such purchase is made in an initial offering or in a secondary market transaction. (pp. 43-44)

2. Transactions Involving the Issuer of Securities. SIA proposes that, through an amendment to Regulations G, T or U or a clarifying statement, the Board exclude from the scope of its margin regulations any credit arising out of transactions with an issuer or its affiliates involving the issuer's securities. (pp. 44-45)

3. Foreign Installment Offerings. SIA requests that the Board clarify that the purchase by a broker-dealer of foreign securities in an installment offering does not constitute an "extension of credit" for purposes of the margin rules. (pp. 45-46)

4. Forwards and Other Transactions Involving Bilateral Credit Exposures. SIA requests that the Board amend its margin regulations to clarify that they do not apply to forwards and similar transactions that involve bilateral credit exposures but not extensions of credit. (pp. 46-47)

Net Settlement in Cash Account. SIA proposes that the Board eliminate the general prohibition on net settlement of transactions in the cash account, at least for transactions executed by institutional investors in a DVP context. Alternatively, SIA requests that the Board make clear that a 90-day freeze should not be imposed on an investor that sells a security prior to the settlement date for its purchase unless and until the investor fails to pay for the security within the time periods specified by Regulation T. (pp. 47-48)

Scope of Regulation T With Respect to "Creditors" and "Customers."

1. Definition of Creditor. SIA proposes that the Board amend the definition of "creditor" to (i) exclude explicitly foreign broker-dealers that are not required to register under Section 15 of the Exchange Act and (ii) delete any references to any entities that are controlled by broker-dealers, at least insofar as such entities are not engaged in the business of extending, maintaining or arranging purpose credit. (pp. 48-49)

2. Credit Extended to Other Broker-Dealers. SIA proposes that the Board amend Regulation T to permit broker-dealers to effect, clear and finance the transactions of any other registered broker-dealer on a margin basis satisfactory to the parties. (pp. 49-51)

Borrowing Restrictions on Creditors. SIA requests that the Board continue to support legislation that would reduce or eliminate the restrictions imposed by Exchange Act Section 8(a) on broker-dealers' ability to borrow against listed equity securities, and proposes that the Board eliminate the restrictions in Regulations G and T that go beyond the requirements of Section 8(a). (pp. 51-52)

Convertible Securities. SIA requests that the Board clarify whether convertible securities are subject to the same margin requirements as "margin equity securities" under Section 220.18. SIA recommends that the Board include convertible *preferred* securities in the definition of "margin security." (p. 52)

Private Custodial Receipts for Exempted Securities. SIA proposes that the Board clarify that private custodial receipts for all exempted securities, not just U.S. Treasury securities, may be treated as exempted securities under Regulation T. (pp. 52-53)

Money Market Instruments. SIA proposes that the Board amend Regulation T to permit money market instruments to have "good faith" loan value for all purposes under Regulation T. SIA requests that, at a minimum, the Board clarify that for purposes of Regulation T commercial paper should be treated the same as economically comparable debt securities.

In addition, SIA requests that the Board (i) amend Regulation T to permit money market instruments (other than commercial paper) to be used as cash equivalents for all purposes under the Regulation, and (ii) amend the nonsecurities credit account to permit broker-dealers to effect transactions in money market instruments without obtaining a Form T-4 from the customer. (pp. 53-54)

Account Guarantees. SIA proposes that the Board amend Section 220.3(d) to permit a guarantee of a customer's account to be given effect under Regulation T to the extent permitted by the creditor's SRO. (p. 55)

Other Conforming Changes to Regulations G and U.

1. Actions for Creditor's Protection. SIA proposes that the Board conform Section 220.1(b)(2), regarding actions that may be taken for a creditor's own protection, to the corresponding provisions of Regulations G and U. (pp. 55-56)

2. Good Faith Mistakes. SIA proposes that the Board conform Section 220.3(h) of Regulation T, dealing with good faith mistakes, to the corresponding provisions of Regulations G and U. (p. 56)

**Additional Technical Comments.**

SIA also proposes that certain additional technical and conforming changes be made to Regulation T. (p. 57)

**II. Comments on Amendments Proposed by the Board and Related Topics.**

**A. Loan Value for Non-Equity Securities.**

**1. Granting "Good Faith" Loan Value to all "Non-Equity Securities".**

SIA strongly supports the Board's proposal to grant "good faith" loan value under Regulation T to all "non-equity securities." SIA favors defining the term "non-equity securities" as the Board has proposed: all securities that are not "equity securities" under Section 3(a)(11) of the Exchange Act. SIA does not consider it necessary or desirable for the Board to attempt to define a separate category of "equity-linked" debt securities that would be excluded from the definition of "non-equity security."

As noted by the Board in the Proposing Release, since Regulation T currently affords no loan value to any non-exempted debt securities that do not qualify under the Regulation as "registered" non-convertible debt securities or "OTC margin bonds," broker-dealers are effectively prohibited from extending any credit against such securities, including through a wide range of financing transactions such as repos, forwards and similar transactions. In contrast, Regulations G and U do not impose any margin requirements on non-broker-dealer lenders who extend credit against any non-convertible debt securities. Thus, customers who wish to enter into financing transactions on many categories of fixed income securities are effectively encouraged by the structure of Regulations G, T and U to do so with banks and other non-broker-dealer lenders, or with foreign institutions not subject to the Board's margin requirements, rather than with U.S. broker-dealers.

This competitive burden on the fixed income securities activities of U.S. broker-dealers is exacerbated by the predominant role played by institutional and foreign investors in the fixed income markets: institutional investors generally possess sufficient sophistication and resources to seek credit from lenders that are not subject to the restrictions of Regulation T, and both foreign and institutional investors typically have a number of non-broker-dealer sources of credit readily available to them outside of the United States. Thus, institutional and foreign investors are frequently able to find lenders willing to offer significantly better terms for loans against non-marginable fixed income securities than the zero loan value currently imposed by Regulation T.

These competitive disparities created by Regulations G, T and U do not appear to be supported by any clear policy rationale. Although the Board's margin rules have never limited the ability of non-broker-dealer lenders to extend credit involving any debt securities, there is no evidence that the credit extended by these lenders has been detrimental to investors, lenders or the securities markets. Moreover, there is no evidence that broker-dealers are any less competent than these non-broker-dealers to extend credit against debt securities at prudential levels, particularly since broker-dealers -- unlike most non-broker-dealers -- are otherwise subject to a comprehensive regulatory scheme applicable to their extensions of securities credit, including suitability and financial responsibility requirements imposed by SEC and SRO rules. The only apparent impact of the existing limitations imposed on broker-dealers, therefore, has been to create an unwarranted competitive burden on broker-dealers and to reduce the potential sources of securities credit for investors. SIA therefore urges the Board to remove this competitive burden by permitting broker-dealers to extend "good faith" loan value against all debt securities.

SIA does not believe that it is necessary for the Board to adopt a special definition of "equity-linked" debt security that would be ineligible for "good faith" loan value. As noted by the Board, the proposed definition of a "non-equity security" (*i.e.,* any security that is not an "equity security" as defined in Section 3(a)(11) of the Exchange Act) may include certain non-convertible notes whose payment features are linked to the performance of an underlying equity security. As a matter of market practice, non-convertible notes are generally viewed and traded as debt securities. While it may be appropriate to treat "equity-linked" debt securities as equity securities in certain circumstances, SIA does not believe that such treatment is necessarily appropriate in general or in the specific context of the Board's margin regulations. To the extent that certain "equity-linked" debt securities do raise particular sales practice or other concerns, the SEC and the SROs have adequate authority-- and are better situated than the Board-- to identify such securities and implement appropriate regulation.

**2. Definition of "OTC Margin Bond".**

In the event that the Board determines not to grant "good faith" loan value to all non-equity securities under Regulation T, SIA requests that the Board make a number of additional revisions to the current definition of "OTC margin bond."

First, as noted in its comment letter on the 1995 Release, SIA believes that the Securities Act registration requirement in clauses (1) and (2) of the definition of "OTC margin bond" should not apply to debt securities that are exempt from registration under Securities Act Section 3(a)(2) (securities issued by banks and certain other issuers), Section 3(a)(5) (securities issued by certain savings and loan associations, farmer's cooperative organizations and other issuers), Sections 3(a)(9) and 3(a)(10) (certain securities offered in exchange for existing securities or claims) and Section 1145 of the Bankruptcy Code (certain securities offered pursuant to a plan of reorganization). As currently drafted, clauses (1) and (2) of the definition of "OTC margin bond" exclude these securities because they are not registered under the Securities Act, even if they meet the other requirements of these clauses. In general, the availability of exemptions from registration under the Securities Act for such securities appears to be based on policy grounds that also support the use of these securities as collateral for margin loans.

Second, SIA requests that the Board amend the definition of "OTC margin bond" to clarify that

Exchange Act reports need be filed under subclauses (1)(ii) or (2)(ii) only to the extent that the issuer is required to file such reports under applicable securities laws. Many issuers of asset backed securities (whether structured as pass-through securities under clause (2) of the definition of "OTC margin bond" or as secured debt obligations under clause (1)) are excluded by SEC order or no-action letter from some or all of the reporting requirements of the Exchange Act. In addition, SIA notes that the Board should clarify that the requirement in these clauses that the issuer be a reporting company under the Exchange Act does not apply to securities offered pursuant to Securities Act Sections 3(a)(2) and 3(a)(5) (whose issuers are banks and other institutions exempt from such reporting requirements).

