DEPARTMENT OF THE TREASURY

Fiscal Service

31 CFR Part 357

[Department of the Treasury Circular, Public Debt Series, No. 2–86]

Regulations Governing Book-Entry Treasury Bonds, Notes, and Bills

AGENCY: Bureau of the Public Debt, Fiscal Service, Treasury.

ACTION: Proposed rule.

SUMMARY: Treasury is proposing regulations that will govern Treasury bonds, notes, and bills (marketable Treasury securities) in book-entry form held in the commercial book-entry system. The rules incorporate recent and significant changes in commercial and property law addressing the holdings of securities through financial intermediaries. The proposed rules would replace existing Treasury regulations that contain outdated legal concepts.

DATES: Comments must be submitted on or before May 3, 1996.

ADDRESSES: Send comments to the Office of the Chief Counsel, Bureau of the Public Debt, Room 503, E Street Building, Washington, DC 20239–0001. Comments received will be available for public inspection and copying at the Treasury Department Library, Room 5030, Main Treasury Building, 1500 Pennsylvania Avenue, NW, Washington, DC 20220.

FOR FURTHER INFORMATION CONTACT: Walter T. Eccard, Chief Counsel (202) 219–3320, or Cynthia E. Reese, Deputy Chief Counsel, (202) 219–3320.

SUPPLEMENTARY INFORMATION:

I. Introduction

Treasury is reproposing rules for the Treasury/Reserve Automated Debt Entry System (''TRADES''). The adoption of TRADES is the culmination of a 27-year Treasury process of moving from issuing securities only in definitive (physical/certificated/paper) form to issuing marketable securities exclusively in book-entry form.

Some numbers help put the scope of this process in perspective. In 1967, the year before Treasury issued its first book-entry security, there were $211 billion of marketable Treasury securities outstanding—all in definitive form. As of December 31, 1995, there were approximately $3.3 trillion of marketable Treasury securities outstanding (not counting Treasury securities held by various government trust funds), 99.7% of which were in book-entry form.

Treasury had considered the potential benefits of converting from definitive securities to securities in book-entry form at various times since as early as 1940. In 1964, following substantial losses of definitive securities, Treasury and the Federal Reserve Banks began a four-year study of the practical and legal aspects of initiating a book-entry system.

As a culmination of this study, the first Treasury book-entry securities regulations were issued effective January 1, 1968.[1] Securities converted to book-entry form pursuant to these regulations consisted of marketable Treasury securities held by Federal Reserve Banks that were either held as collateral pledges to the United States or represented proprietary holdings of member banks. The Federal Reserve Banks, which already acted as Treasury's fiscal agent with respect to transactions in definitive U.S. securities, began to act in that capacity with respect to Treasury's book-entry securities as well.

During the following year, the then applicable regulations were revised to extend the book-entry system to Treasury securities held by the Federal Reserve Banks that were pledged to third parties, such as courts or other public officials, for the performance of certain obligations or to secure deposits of public funds. The book-entry conversion authority initiated in 1968 and 1969 allowed the Federal Reserve Banks to reduce both the increasing volume of definitive securities stored in their vaults and the risk of loss. Studies were undertaken at that time to determine the feasibility of expanding the system to include other Treasury securities not initially eligible for the Treasury book-entry system.

In 1971, Treasury regulations were further revised to allow for all marketable Treasury securities to be held in book-entry form.[2] The regulations permitted member banks to place in book-entry form securities held for customers, including those of dealers. Pursuant to these regulations, holding marketable Treasury securities in book-entry form was optional and book-entry securities could be converted to definitive form.

Issuance of these regulations was significant in several respects. They were a key factor in averting a crisis in the government securities market. At that time, banks, brokers and dealers were being threatened with cancellation of insurance coverage because of large losses resulting from the theft of definitive securities. The dramatic increase in thefts and losses of government securities during the late 1960's ($30 million in 1969 and again in 1970) required Treasury to obtain new legislation and implement new claims procedures to grant relief to claimants through replacement of lost or stolen securities prior to maturity.[3] At the close of fiscal year 1971, about $230 billion of marketable Treasury securities were outstanding and about $125 billion of that amount was in book-entry form.

This initial success led to Treasury's decision to expand its efforts to move toward a complete book-entry system. A Treasury and Federal Reserve Bank task force was formed in 1976 to plan for the expansion of the book-entry system for issuing Treasury securities. The goal of the task force was to eliminate the issuance of definitive securities in all new marketable Treasury offerings, with an overall purpose of reducing paperwork, protecting against loss, theft, and counterfeiting, and reducing printing costs. The task force planned for a timed phase-out of the issuance of all definitive securities, beginning in late 1976.