**3. Non-Convertible Preferred Securities.**

SIA requests that the Board amend Regulation T so that non-convertible preferred securities will be treated in the same manner as comparable debt securities. Highly-rated non-convertible preferred securities, while technically "equity" securities, generally trade based on the specified dividend levels established for the security. In this respect, non-convertible preferred securities are functionally comparable to debt securities, which trade on the basis of their yield. Thus, SIA requests that the Board permit transactions in non-convertible preferred securities to be effected in the proposed "non-equity account" on the same basis as "non-equity securities"; similarly, non-convertible preferred securities should be eligible for "good faith" loan value in transactions effected in the margin account on the same basis as comparable debt securities. To the extent that any payments on an over-the-counter non-convertible preferred security are in arrears, the security should be treated like a debt security that is in default and therefore ineligible for "good faith" loan value.

**B. Establishment of Non-Equity Account.**

SIA strongly supports the Board's proposal to create a new "non-equity" account under Regulation T in which a broker-dealer may effect any transaction involving a non-equity security. SIA firmly believes, however, that the proposed prohibition on transactions or withdrawals that would cause the account to "liquidate to a deficit" should not be adopted.

As SIA noted in the 1995 Comment Letter, the present account structure of Regulation T does not adequately accommodate a variety of financing transactions common to the fixed income markets, including repos, forwards and similar transactions. As a result, Regulation T presents a number of interpretive and technical uncertainties as to how these transactions should be conducted and unnecessarily impairs the ability of U.S. broker-dealers to compete with other U.S. and foreign sources of securities credit. For example, it is frequently unclear which account under Regulation T -- and what margin requirement -- is appropriate for repos, forwards and similar transactions. In addition, no account adequately accommodates current market practices with respect to these transactions, and broker-dealers therefore are often unable to enter into these transactions on terms that are competitive with those offered by non-broker-dealer lenders.

The creation of a new "non-equity account" in which broker-dealers may effect any transactions in a "non-equity security" will substantially clarify the treatment of repos, forwards and similar transactions under Regulation T. In addition, the new account will provide broker-dealers with greater flexibility to enter into these transactions on terms that are consistent with market practice. The "non-equity account" will therefore provide significant competitive relief to broker-dealers, particularly in those markets (such as many foreign markets) where other sources of securities credit are not subject to Regulation T. By providing a framework under Regulation T for addressing any type of transaction in fixed income securities, moreover, the proposed amendment will permit broker-dealers to participate in the development of new fixed income transactions and products without requiring ongoing clarification from the Board as to how each such transaction or product should be treated under Regulation T.

The potential benefits of the "non-equity account" will be substantially undermined, however, by the Board's proposed prohibition on any transaction or withdrawal in the account that would cause the account to "liquidate to a deficit." The Board indicated in the Proposing Release that this limitation would prohibit any transaction or withdrawal that would "cause the marked-to-market value of the securities held in the account to be less than the credit outstanding." The Board also indicated that this limitation is necessary "to ensure that unsecured credit would not be extended under the rubric of good faith margin" in the new account.

Presumably, the Board has attempted to limit "unsecured credit" in the proposed account on the assumption that doing so is necessary either to comply with applicable statutory requirements (*e.g.,* Exchange Act Section 7(c)(2)) or to achieve some policy objective. As discussed in greater detail below, however, the "liquidate to a deficit" requirement is not mandated by Section 7 of the Exchange Act and, as a policy matter, will impair substantially the utility of the non-equity account. SIA therefore strongly opposes the inclusion of this limitation on transactions in the proposed non-equity account.

### 1. The "Liquidate to a Deficit" Limitation is Not Required by the Exchange Act.

In SIA's view, the Board has ample authority under Section 7 of the Exchange Act to adopt the "non-equity account" without the "liquidate to a deficit" limitation.

Under Section 7(c)(2) of the Exchange Act, broker-dealers may not extend, maintain, or arrange for the extension or maintenance of credit without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board may prescribe pursuant to that Section. In particular, the Board has explicit authority under Section 7(c)(2)(B) to adopt rules pursuant to which broker-dealers may extend unsecured credit that is not for the purpose of "evading or circumventing" the Board's margin requirements. More generally, Section 7 of the Exchange Act grants the Board wide authority to establish rules governing margin credit, including rules that establish margin requirements for securities transactions that are lower or higher than those set out in Section 7(a).

Consistent with its broad rulemaking authority under Section 7, the Board has adopted rules in numerous instances pursuant to which broker-dealers may extend or arrange credit without securities collateral. For example, the Board has long authorized broker-dealers to "arrange" unsecured extensions of credit, initially in certain limited classes of transactions and more recently for all transactions that do not violate Regulations G, U or X. The Board's actions reflect the conclusion of the General Counsel of the Federal Reserve Bank of New York, who determined after comprehensive analysis of the language of Section 7(c)(2) and the legislative history of the Exchange Act, that "the Board is empowered to determine the types of unsecured credit transactions which may be arranged by brokers and dealers."

Similarly, outside the arranging context, the Board established the government securities account in 1994 without imposing any "liquidate to a deficit" requirement -- even though the general restrictions of Section 7(c)(2) apply with equal force to credit that is extended *or* arranged by a broker-dealer without securities collateral. Again, the Board presumably was relying on a determination that transactions in that account would not be for the purpose of "evading or circumventing" the Board's margin requirements. The Board has also exercised its exemptive authority under Section 7(c)(2) in the areas of maintenance margin, securities borrowing and lending, and transactions involving commodities and foreign exchange.

Accordingly, so long as broker-dealers are not permitted to effect transactions in the non-equity account for the purpose of "evading or circumventing" the Board's margin regulations, there is no requirement under Section 7(c)(2) that the Board prohibit transactions in that account that may involve an extension of unsecured credit to the counterparty. In SIA's view, the objective of preventing any "evasion or circumvention" of the Board's margin requirements can be most effectively met by imposing a modified "good faith" requirement on transactions in the non-equity account -- *i.e.,* a requirement that credit be extended on *bona fide* arm's-length terms by the broker-dealer exercising sound credit judgment. This "good faith" requirement would limit any unsecured extensions of credit to those situations in which such credit is consistent with the broker-dealer's exercise of sound credit judgment and with the terms that would otherwise be negotiated by the parties in an arm's-length transaction. By including such a "good faith" requirement, moreover, the Board would be imposing even greater restrictions on extensions of unsecured credit in the non-equity account than currently exist in the government securities account, which has no "good faith" requirement, or in the context of credit arranged by broker-dealers, which may be wholly unsecured.

In analyzing the appropriateness of substituting a modified "good faith" test for the proposed "liquidate to a deficit" requirement, SIA also considers it important to note the Board's authority to define terms such as "extension of credit" as used in Section 7 of the Exchange Act. As discussed in greater detail in the 1995 Comment Letter, a variety of transactions between broker-dealers and their customers -- including repos, buy/sells, forwards, and securities lending transactions -- give rise to *bilateral credit exposures* rather than a unilateral *extension of credit* by one party to the other, since each party is exposed to the risk of non-performance by the other party of its future obligations under the transaction. Depending on their relative creditworthiness, the two parties may determine to offset these bilateral credit exposures through the delivery of a collateral "cushion" ( *i.e.,* from the less creditworthy party to the more creditworthy party). Where the broker-dealer is the less creditworthy party, this collateral "cushion" may cause the account, as a technical matter, to "liquidate to a deficit." As an economic matter, however, such collateral should not be viewed as an *extension of credit* by the broker-dealer; indeed, in the absence of such collateral, the customer would arguably be extending credit *to* the broker-dealer. In this context, therefore, the prohibition on transactions that cause the non-equity account to "liquidate to a deficit" is not necessary because such transactions do not entail an *extension of credit* by the broker-dealer to the customer for purposes of Section 7(c).

### 2. Practical Difficulties Posed by the "Liquidate to a Deficit" Limitation.

As a policy matter, SIA believes that the proposed "liquidate to a deficit" limitation would substantially undermine the benefits which would otherwise accrue to broker-dealers and their customers as a result of adopting the non-equity account. In particular, for example, it is not clear how the "liquidate to a deficit" requirement would be applied in a number of situations; in other instances, that requirement would prohibit broker-dealers from effecting in the account a number of common debt market transactions the facilitation of which is among the principal advantages of creating the non-equity account. As a competitive matter, moreover, the "liquidate to a deficit" requirement would impose a substantial burden on broker-dealers, especially in view of the absence of any comparable restriction on transactions in non-equity securities by banks or other lenders subject to Regulations G and U.

In a number of different scenarios, the "liquidate to a deficit" limitation would create ambiguity and uncertainty. For example, if a customer has purchased a security on a forward basis and there are no other securities in the account, how does a creditor calculate whether "the value of the securities in the account is less than the outstanding credit"? Are there any securities "in the account"? What is the amount of the "outstanding credit"? In addition, if the forward purchase price is lower than the current market value of the security, would the account always "liquidate to a deficit"?

In other circumstances, the "liquidate to a deficit" prohibition could be interpreted to prohibit certain transactions from being effected in the account. For example, a broker-dealer that borrows securities is required, under SEC Rule 15c3-3, to provide the lender with collateral (which may include cash collateral) equal to *at least* the value of the securities borrowed. In many instances, market practice requires the collateral to equal 102-105% of the value of the securities borrowed. If effected in a non-equity account, such transactions could be viewed as "liquidating to a deficit," since the value of the securities borrowed is less than the cash collateral. Similarly, in a repo transaction -- in which the broker-dealer initially sells securities to the customer subject to an agreement to repurchase those securities at a later date -- market convention ordinarily would dictate that the value of the securities exceed the value of the cash received on the initial sale. As a technical matter, however, it could be argued that such a transaction would "liquidate to a deficit" and would therefore be prohibited from the account.

As noted above, these practical and interpretive difficulties could be resolved by eliminating the "liquidate to a deficit" requirement and replacing it with a "good faith" requirement for all transactions effected in the non-equity account. SIA therefore strongly recommends that the Board permit any transactions in the non-equity account to be conducted on a "good faith" basis.

## C. Portfolio Margining.

### 1. Amendment to Definition of "Good Faith Margin".

SIA strongly supports the Board's proposed amendments to the definition of "good faith margin." The current definition of "good faith margin" -- which requires that margin be determined with respect to a specified security position and without regard to other assets or securities positions of the customer held in connection with unrelated transactions -- imposes a "position-based" margin requirement that is no longer consistent with the realities of modern risk management. Where a customer borrows against securities eligible for "good faith margin" and has other assets or securities positions in its accounts at the broker-dealer, the broker-dealer should be able to take those other assets or securities positions into consideration when determining the amount of credit it is willing to extend to the customer. At present, Regulation T fails to recognize that the customer's other assets or securities positions may substantially reduce the overall risk to the broker-dealer (and to the customer) entailed in any extension of credit to the customer.

As discussed above, any amendment to the definition of "good faith margin" should clearly address the inherently bilateral credit involved in repos, forward trades and similar transactions. Thus, the Board should explicitly clarify that the "good faith" requirement permits credit to be extended on *bona fide* arm's-length terms by a broker-dealer exercising sound credit judgment. This "good faith" requirement could sometimes be satisfied, in a reverse repo, where the value of the securities "reversed in" is less than the cash purchase price (as would be the case in a comparable borrowing of the securities). Similarly, the "good faith" requirement, if determined on an arm's-length basis and with the exercise of sound credit judgment, might in some cases result in a broker-dealer providing collateral to a counterparty in a forward transaction.

SIA recommends that the proposed revision to the term "good faith margin" apply to all accounts in which that definition is used, not just to the proposed "non-equity account." The same principles which justify the revision to this definition in the context of the "non-equity account" also apply to the margin account and the market functions account.

**2. Separation of Accounts.**

SIA strongly supports the Board's proposed amendments to Section 220.3(b) that would explicitly allow commodities and foreign exchange positions in the nonsecurities account to be considered in calculating margin for any securities positions in the proposed "non-equity account" or the margin account. SIA also supports the elimination of the general prohibition in Section 220.3(b) on meeting the requirements of one account by considering items in another account. In SIA's view, a customer should be permitted to use any excess in one account to satisfy the requirements of another account without effecting an actual transfer of funds or assets between the two accounts.

The current structure of Regulation T -- which carves a customer's securities positions out of its entire portfolio of transactions with a broker-dealer and permits only those positions to have loan value for securities credit transactions -- fails to recognize both the collateral value inherent in the customer's nonsecurities positions and the risk-reducing benefits of offsetting positions in securities and other related financial instruments. As noted in SIA's 1995 Comment Letter, where a customer is short an option on the S&P 500 in its account with a broker-dealer, that position may be fully hedged, as an economic matter, by either a futures contract on the S&P 500 or a long option on the S&P 500. There is no clear policy rationale for requiring the customer to post margin if it is hedged by the futures contract but not if it is hedged by the long option. The Board noted in the Proposing Release that, in view of the amendments to the options provisions, "Regulation T will allow financial futures to serve in lieu of margin for securities options consistent with SRO rules." SIA supports broadening this relief to permit commodities and foreign exchange positions to be considered in calculating margin for *any* securities transaction.

For the reasons described in Part II.B.1 above, SIA believes that the Board has ample rulemaking and interpretive authority under Section 7 of the Exchange Act to adopt rules permitting portfolio margining, including rules pursuant to which securities positions are "cross-margined" with commodities and other non-securities positions, particularly where there is no purpose of evading or circumventing the Board's margin requirements.

SIA also recommends that the Board facilitate more generally the process of developing appropriate portfolio margining requirements by amending Regulation T to permit a creditor -- in lieu of satisfying the account structure and requirements of Regulation T -- to comply with any portfolio margining requirements that may be established by the creditor's SRO. This proposal would provide SROs with the flexibility to develop and implement appropriate portfolio margining requirements on an ongoing basis.

SIA further believes that the special memorandum account should be retained even if the Board amends Section 220.3(b) (regarding the separation of accounts) to permit any excess margin in one account to be used to meet a margin deficiency in another account. The special memorandum account provides an important mechanism by which customers may preserve for future use (*e.g.,* for withdrawal or as margin for new commitments) any margin excess in their margin account. Even with the adoption of "cross-margining" between accounts or, more generally, portfolio margining, it will be desirable to continue providing customers with the benefits of the special memorandum account. This is particularly true with respect to those customers who will continue to utilize only the margin account or whom a broker-dealer determines to be unsuitable for portfolio margining. Maintaining the special memorandum account will provide both broker-dealers and their customers with greater flexibility in structuring their transactions under Regulation T.

**D. Borrowing and Lending of Securities by Broker-Dealers.**

SIA appreciates the important amendments adopted by the Board with respect to securities borrowing and lending transactions. SIA's recommendations regarding additional amendments to facilitate the borrowing and lending of securities under Regulation T fall into three categories: first, the Board should expand the categories of permissible collateral for securities borrowings and clarify certain ambiguities that arise in connection with the categories of collateral currently permitted under Regulation T; second, the Board should revise Section 220.16(b) to permit a creditor to lend any foreign securities under that section (not just "non-U.S. traded" foreign securities); and third, the Board should expand and clarify the types of "permitted purposes" for which a creditor may borrow or lend securities.

### 1. Permissible Categories of Collateral.

SIA supports the Board's proposal to amend Section 220.16 to allow any security or other asset, valued at its market value, to serve as collateral for securities borrowings. If the Board determines not to adopt this approach, it should, at a minimum, permit any marginable security to serve as collateral, valued at its regulatory loan value.

In SIA's view, moreover, the collateral requirements of Section 220.16 could be eliminated entirely (subject to the restrictions of Section 8(a) of the Exchange Act) without detracting from its underlying policy objective -- *i.e.,* to limit the ability of a creditor and its customer to circumvent the margin requirements of Regulation T. Such circumvention is adequately prevented by the current "permitted purpose" requirement of Section 220.16, which permits broker-dealers to borrow securities only to cover a short sale or a fail. In SIA's view, the collateral requirements of Section 220.16 do not inhibit parties from circumventing the Board's margin rules; indeed, they appear directly at odds with the policy objective of Section 220.16 (since they require a broker-dealer to provide the customer with cash or other liquid collateral in an amount that may exceed the loan value of the securities borrowed). While SIA acknowledges that a broker-dealer's borrowing of securities from a customer also raises customer protection concerns regarding the amount and quality of the pledged collateral, these concerns are adequately addressed by the SEC's customer protection rule, Rule 15c3-3.

To the extent that the Board continues to limit the types of permissible collateral for securities borrowings, SIA requests that the Board make several clarifications and changes to the requirements of Section 220.16 that would further reduce the competitive disadvantages facing U.S. broker-dealers without offending the policies of the margin regulations. First, SIA requests that the Board clarify that formal or informal interpretations and no-action positions adopted by the SEC or its staff with respect to Exchange Act Rule 15c3-3 are subsumed within the cross-reference to that Rule in revised Section 220.16. This clarification would ensure that the permitted categories of collateral for securities loans under the margin rules are at least as broad as the categories permitted under Rule 15c3-3.

Second, SIA reiterates its recommendation that the list of banks whose letters of credit are permissible collateral under Section 220.16 be expanded to facilitate a broker-dealer's ability to obtain a letter of credit denominated in a foreign currency. Letters of credit denominated in the currency of the loaned securities enable the lender to avoid a currency exposure, since any loss resulting from a default by the borrower will likely be denominated in that currency. Many foreign banks, an obvious source of such letters of credit, are not eligible to file a Form T-2 or have no other business purpose for doing so. No significant public policy is served by making the filing of a Form T-2 a condition for the use of a foreign bank's letter of credit denominated in a foreign currency as collateral under Section 220.16.

Third, SIA requests that the Board permit a broker-dealer to accept as collateral for purposes of Section 220.16 a letter of credit issued by a non-U.S. office of a U.S. or foreign bank otherwise eligible to provide letters of credit under Section 220.16, even though such office would not be covered by FDIC insurance or the Form T-2.

### 2. Borrowing and Lending of Foreign Securities.

SIA requests that the Board reconsider its determination to permit only "non-U.S. traded foreign securities" to be loaned to a foreign person pursuant to revised Section 220.16(b). SIA also requests that the Board clarify the requirement that such securities be loaned to a "foreign person."

a. "Non-U.S. Traded Foreign Securities". SIA reiterates its request that the Board permit all foreign securities, not just "non-U.S. traded foreign securities," to be loaned to a foreign person pursuant to revised Section 220.16(b). In connection with adopting the definition of a "non-U.S. traded foreign security," the Board noted a concern that all securities that are publicly traded in the United States, whether issued by foreign or U.S. companies, be treated equally. Such concerns regarding the equal treatment of publicly-traded securities were originally expressed in connection with the Board's previously proposed amendments to the arranging prohibition of Section 220.13, which would have permitted a broker-dealer to arrange credit for U.S. persons to purchase or sell foreign securities but not U.S. securities. With regard to securities loans to foreign persons under Section 220.16(b), however, such concerns are misplaced. To the extent that there would be any disparity of treatment between publicly-traded securities under SIA's proposal, such disparity would only arise in connection with loans of securities to *foreign* persons, not U.S. persons. In the United States, equivalent restrictions would apply to loans of both U.S. securities and dual-listed foreign securities. In any event, moreover, loans of foreign securities, whether exchange traded or not, to foreign persons to facilitate transactions in foreign markets should not be subject to the same regulatory restrictions as loans of U.S. securities for use in foreign markets where they are not primarily traded.