In December 1976, with the promulgation of new regulations,[4] Treasury took the first step towards an exclusive book-entry environment by offering Treasury bills only in that form, phasing in this change for the various bill maturities. A 52-week bill issue in December 1976 became the first offering of securities exclusively in book-entry form. Use of book entry was expanded to include 26-week bills in June 1977 and 13-week bills in September 1977.

Also, beginning in December 1976, Treasury, for the first time, began to provide book-entry accounts for investors who did not choose to hold their book-entry securities accounts at financial institutions or dealers. As of September 30, 1977, Treasury maintained 6,690 book-entry accounts holding a total $182 million of Treasury bills. These accounts were the predecessor to the current TREASURY DIRECT system,[5] which was established in 1986. Treasury notes and bonds were issued in book-entry only form beginning in August 1986, upon implementation of the TREASURY

[1] 32 FR 15672 (November 14, 1967).

[2] 35 FR 20001 (December 31, 1970) and 36 FR 6749 (April 18, 1971).

[3] Pub. L. No. 92–19, May 27, 1971, 85 Stat. 74.

[4] 41 FR 5335 (December 6, 1976).

[5] TREASURY DIRECT is a system in which persons purchasing or already owning marketable Treasury securities may hold such securities directly with the Treasury in book-entry accounts maintained in their names. As of December 31, 1995, there were 922,397 accounts holding $85.3 billion of marketable Treasury book-entry securities.

DIRECT system pursuant to new Treasury regulations.[6]

With the issuance of these regulations, all original issues of marketable Treasury securities (bills, notes, and bonds) were required to be in book-entry form. Book-entry holdings in Treasury securities have increased dramatically since that time. The following chart illustrates this rapid increase.

TOTAL MARKETABLE SECURITIES OUTSTANDING [7]

Year	Percent in book-entry
June 1965	0
August 1976	82
August 1982	95.6
August 1986	97.2
December 1995	99.7

[7] Exclusive of securities held in various government trust funds.

Adoption of the TRADES regulations, to govern the commercial book-entry system counterpart to TREASURY DIRECT, will mark a major step in the evolution of Treasury's full book-entry securities project by providing a clearer legal framework for all commercially-maintained marketable Treasury book-entry securities.

II. Legal Development

As Treasury began to issue securities in book-entry form, it confronted a legal landscape that did not provide a framework for describing how such securities should be treated. As described by Professor James Rogers, the reporter for the drafting committee that produced Revised Article 8, Investment Securities of the Uniform Commercial Code (UCC), adopted by the American Law Institute (''ALI'') and the National Conference of Commissioners on Uniform State Laws (''NCCUSL'') in 1994 (''Revised Article 8''), the version of Article 8 in effect in the late 1960s and early 1970s ''* * * was based on the assumption that possession and delivery of physical certificates are the key elements in the securities holding system.'' [8] Those assumptions, however, did not fit the commercial reality of marketable Treasury book-entry securities.

As noted above, beginning in 1968, Treasury began to promulgate regulations for its marketable securities held in book-entry form. These regulations provided, for the first time, a legal framework for treating marketable book-entry securities issued by Treasury. These regulations, particularly those adopted in 1971, contained several important innovations. First, they described transfers of interests in securities by means other than by moving paper certificates.[9] As currently set forth in the regulations,[10] a transfer of a marketable Treasury book-entry security occurs when a Federal Reserve Bank makes an entry in its records. Second, the regulations implicitly acknowledged that interests in marketable Treasury book-entry securities held in the commercial book-entry system were held in a tiered system.[11]

Specifically, the regulations developed by Treasury had rules for transfers both at the level of institutions having accounts at a Federal Reserve Bank and rules for transfers at custodial levels below that level. These were significant innovations.

The regulations developed by Treasury to describe the nature of a book-entry security, however, also deemed such security to be the equivalent of a bearer-definitive security. This bearer-definitive security fiction, as it came to be known, had the advantage of simplicity. It was also, at the time of its adoption, a useful concept that allowed for the application of existing law at a time when holding securities in book-entry form was a new development. Ultimately, however, the bearer- definitive fiction proved to be unsatisfactory because the attempt to graft the rules of certificated securities onto book-entry securities left too many questions unanswered.[12] This uncertainty poses risks in the event of systemic failure.[13] TRADES is designed to ameliorate these risks.