In addition, as noted in the 1995 Comment Letter, the exclusion from Section 220.16(b) of securities listed on a U.S. exchange or traded on NASDAQ would appear likely to create a disincentive to foreign companies considering a dual listing arrangement in the United States. For many foreign companies, the ability to have their ordinary shares traded on a U.S. exchange or on NASDAQ may provide only slight advantages, especially if there is already active trading of their ADRs in the United States. In such cases, the loss of "non-U.S. traded foreign securities" status could discourage the issuer from seeking a U.S. listing.

Moreover, the limitation in Section 220.16(b) to "non-U.S. traded foreign securities" is not consistent with the policy basis for that Section. Section 220.16(b) permits U.S. broker-dealers to act as intermediaries between U.S. lenders and foreign borrowers -- and in so doing to compete with foreign broker-dealers and U.S. and foreign banks as lenders of foreign securities to foreign persons. The amendment recognized, and sought to accommodate the pressures created by, the direct competition between U.S. broker-dealers and unaffiliated foreign firms not subject to U.S. margin regulations. To the extent that foreign securities happen to become listed on a U.S. exchange or NASDAQ, the dual listing will neither relieve these competitive pressures nor will it change foreign customers' expectations regarding whether they can borrow such securities outside the United States. Thus, when a U.S. listing is acquired for a particular security, foreign securities firms will gain a competitive advantage over U.S. firms with respect to their ability to lend those securities in connection with transactions in foreign markets. U.S. broker-dealers should not be denied the flexibility to lend dual-listed foreign securities to their foreign affiliates and customers who are executing transactions in those securities in foreign markets and on foreign exchanges.

If the Board determines, notwithstanding the foregoing considerations, to continue to exclude U.S.-traded foreign securities from Section 220.16(b), SIA believes that the Board should draw a distinction between loans of such securities in connection with transactions executed in the U.S. market and loans of such securities for transactions executed in a foreign market. Under this approach, a U.S. broker-dealer would be allowed to lend a U.S.-traded foreign security to a foreign person for a purpose that is permitted in the country where the security is to be used only if the security will be used in connection with a transaction that is executed on a foreign exchange or other foreign market. Thus, loans in connection with transactions that have no relationship to the United States would be permitted while loans of foreign securities that are to be used to cover a short sale in the United States would be prohibited.

b. "Foreign Persons". SIA appreciates the Board's clarification in the Adopting Release regarding the status under Section 220.16(b) of a foreign person that is the beneficial owner of an account managed by a U.S. investment adviser or other fiduciary. SIA requests that the Board also amend the definition of "foreign person" to encompass foreign branches of U.S. banks. Foreign branches of U.S. banks, while part of entities organized under U.S. law, serve many of the same functions abroad for U.S. banks as foreign subsidiaries serve for other financial market participants. These branches are subject to regulation in accordance with local banking practice, compete directly with non-U.S. branches of foreign banks and foreign subsidiaries of U.S. firms, and are formed for legitimate business reasons unrelated to Regulation T. In addition, while such branches generally are subject to Regulation U, their activities outside the United States have been exempted from the application of that Regulation's margin requirements. Accordingly, categorization of these branches as "foreign persons" would be consistent with the objectives of the Board's recently-adopted amendments to Section 220.16.

**3. Permitted Purpose Requirement.**

SIA appreciates the Board's clarification, through its amendment to Section 220.16(a), that a creditor who reasonably anticipates a short sale may borrow securities up to one standard settlement cycle in advance of the trade date. SIA requests that the Board (a) clarify the meaning of "one standard settlement cycle" as used in Section 220.16(a) and permit borrowings in advance of execution where a creditor reasonably anticipates an obligation to deliver securities it does not have, and (b) amend Section 220.16 to permit borrowings for the purpose of participating in dividend reinvestment and stock purchase plans.

a. Borrowing in Advance of an Execution. SIA requests that the Board clarify that for purposes of Section 220.16(a) the "standard settlement cycle" for all securities currently is at least three business days, and that for foreign securities the standard settlement cycle is the period in which settlement is required to occur by the rules of the relevant foreign securities market. In the Adopting Release, the Board stated that "the standard settlement cycle is contained in SEC Rule 15c6-1 and is currently three business days." By its terms, however, Rule 15c6-1 does not apply to certain securities (*e.g.,* exempted securities). Moreover, the SEC has exempted from that Rule certain other securities, including certain foreign securities for which the settlement period in the local market for the securities is longer than three business days. The clarification requested by SIA would provide greater certainty with respect to the scope of the Board's recent amendment and, in the case of foreign securities, would be consistent with the Board's recent revisions to the cash account (Section 220.8(b)(1)(ii)) to accommodate extended settlement periods for foreign securities.

SIA also requests that the Board amend Section 220.16(a) to permit broker-dealers to borrow up to one settlement cycle in advance of trade date (whether for a transaction for their own account or for a customer) where the broker-dealer reasonably anticipates an obligation to deliver securities it does not have (as in the case of a "fail"), not just a "short sale" of securities. This amendment would clarify the ability of a broker-dealer to borrow securities, for example, in connection with the sale of certificated securities bearing "Rule 144A legends" that will not arrive by the settlement date because the transfer agent has not completed the mechanics of processing the transfer. An obligation to deliver securities that the broker-dealer does not have may also be reasonably anticipated in cases where an in-the-money option is close to expiration and has not yet been exercised (because its exercise on or prior to the expiration date reasonably can be expected to occur). If the need to deliver the security does not arise as anticipated, the broker-dealer would have to return the borrowed securities, as in the case of a borrowing in advance of a short sale that does not occur.

A broker-dealer's ability to borrow where it reasonably anticipates an obligation to deliver securities would have a beneficial impact on market efficiency by reducing the volume of fails. If broker-dealers were permitted to borrow where they reasonably expect an obligation to deliver securities, they would be better able to avoid failing to deliver those securities to another party. This advantage would be potentially significant both for transactions effected in the United States, in view of the recently adopted "T+3" settlement cycle, and for transactions involving securities to be delivered in foreign jurisdictions, where settlement periods may be effectively shortened by differences in time zones and holidays and by the time required for communications between the lender and its customer. In this regard, SIA notes that the clarification sought by SIA would in fact further the Board's policy to "help the securities markets complete transactions" without permitting securities loans to be used to circumvent the other restrictions imposed by Regulation T. In addition, the requested amendment would be consistent with the policy objectives implicit in New York Stock Exchange, Inc. ("NYSE") Rule 440C and related "locate" regulations designed to require broker-dealers to avoid fails and would provide broker-dealers with a greater opportunity to fulfill effectively such "locate" requirements.

b. Dividend Reinvestment and Stock Purchase Plans. SIA continues to recommend that the Board add borrowings for the purpose of participating in dividend reinvestment and stock purchase plans to the list of permitted purposes under Section 220.16. The Board has not identified any policy rationale for rejecting SIA's proposal -- which would achieve a number of worthy policy objectives, such as reducing the cost of capital to issuers, without significantly undercutting the primary purpose of the restrictions on borrowing and lending securities. One of the principal reasons issuers set up such plans is to raise capital periodically without incurring the expensive costs of an underwriting. This goal is furthered whether the present shareholder or a broker-dealer that borrows the shares participates in the plan.

Expanding the list of permitted purposes to include such borrowings would not significantly threaten the underlying policy objective of Section 220.16 -- *i.e.,* preventing an evasion of the Regulation T margin requirements by limiting the circumstances in which a customer may receive cash collateral that exceeds what the customer would be able to obtain by borrowing against the securities. Moreover, these borrowing transactions could easily be limited to a very short period by permitting them to occur only for the length of time ( *e.g.,* over the applicable record date) reasonably necessary for the borrower to participate in the plan.

**E. Foreign Broker-Dealers**.

**1. Extensions of Credit by Foreign Affiliates of U.S. Broker-Dealers.**

SIA supports the Board's proposal to exclude foreign branches of U.S. broker-dealers from Regulation T when they extend credit to foreign persons on foreign securities. As noted by the Board, this amendment would more closely conform the margin treatment accorded such branches with that of foreign branches of U.S. banks under Regulation U.

**2. Omnibus Account Arrangements Involving Foreign Broker-Dealers.**

SIA requests that the Board amend Section 220.10 to permit broker-dealers to establish omnibus account arrangements for foreign broker-dealers and other foreign persons that would be eligible counterparties for transactions in the broker-dealer credit account (Section 220.11(a)(1)). These foreign firms provide services to their customers comparable to those provided by U.S. broker-dealers and thus, in SIA's view, should be eligible to use the omnibus account under Regulation T.

**F. Options.**

SIA greatly appreciates the important modifications made by the Board to the treatment of options under Regulation T. By providing loan value to exchange-traded options, increasing the reliance on SRO margin rules, and amending the option cover provisions, the Board has removed a number of unnecessary restrictions on broker-dealers' options activities and has increased the flexibility of SROs to establish appropriate options margin requirements.

**1. Options as Cover for a Short Sale.**

SIA supports the Board's proposal to permit, for purposes of satisfying the short sale margin requirements, a call option to qualify as a "security exchangeable or convertible. . . into the security sold short," thereby making such call option eligible to serve in lieu of the 50 percent margin requirement otherwise applicable to the short sale. As noted by the Board in the Proposing Release, a customer desiring to use call options to cover a short sale is not in a significantly different position from a customer who uses a warrant, which is currently permitted as cover for the short sale under the Board's rules.

In the Proposing Release, the Board requested comment on whether this amendment would bias the market in favor of short sales (because a customer wishing to purchase margin stock must come up with at least 50% of the purchase price, but a customer wishing to sell such stock short would only be required to come up with the premium necessary to purchase a call option for the applicable securities). In SIA's view, permitting call options to serve as cover for short positions does not pose any significant policy concerns. As a general matter, investors' decisions to purchase or sell margin stock are not likely to be affected by the proposed amendment. Moreover, the ability of investors under the current regulation to cover short positions with warrants has not resulted in any adverse consequences. If the Board determines that exact parity in the treatment of long and short positions is necessary in this context, however, SIA recommends that the Board permit long puts to serve in lieu of margin for long positions in margin stock, which would eliminate any potential bias in favor of the short side of the market.

SIA requests that the Board clarify that a call option may also serve as a security which is "exchangeable or convertible" into a security sold for purposes of a riskless arbitrage transaction effected in the arbitrage account (Section 220.7).

**2. Options Under Regulation U.**

SIA supports the Board's proposal to amend Regulation U to permit banks to lend against exchange-traded options to the extent permitted by the rules of the exchange authorized to trade the options. SIA has consistently supported the creation of parity between Regulations T and U with respect to all margin requirements. If the Board has concerns about requiring banks to comply with the margin rules of options exchanges of which they are not members, SIA recommends that the Board, in consultation with the exchanges, amend Regulation U to provide suitable loan values for listed options.

**3. Cash Account Transactions.**

SIA supports the Board's proposed technical change to shorten the definition of a "covered option transaction" to include (effective June 1, 1997) "any transaction eligible for the cash account under the rules of the registered national securities exchange authorized to trade the option or warrant or the creditor's examining authority in the case of an unregistered option provided that all such rules have been approved or amended by the SEC."

**4. Delegation of Margin Setting Authority to SROs.**

SIA requests that the Board clarify several issues regarding the timing and the scope of the Board's delegation of margin setting authority for options positions to the SROs. In the Adopting Release, the Board indicated that it was "delaying the effectiveness of the new options provisions in Regulation T until June 1, 1997." SIA notes, however, that although this delay is implemented in connection with the provisions of revised Section 220.4(b)(9) (regarding cover or positions in lieu of margin for options on equity securities), Section 220.18(f)(2) appears to provide SROs with immediate authority to establish additional cover or positions in lieu of margin for OTC options on equity securities. SIA requests that the Board explicitly clarify the authority of the SROs in this regard.

In addition, SIA notes that there does not appear to be any delay in the authority of SROs to establish loan values for long options on non-equity securities. Moreover, although the Adopting Release referred only to granting loan value to long listed options, the text of revised Section 220.18(f)(2) does not appear to be so limited. SIA requests that the Board clarify the authority of the exchanges and the SROs to establish loan values for long listed options and long OTC options, respectively.

**5. Employee Stock Options and Other Benefit Plans.**

SIA welcomes the amendments adopted by the Board in connection with the "cashless exercise" of employee stock options. SIA notes, however, that to achieve the Board's intent --

as indicated in the 1995 Release -- to broaden the Regulation to include other types of securities (such as employee stock warrants), the reference to "stock" in Section 220.3(e)(4) should be replaced with the term "securities." In addition, SIA recommends that the Board permit creditors to finance a customer's receipt of securities pursuant to any employee benefit plan. As currently drafted, Section 220.3(e)(4) would *not* permit a creditor to finance a customer's receipt of securities that are registered on an SEC form other than S-8 (*e.g.,* Forms S-1 or S-3) or that are offered pursuant to an exception from SEC registration. To the extent that the Board has referred to Form S-8 because it desires to limit the class of customers who may borrow pursuant to Section 220.3(e)(4) to those persons eligible to purchase securities registered on Form S-8, SIA recommends that the Board implement this intended limitation by adding an additional sentence to the end of the paragraph to read as follows: "For purposes of this paragraph, the term customer shall include any person to whom the securities could have been sold if the plan were registered on Form S-8."

**G. Eligibility of Equity Securities for Credit Under Regulations G, T and U.**

**1. Definition of "Foreign Margin Stock".**

SIA welcomes the Board's amendment to Regulation T that includes within the definition of "foreign margin stock" any foreign stock that has a "ready market" for purposes of the SEC's net capital rule. SIA has three additional comments regarding this definition: first, the test for "foreign margin stock" under Section 220.17(c)(1)-(5) should be maintained; second, a security deemed to have a "ready market" for purposes of SEC Rule 15c3-1 should be automatically treated as a "foreign margin stock," without needing to be added to the Board's list of "foreign margin stock"; and third, the Board should explicitly clarify that a broker-dealer may determine when a foreign security has a "ready market" and may be treated as a "foreign margin stock."

The Board requested comment on whether it should rely exclusively on the "ready market" test in determining which foreign securities qualify as "foreign margin stock." SIA urges the Board to continue to maintain the criteria for "foreign margin stock" set forth in subsections (1)-(5) of Section 220.17(c). As noted in the Proposing Release, a significant number of stocks appearing on the Board's foreign list do not appear on the Financial Times/S&P World Actuaries Indices (the "FT List") (securities listed on which are deemed by the SEC, pursuant to a no-action letter, to have a "ready market" for purposes of SEC Rule 15c3-3). Moreover, it will very likely continue to be the case that certain securities that qualify as "foreign margin stock" under subsections (1)-(5) of Section 220.17 will not be included in an index of securities deemed to have a "ready market" by the SEC. For example, a security in a particular industry may not be included on an index such as the FT List because the relevant industry sector is already adequately represented in the index, even though the security itself may have a liquid market and otherwise meet the Board's requirements for a "foreign margin stock." Broker-dealers should continue to have the ability to certify such stocks for inclusion on the Board's list in accordance with the Board's current rules. Therefore, SIA requests that the Board's existing process for certifying individual securities be retained and that the Board continue to maintain its own list of foreign margin stocks that have been so certified.

SIA notes that there may be a lag between changes to the indices of securities deemed to have a "ready market" by the SEC and the publication of a revised Board list of "foreign margin stock." SIA recommends that the Board address this problem by amending the definition of "foreign margin stock" in Section 220.2 to include both securities on the Board's foreign list *and* securities that are deemed to have a "ready market" for purposes of the SEC's net capital rule (regardless of whether such securities are on the Board's list of foreign margin stock). In this manner, the Board would ensure that any changes in the foreign securities deemed to have a "ready market" ( *e.g.,* because of a change in the securities appearing on the FT List) would be immediately incorporated into the Board's definition of "foreign margin stock" without the need to update and republish the Board's list. In addition, this amendment would clarify that "foreign margin stock" for purposes of Regulation T includes any foreign stock that has a "ready market" for purposes of Rule 15c3-1, regardless of whether such stock appears on an index whose securities are deemed by the SEC to have a "ready market."

Finally, SIA also seeks explicit acknowledgment by the Board that a broker-dealer (subject to oversight by its examining authority) may determine that a foreign stock has a "ready market" for purposes of SEC Rule 15c3-1 -- and is therefore a "foreign margin stock" for purposes of Regulation T -- without receiving further approval from the Board or the SEC. Typically, the determination as to whether a security has a "ready market" for purposes of SEC Rule 15c3-1 is made by each broker-dealer. Except in limited circumstances, such as the no-action letter regarding the FT List, the SEC generally does not make or approve determinations as to whether particular securities have a "ready market," and presumably the Board does not wish to begin making or approving such determinations. In SIA's view, where a broker-dealer is permitted to determine whether a foreign stock is a "ready market" security for purposes of its calculation of capital charges under SEC Rule 15c3-1, that determination should also be deemed sufficient for purposes of Regulation T.

**2. Definition of "OTC Margin Stock".**

SIA supports the Board's proposal to supplement the current criteria for qualification as an "OTC margin stock" in Section 220.17 of Regulation T to include any stock traded on a national securities exchange, quoted on NASDAQ, or otherwise having a "ready market" for purposes of the SEC's net capital rule. As with foreign securities that are deemed to have a "ready market" by the SEC, U.S. stocks determined to have a liquid market for purposes of the net capital rule should qualify as "OTC margin stocks" for purposes of the Board's margin rules. In addition, by establishing a category of stocks that would be deemed to be margin eligible, the Board would eliminate the cumbersome process of designating each individual stock in that category for the Board's list of "OTC margin stocks."

SIA also recommends that the Board permit stocks to qualify for the Board's list of "OTC margin stocks" by satisfying either the current or the proposed criteria. As noted above in connection with the Board's amendments to the criteria for "foreign margin stock," there may be certain securities that satisfy the Board's current criteria for "OTC margin stock" but that would not satisfy the proposed additional "ready market" criteria. In SIA's view, there is no reason to exclude from the definition of "OTC margin stock" any securities which currently satisfy that definition.

As noted by the Board in the Proposing Release, an expansion in the number of "OTC margin stocks" would have different implications under Regulation T, on the one hand, and Regulations G and U, on the other. The addition of an equity security to the Board's list of "OTC margin stocks" would *increase* the amount of credit which a broker-dealer may extend against that security under Regulation T, but would *limit* the amount of credit which a bank or other non-broker-dealer lender would otherwise be able to extend against the security under Regulations G and U (although it is unclear what the practical impact of such a conforming regulatory limitation would be on the amount of credit *actually* extended by banks and other lenders, exercising sound credit judgment on a day-to-day basis, on "OTC margin stock"). SIA has consistently favored harmonizing the margin requirements and related regulatory burdens (including the maximum loan value of equity securities) under Regulation T with those of Regulations G and U. At the same time, however, SIA does not favor creating additional regulatory burdens for any lenders of securities credit, including banks and other non-broker-dealer lenders. Accordingly, SIA supports creating a parallel definition of "OTC margin stock" under Regulations G, T and U, but believes other alternatives that provide relief to broker-dealers without increasing regulatory burdens for non-broker-dealers may also be acceptable.

**III. Comments on Other Topics Not Specifically Addressed by the Board.**

**A. Arbitrage Account and Hedged Positions.**

Consistent with the Board's efforts to promote portfolio margining, SIA urges the Board to review the treatment of hedged positions under Regulation T, including but not limited to convertible arbitrage transactions. As noted by the Board in the Proposing Release, Regulation T has defined limited positions that may serve as offsets for purposes of determining applicable margin requirements, but any combination of positions not specifically permitted by the Regulation may not offset each other. The Board's proposed creation of a non-equity account and amendments to the definition of "good faith" margin will provide important relief for certain types of transactions, but will not address a variety of fully hedged or limited risk strategies which are currently treated as entirely separate positions under Regulation T. For example, as noted in the 1995 Comment Letter, customers typically have a number of *bona fide*, non-speculative purposes for entering into convertible arbitrage transactions, which involve the purchase of a convertible debt security or convertible preferred stock combined with the offsetting sale of the underlying stock. However, Regulation T currently imposes a margin requirement on convertible arbitrage transactions unless they satisfy the strict requirements of the arbitrage account (*i.e.,* the transaction must be effected for the purpose of taking advantage of a concurrent disparity in the prices of the convertible security and the underlying security).

In SIA's view, hedged customer positions, such as convertible arbitrage transactions, should not be subject to the margin requirements of Regulation T. Customer transactions that are hedged do not involve the types of speculation or leverage that the margin requirements of Regulation T are designed to address. Indeed, Regulation T does not require margin in a number of situations in which a customer's position is hedged, such as where a customer writes a covered put or call option. In addition, certain hedged transactions, such as convertible arbitrages and covered options, have been appropriately addressed by SRO margin rules which recognize the risk-reduction inherent in the offsetting hedge and apply a maintenance margin requirement to the combined position which is lower than the initial margin requirement under Regulation T.

SIA recommends that the Board amend the margin requirements of Regulation T to recognize and encourage the risk reducing benefits of transactions that involve offsetting risk positions, including convertible arbitrage transactions. In addition, SIA urges the Board to provide SROs with the flexibility to determine the types of offsetting transactions that provide a customer with a "hedged" or "covered" position for which no margin or reduced margin requirements should apply. Although such hedged positions would presumably include convertible arbitrage transactions, they could also include other combinations of transactions involving different hedging strategies. In addition, the Board should permit the creditor's SRO to determine the appropriate margin requirement applicable to each hedged position. These objectives could be accomplished by adding the following provision to Section 220.4(b):

Hedged Positions. The margin requirement on any convertible arbitrage transaction, limited risk transaction or any other transaction or combination of transactions determined by a creditor's examining authority to be a hedged position shall be the amount or other position required by the maintenance rules of such examining authority.

If the Board determines not to adopt this proposal, SIA recommends that the Board establish an intermediate margin requirement under Regulation T for convertible arbitrage transactions and other hedged positions. In particular, SIA recommends that Section 220.18 be amended so that the margin requirement applicable to a convertible arbitrage transaction that is not eligible for the arbitrage account (*i.e.,* one that is not for the purpose of taking advantage of a concurrent disparity in prices) or any other fully or partially hedged positions would be lower than the margin required for other margin account transactions in the same securities. SIA believes that this approach would more appropriately reflect the "covered" nature of such hedged positions and would be consistent with other efforts by the Board to facilitate portfolio margining.

SIA also urges the Board to permit a creditor to provide a customer with "good faith" loan value for a fully-paid long position in a convertible debt security that is fully-hedged by an offsetting short position in the underlying stock. At present, the maximum loan value under Section 220.18 for a convertible debt security -- which is a "margin security" -- is 50 percent of the market value of the security. Where any future changes in the value of the convertible security are fully-hedged by an offsetting short position, however, there would not appear to be any policy justification for limiting the amount of "loan value" that may be provided for that security.

B. Definition of "Extension of Credit" Under the Board's Margin Regulations**.**

SIA requests that the Board amend Regulation T, as well as Regulations G and U as appropriate, to clarify that the transactions discussed below do not involve an "extension of credit" subject to the Board's margin requirements. In SIA's view, these transactions either do not entail a direct or indirect "extension of credit," as traditionally defined by the Board and its staff, by one party to another, or involve credit which should be exempted from the Board's margin requirements in order to achieve important public policy objectives.

**1. Purchases of Certain Debt Securities.**

SIA requests that the Board clarify and modify the treatment under Regulation T of a broker-dealer's purchase of privately-placed debt securities. In particular, SIA requests that the Board clarify that a broker-dealer's purchase of privately-placed debt securities for resale under an exemption from Securities Act registration, regardless of whether such purchase is made in an initial offering or in a secondary market transaction, does not involve an extension of credit by the broker-dealer.

In a number of prior interpretations, Board staff has taken the position that the purchase by a broker-dealer of a debt security in a private placement involves an "extension of credit" by the broker-dealer to the issuer of the security that is subject to Regulation T. In SIA's view, however, a broker-dealer's purchase of securities *for resale* under an exemption from Securities Act registration, such as Section "4(1½)," should be excluded from the definition of "extension of credit." The Board has already adopted an interpretation that the purchase by a broker-dealer of a debt security for resale under SEC Rule 144A is a permissible "arranging" of credit rather than an "extension of credit" by the broker-dealer. Thus, a broker-dealer can purchase a debt security for resale under Rule 144A but cannot purchase an otherwise identical security -- sold contemporaneously by the issuer -- for resale under another Securities Act exemption. SIA requests that the Board's position with respect to resales pursuant to Rule 144A be codified and extended to any debt security which a broker-dealer purchases with the intent to resell, regardless of whether such resale will be made in reliance on Rule 144A or some other exemption from the registration requirements of the Securities Act.

Similarly, purchases of debt securities by a broker-dealer in ordinary secondary market transactions that are not part of a plan or scheme to evade the margin regulations also should be excluded from the meaning of "extension of credit." If secondary market purchases of privately-placed securities by a broker-dealer were subject to the margin requirements, broker-dealers would be substantially prevented from investing in such securities (since such securities are unlikely to be secured with collateral permissible under Regulation T and it generally would be very difficult to obtain a nonpurpose statement in connection with the sale). By permitting broker-dealers to purchase debt securities in ordinary secondary market transactions (where there is no intention by the broker-dealer to evade Regulation T), the Board would significantly enhance the liquidity of privately-placed securities.

### 2. Transactions Involving the Issuer of Securities.

SIA also urges the Board to reconsider SIA's proposal that any credit extended to an issuer of securities or its affiliates in transactions involving the issuer's securities be excluded from the definition of an "extension of credit" for purposes of the Board's margin regulations. As noted in the 1995 Comment Letter, prior interpretations of the Board and its staff have provided limited interpretive relief for extensions of credit by a broker-dealer directly to an issuer (not an affiliate) to purchase securities that will be retired immediately upon delivery to the issuer. An issuer of securities may, however, have a variety of legitimate corporate purposes for engaging in transactions involving its securities that do not involve their immediate retirement. For example, issuers increasingly have found it desirable to achieve important corporate financing and related objectives by engaging in transactions such as forward purchases and sales and options on their securities. Although these transactions provide issuers with an efficient means of raising capital or hedging their obligations in related capital formation activities and do not reflect the type of speculative or excessive securities credit that Regulations G, T and U were designed to curb, the margin requirements imposed by these Regulations frequently make it uneconomical to conduct these transactions. Accordingly, SIA believes that the Board should exempt such transactions from the scope of its margin regulations.

In addition, in some circumstances an issuer may find it desirable, for tax, accounting or other purposes, to conduct such repurchases of or related transactions in its own securities through an affiliate. In such cases, lenders should be permitted to provide financing for such transactions so long as they serve a legitimate corporate purpose of the issuer. In SIA's view, the application of Regulations G, T and U should not dictate how a corporate group engages in financing or related transactions in the securities of one of its members.

**3. Foreign Installment Offerings.**

SIA requests that the Board clarify, by means of an amendment to Regulation T or otherwise, that the purchase by a broker-dealer of foreign securities in an installment offering does not constitute an "extension of credit" for purposes of the Board's margin rules. As has been recognized by the Board, many foreign offerings of securities are conducted on an installment basis. Pursuant to certain Board interpretations, however, a broker-dealer's purchase as principal of such securities may be viewed as an "extension of credit" by the issuer to the broker-dealer that potentially could be prohibited by Section 8(a) of the Exchange Act. In view of the Board's amendments to the former "arranging prohibition," broker-dealers may now arrange an installment offering that does not violate Regulations G, U or X. Broker-dealers continue to be unable, however, to purchase as principal certain securities sold in installment offerings. SIA believes that even if a broker-dealer's purchase in an installment offering is viewed as a borrowing, it is not the type of borrowing which was intended to be covered by Section 8(a). Accordingly, SIA requests that the Board clarify that a U.S. broker-dealer's purchase, as principal, of a security sold on an installment basis is not a borrowing by the broker-dealer from the seller of the security.

In addition, conforming amendments also should be made to Regulations G and U to permit U.S. persons to purchase "margin stock" in an installment offering arranged by a U.S. broker-dealer and to resell such securities in a qualifying installment sale on equivalent terms without violating Regulations G, U or X.

**4. Forwards and Other Transactions Involving Bilateral Credit Exposures**

SIA requests that the Board reconsider its proposal, set forth in the 1995 Comment Letter, that the Board amend its margin regulations to address more effectively transactions that give rise to *credit exposures*, including in particular forward transactions, but that do not entail an *extension of credit* by one party to the other. The Board's margin regulations, which are drafted to address transactions involving an *extension of credit,* frequently impose margin requirements on transactions involving bilateral credit exposures that do not reflect the fundamental economic relationships between the parties. If adopted with the modifications requested by SIA above, the Board's proposed "non-equity account" would provide greater flexibility for broker-dealers to effect forwards and other transactions involving bilateral credit exposures in the context of non-equity securities. Additional amendments are required with respect to Regulations G, T and U, however, to clarify the treatment of forwards and similar transactions involving equity securities and to provide for margin requirements consistent with the economic nature of these transactions.

Bilateral credit exposures may arise out of a number of contractual commitments that do not involve an actual extension of credit by one party to the other. In a forward transaction, for example, each party is exposed to the risk that its counterparty will not perform its obligations on the forward settlement date. The seller faces the risk that the buyer will not pay for the securities, and the buyer faces the risk that the seller will not deliver the securities. Neither party has actually advanced funds or securities to the other, and thus neither party has "extended" credit in any conventional sense.

Because Regulations G, T and U are drafted to address *extensions of credit* -- as broadly defined by those regulations -- and not *bilateral credit exposures* of the type created by a forward transaction, they arguably can be read to suggest that merely entering into a forward transaction involves an extension of credit subject to these regulations. This reading creates a number of conceptual and technical problems. For example, it is not clear which party -- the forward seller or the forward purchaser -- is "extending credit" to the other. As a matter of logic, it would seem impossible for a party to be "extending credit" both when it is *selling* a security for forward delivery and when it is *purchasing* for forward delivery. Under a conservative reading of Regulation T, however, a broker-dealer would be required to take margin regardless of whether it is purchasing or selling on a forward basis. Similarly, under Regulations G and U it is frequently unclear which party is required to provide margin to the other in a forward transaction.

SIA therefore requests that the Board clarify that its margin regulations apply only to transactions that involve extensions of credit and not transactions that merely give rise to credit exposures. As noted in Part II.B.1 above (in connection with the Board's proposed "non-equity account"), this clarification could be made pursuant to the Board's authority under the Exchange Act to determine what types of transactions entail an "extension of credit" and to establish the margin requirements applicable to such transactions. SIA suggests that the Board impose a "good faith" margin requirement on forwards and similar transactions, and clarify that "good faith" means the amount of credit extended on arm's-length terms in the exercise of sound credit judgment.

**C. Net Settlement in Cash Account.**

SIA requests that the Board reconsider the general prohibition on net settlement of transactions in the cash account. At least in the context of DVP transactions with institutional counterparties, the existing limitations on net settlement in the cash account are unnecessary and inconsistent with more general efforts by the Board and others to reduce systemic risk by encouraging netting and pair-offs wherever possible.

Many institutional investors which are unable to maintain a margin account actively manage their portfolios and routinely may "contemplate" reselling a security prior to the settlement date for its purchase -- which in the case of certain foreign securities may not occur until after the standard three-day settlement cycle. They also actively manage their cash balances and often do not have sufficient cash in their cash account on the trade date to pay for the purchase. In practice, to avoid a 90-day freeze, such investors will purchase the security at one broker-dealer and, if they decide to sell prior to the settlement date, will sell the security at another broker-dealer. Thus, such institutional investors are not seeking to "free-ride" in the manner that has concerned the Board staff in the past because they in fact pay the purchase price of the security on the settlement date. By permitting net settlement under these limited circumstances, the Board would enable such customers to seek the best execution of a trade (even if that means using the broker-dealer with which the security was purchased), would reduce overdrafts and transaction costs and, consistent with other recent regulatory initiatives, would reduce financial risk for the broker-dealer and systemic risks for the markets generally.

At a minimum, in SIA's view, the Board should make clear under the cash account provisions of Regulation T that the 90-day freeze should not be imposed on an investor that sells a security prior to the settlement date for its purchase unless and until the investor fails to pay for the security within the time periods specified by Regulation T. As noted above, the presumption of "free-riding" embodied in the 90-day freeze should not apply where the security is paid for within one payment period of the date specified in Section 220.8(b). This amendment would substantially assist institutional investors in transactions in which they purchase a security with an extended settlement date (*e.g.,* a foreign security or a "when-issued" security) and subsequently determine to sell that security prior to such settlement date.

**D. <u>Scope of Regulation T with Respect to "Creditors" and "Customers"</u>.**

**1. <u>Definition of "Creditor"</u>.**

SIA again recommends that the Board revise the definition of "creditor" in Section 220.2 so as to exclude foreign broker-dealers and associated persons of U.S. broker-dealers.

Although in the 1995 Release the Board clarified that foreign broker-dealers not required to register with the SEC are not creditors under Regulation T, SIA continues to believe that the definition of "creditor" should be amended explicitly to exclude such foreign broker-dealers. Such an amendment would clarify, for example, that foreign broker-dealers engaging in securities transactions with U.S. persons pursuant to SEC Rule 15a-6 are not "creditors" under Regulation T.

SIA also recommends that the Board revise the existing definition of "creditor" to exclude entities controlled by a broker-dealer, at least insofar as such entities are not engaged in the business of extending, maintaining or arranging purpose credit. In SIA's view, the imposition of "creditor" status on entities controlled by broker-dealers is overly restrictive and unnecessary to achieve the purposes of Regulation T. Read literally, the current definition of "creditor" is particularly burdensome, for example, in the case of a subsidiary of a broker-dealer engaged entirely in other businesses, such as real estate, or an investment partnership that has a broker-dealer as its managing general partner, even where the partnership is not engaged in investing in securities and most of its equity is contributed by third parties who are not broker-dealers. Such "creditor" status imposes a number of potential burdens on these entities, including the potential requirement that they obtain a "purpose statement" for any nonpurpose credit they extend and potential limitations on their ability to sell their own securities on credit. These concerns are especially acute for affiliates of broker-dealers who are not controlled by a holding company.

**2. <u>Credit Extended to Other Broker-Dealers</u>.**

SIA again proposes that the Board amend Regulation T to permit broker-dealers to effect, clear and finance transactions of other broker-dealers on a margin basis satisfactory to the parties.

SIA believes that broker-dealers should be treated less restrictively than public customers for several reasons. First, legislation recently proposed by the SEC, and supported by the Board, the U.S. Department of the Treasury and the CFTC, would have exempted from the margin requirements of Section 7 any credit extended, maintained, or arranged by a broker-dealer to or for a broker-dealer (i) whose business consists substantially of transactions with persons other than broker-dealers or (ii) to finance activities of a marketmaker or an underwriter. By exempting broker-dealers from the margin requirements of Regulation T, therefore, the Board would be implementing an important policy objective that has received the support of a broad segment of the regulatory community.

Second, in adopting Exchange Act Section 7(c), which makes it unlawful for broker-dealers to extend, maintain or arrange credit "to or for any *customer*" (emphasis added) except in compliance with the margin requirements established by the Exchange Act and the Board, Congress intended to cover only public investors. In this regard, Congress viewed credit extended to *public* securities investors as a principal cause of the run-up in securities prices during the 1920s and of the subsequent "crash" in the 1929-1930 period. Indeed, the deliberate use of the term "customer" in Section 7(c) of the Exchange Act strongly indicates that the limitations of that Section were *not* intended to reach credit extended *to* broker-dealers.

Third, broker-dealers are subject to additional regulatory regimes, such as the SEC net capital rule, that limit the degree of leverage they may obtain. In contrast, for many customers the requirements of Regulation T (made applicable to such customers directly through Regulation X) are the only federal restriction on their securities credit activities. Eliminating the Regulation T margin requirements on credit extended by one broker-dealer to another broker-dealer would also conform the Regulation to current SRO margin rules, which generally do not impose normal margin requirements on the proprietary accounts of registered broker-dealers. For example, NYSE Rule 431(e)(6) and NASD Rule 2520(c)(5)(F) currently provide that a member organization "may carry the proprietary account of another broker/dealer, which is registered with the [SEC], upon a margin basis which is satisfactory to both parties," provided that certain conditions are met.

SIA believes that the experience with joint back-offices provides evidence that the SEC and the SROs, together with the broker-dealer community, can develop a workable set of guidelines to ensure that an exemption for credit extended by one broker-dealer to another is implemented in a manner consistent with regulatory policies. In addition, SIA notes that the elimination of margin requirements with respect to financing transactions between registered broker-dealers would not in any way affect the amount of credit that could be extended by broker-dealers to their customers, which would continue to be subject to all the limitations of Regulation T. In this respect, elimination of margin requirements for financing transactions of a registered broker-dealer would be consistent with the theory of the omnibus account (Section 220.10), in which a broker-dealer may finance the customer positions of another broker-dealer because the broker-dealer obtaining the credit is limited by Regulation T in extending credit to its own customers.

In view of these considerations, SIA strongly recommends that the Board amend Regulation T to permit a broker-dealer to effect, clear and finance, on a margin basis satisfactory to the parties, the transactions of another SEC-registered broker-dealer.

**E. Borrowing Restrictions on Creditors.**

SIA strongly encourages the Board to continue to support legislation currently before Congress that would reduce or eliminate the restrictions imposed by Exchange Act Section 8(a) on broker-dealers' ability to finance their inventories of listed equity securities. The current restrictions of Section 8(a) prevent broker-dealers from obtaining capital at the lowest available cost and imposes upon broker-dealers needlessly high financing costs, to the detriment of the U.S. financial system. Pending legislation, which in this respect has broad support among the regulatory community and the securities industry, would permit broker-dealers to obtain financing from a wider range of sources than is now permitted by the Exchange Act, including lenders subject to Regulation G and foreign lenders not subject to Regulations G or U.

While Congress is considering this legislation, SIA believes that the Board should eliminate the provisions of its own regulations that go beyond the requirements of Section 8(a). In particular, Regulation G currently prohibits loans to broker-dealers on securities that constitute "margin stock" (as defined in Section 207.2(i) of Regulation G), except in the case of emergency loans or capital contribution loans, although "margin stock" includes many securities that are not "registered securities" subject to the restrictions of Exchange Act Section 8(a).

**F. Convertible Securities.**

SIA welcomes the Board's amendment to the definition of "margin security" in Section 220.2 to include "any debt security convertible into a margin security." SIA assumes that the margin requirement applicable to a convertible debt security is the same as that applicable to the underlying security (which would be clarified by the adoption of the Board's proposed definition of "margin equity security"). SIA also recommends that the Board amend the definition of margin security to include convertible *preferred* securities which, like convertible debt securities, are frequently viewed as the economic equivalent of the underlying security.

**G. Private Custodial Receipts for Exempted Securities.**

SIA reiterates its request that the Board clarify that privately-issued custodial receipts for exempted securities may be treated as exempted securities for purposes of Regulation T. In the 1995 Release, the Board stated that it would not object to privately-issued Treasury receipts being treated as exempted securities for all purposes under Regulation T. There does not appear to be any policy justification for distinguishing between custodial receipts for Treasury securities and custodial receipts for other types of exempted securities, which like Treasury securities are the economic equivalent of the underlying security. Therefore, SIA requests that the Board confirm that private custodial receipts for all types of exempted securities may be afforded the same status under Regulation T.

**H. Money Market Instruments.**

As noted in the 1995 Comment Letter, SIA favors granting "good faith" loan value to money market instruments, such as commercial paper, certificates of deposit and bankers' acceptances, for all purposes under Regulation T. This approach would be consistent with the Board's proposed amendments that would permit positions in the nonsecurities credit account to be considered in calculating margin for any securities transactions effected in the margin account or the non-equity account. In addition, "good faith" loan value for money market instruments is justified by the highly-creditworthy nature of these instruments and the depth and liquidity of the markets in which they trade. For the reasons described in Part II.B.1 above, moreover, SIA believes that the Board has ample authority under Exchange Act Section 7 to adopt such amendments, particularly where the purpose of the credit would not be to evade or circumvent the margin requirements of Regulation T.

At a minimum, in SIA's view, the Board should clarify that for purposes of Regulation T, commercial paper should be treated the same as economically comparable debt securities. Thus, if the Board permits transactions in any non-equity securities to be effected and financed in the non-equity account, the Board should clarify that transactions in commercial paper may also be effected and financed in the non-equity account. Similarly, if the Board retains the current definition of "OTC margin bond," it should clarify that commercial paper may also be treated in the same manner as an "OTC margin bond" if such commercial paper is rated investment grade.

In addition, SIA requests that the Board permit money market instruments (other than commercial paper) to be used as cash equivalents for all purposes under Regulation T. Thus, for example, money market instruments could be used to reduce a customer's debit balance in the margin account or to satisfy option cover requirements in the cash account. This approach would be consistent with current market and business practices, pursuant to which money market instruments are generally viewed as the functional equivalent of cash, particularly in view of their liquidity and creditworthiness. It would also be consistent with the Board's authority, discussed in Part II.B.1 above, to determine how the margin requirements it establishes are to be satisfied.

SIA also requests that the Board amend the nonsecurities credit and employee stock ownership account (Section 220.9) so that transactions in money market instruments effected in that account would be treated the same as transactions in commodities and foreign currency. In particular, broker-dealers should be permitted to effect transactions in nonsecurities instruments without the requirement of obtaining a Form T-4 from the customer. This modification would considerably ease the regulatory burden for transactions in nonsecurities instruments -- particularly repo transactions -- without the need for legislative action.

**I. Account Guarantees.**

SIA requests that the Board amend Regulation T to permit a guarantee of a customer's account to be given effect under Regulation T to the extent permitted by a creditor's SRO. Under Section 220.3(d) of Regulation T, guarantees of customer accounts currently are not given any effect for purposes of determining the customer's margin requirements. SRO rules, however, have successfully permitted the margin account of one customer to guarantee the margin account of another customer without any adverse results. In addition, Regulation T margin calls on the guaranteed account may be satisfied by transfers of funds or securities from the guarantor account to the guaranteed account. SIA believes that there is no significant policy justification for requiring such transfers to be made rather than permitting any margin excess in the guarantor account to satisfy the Regulation T margin call in the guaranteed account.

**J. Other Conforming Changes to Regulations G, T and U.**

SIA again requests that the Board amend certain sections of Regulation T to remove unnecessary and confusing distinctions between the procedural and related requirements of

Regulation T and those of Regulations G and U.

**1. Actions for Creditor's Protection.**

SIA continues to believe that Section 220.1(b)(2) of Regulation T should be conformed to its counterparts in Regulations G and U. Section 220.1(b)(2) provides that "[t]his part does not preclude any. . . creditor from imposing additional requirements or taking action for its own protection." Regulations G and U contain different language concerning the permitted actions which a lender subject to those Regulations may take to protect the credit it has extended to customers. For example, Section 221.3(j) of Regulation U provides that "[n]othing in this part shall require a bank to waive or forego any lien or prevent a bank from taking any action it deems necessary in good faith for its protection." Due to the absence of published interpretations of Section 220.1(b)(2), it is unclear whether this difference in language reflects an intention by the Board to distinguish between the actions permitted to be taken by broker-dealers and other lenders. Since there does not appear to be any policy justification for such a distinction, SIA believes that Section 220.1(b)(2) of Regulation T should be conformed to its counterparts in Regulations G and U to clarify this issue and ensure equality of regulatory treatment.

**2. Good Faith Mistakes.**

SIA also requests that the Board eliminate the distinction between the Regulation T provision dealing with "innocent mistakes" (current Section 220.3(h)) and the corresponding provisions in Regulations G and U. The good faith mistake provisions of Regulation T excuse a broker-dealer from liability for violations of the Regulation resulting "from a mistake made in good faith in executing a transaction or calculating the amount of margin" if "promptly after the discovery of the mistake, the creditor takes appropriate corrective action." In contrast, Section 207.3(n) of Regulation G and Section 221.3(k) of Regulation U provide that "[a] mistake in good faith in connection with the extension or maintenance of credit shall not be a violation of this part."

In general, the good faith mistake provision of Regulation T has been narrowly construed as covering only mechanical mistakes in executing transactions or in determining the amount of margin required in a customer's account. In contrast, Regulation U has been construed as providing a broad exclusion from liability for good faith mistakes made by a bank in extending or maintaining credit. SIA continues to believe that there is no sound statutory or policy justification for imposing greater liability on broker-dealers than on other lenders for mistakes made in good faith in attempting to comply with federal margin regulations. Although many differences in the scope and substance of Regulation T and Regulations G and U are based on the different statutory requirements of Sections 7(c) and 7(d) of the Exchange Act, these statutory provisions do not require that a higher standard of liability for regulatory compliance be imposed on broker-dealers than on other providers of securities credit. Indeed, the vastly greater scope and complexity of Regulation T suggests that the standard of liability to which broker-dealers are subject should be no greater than that imposed on other lenders. Accordingly, SIA requests that the Board amend the provisions in Regulation T relating to good faith mistakes to conform these provisions to Regulations G and U.

**IV. Additional Technical Comments.**

In addition to the specific comments on Regulation T provided elsewhere in this letter, SIA sets forth below certain additional technical comments regarding the drafting of the Regulation.

**A. Cover for Options in the Margin Account.**

SIA notes that in the first sentence of Section 220.4(b)(9)(iii)(F), the words "warrant exceeds the exercise price of the" should be inserted after the words "exercise price of the." In addition, consistent with the substitution of the phrase "underlying asset" for the phrase "underlying security" in 220.4(b)(9)(iii)(A) and (B), in Section 220.4(b)(9)(v) the word "security" should be replaced with the word "asset" each time it appears.

**B. Permissible Transactions in the Cash Account.**

Consistent with the Board's amendments to Section 220.8(a) to clarify the availability of the cash account for purchases and sales of nonsecurities assets, the words "or asset" should also be added after the word "security" in Sections 220.8(a)(2)(i) and (ii).

**C. Definition of "OTC Margin Bond" .**

The word "mortgage" should be deleted from clause (2)(iii) of the definition of "OTC margin bond" in Section 220.2 (to conform to the deletion of the word "mortgage" where it had appeared in the first sentence of clause (2)).

**D. Margin Requirements for Non-Registered Warrants.**

In Section 220.18(f)(2), the words "and warrants" should be added after the words "all other puts and calls", and the word "and" after the words "all other puts" should be deleted. (Although Section 220.18(f)(1) covers registered warrants, other warrants are not currently addressed by Section 220.18(f)(2).)

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The staff of SIA and its members appreciate the opportunity to comment on the Adopting and Proposing Releases 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 at SIA (212-618-0507). You are also welcome to contact Giovanni P. Prezioso of Cleary, Gottlieb, Steen & Hamilton (202-728-2758), special counsel to SIA in this matter, or the undersigned Co-Chairs of SIA's Ad Hoc Committee on Regulation T, Marcy Engel of Salomon Brothers Inc (212-783-5957) and Anthony J. Leitner of Goldman, Sachs & Co. (212-902-5730).

Very truly yours,

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