In 1978 the existing UCC Article 8 was amended and, as part of that process, there was an attempt to provide some guidance on the treatment of book-entry securities. That attempt did not provide sufficient guidance for a tiered system of ownership such as the one that exists for Treasury securities because the rules of that version of Article 8 ''were based on the assumption that changes in ownership of securities would be effected by delivery of physical certificates or by registration of transfer on the books of the issuer.'' [14] In the Treasury system that assumption was not correct. A second level of confusion was created because the Treasury regulations continued to rely on the bearer-definitive fiction but referenced state law (which for most states included the 1978 revision to Article 8). Thus, there was lack of clarity as to how the 1978 amendments to Article 8 and the bearer-definitive fiction interacted and how interests at levels below a Federal Reserve Bank were to be treated.[15]

By 1984 Treasury had concluded that it needed to change its existing book-entry regulations. Several events buttressed that conclusion. As described above, the outstanding amount of marketable Treasury book-entry securities increased dramatically. In 1984 representatives of a number of financial institutions brought to Treasury's attention the need for certainty in the market and raised a number of questions about the existing regulations that they believed undermined that certainty. With the growth of the size of the Treasury market came an increase in the need for, and the use of, short-term financing techniques, such as repurchase transactions, structured to be low risk. In order to preserve the liquidity of this most liquid of markets, it was critical that participants be able to settle their transactions quickly with a high degree of certainty.

Disruptions in the market caused by the failure of some government securities broker-dealers further

[6] 31 CFR Part 357, Subpart C.

[8] James Steven Rogers, Boston College Law School, Reporter, Drafting Committee to Revise U.C.C. Article 8 Investment Securities, Prefatory Note, page 1, U.C.C. Article 8 (1994 official text with comments), hereinafter ''Prefatory Note.''

[9] UCC § 8–320, added in 1962, provided for transfers within a central depository system by the making of appropriate entries on the books of a clearing corporation. Unlike the Treasury regulatory formulation, this UCC provision originally contemplated the deposit of paper certificates with the depository.

[10] 31 CFR 306.118(a).

[11] The Federal Reserve Banks maintain book-entry security accounts for depository institutions and other entities such as government and international agencies and certain foreign central banks. In their book-entry accounts at the Federal Reserve, the depository institutions may maintain their own security holdings and holdings for customers, which may include other depository institutions, dealers, brokers, institutional investors and individuals. In turn, the depository institutions' customers may maintain accounts for their customers. This creates a tiered chain of custodial relationships. Thus, there frequently are multiple levels between the issuer of the security and the ultimate holder of the beneficial interest in that security.

[12] These uncertainties are well described in Charles W. Mooney, Jr., ''Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries,'' 12 Cardozo L. Rev. 305 (1990) (hereinafter ''Beyond Negotiability'').

[13] ''What led to the revision of Revised Article 8 is not intermediary risk itself, that is, the risk that customers of a failed intermediary might suffer loss, but *systemic risk*, that is, the risk that a failure of one security firm might cause others to fail.'' Rogers, *supra*, memorandum accompanying U.C.C. Revised Article 8, (1994 official text with comments), ''Revised U.C.C. Article 8—Why it's Needed—What it Does.''

[14] Rogers, *supra*, U.C.C. Revised Article 8, Prefatory Note, page 4.

[15] Mooney, Beyond Negotiability, *supra*, pp. 345–350.

underscored the need for certainty in the minds of market participants. Events post-1984, such as the 1987 market break and the failure of Drexel Burnham, Lambert validated the concern that lack of certainty, given the magnitude of the dollars involved, posed serious systemic risks—both to the market for Treasury securities and all financial markets.[16] More recently, there has been reaffirmation of the importance of certainty for transactions involving book-entry securities. In a March 3, 1995 speech, Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, stated, ''* * * my experience with financial crises has convinced me that the greatest threat to the liquidity of our financial markets is the potential for disturbance to the clearance and settlement process for financial transactions.'' He went on to note, ''The most important set of concerns relates to the legal and institutional foundations of book entry settlement systems.'' [17]

III. Previous Trades Proposals

In 1985 Treasury began the process of revising its book-entry security regulations. Treasury recognized early on that the process would be quite complicated.

For reasons already explained, the first decision made in the initial proposal of the TRADES regulations [18] was to eliminate the bearer-definitive fiction. This proposed elimination, however, presented two major difficulties in determining what should replace the bearer-definitive fiction. First, state law was not uniform. In 1986 all states had not adopted the 1978 version of UCC Article 8. Because of this lack of uniformity, Treasury determined that for purposes of clarity and certainty, the basic mechanical rules for transfer and pledge of marketable Treasury book-entry securities needed to be set out in the Federal regulations.

The second difficulty was that the provisions in the 1978 version of Article 8 could not be used as a model for the TRADES rules without significant modifications to fit the Treasury book-entry system. As a consequence, although this first proposal was based on provisions of the 1978 version of Article 8, there were some significant modifications. Treasury's goal was to clarify the rules for marketable Treasury book-entry securities to the extent possible without causing unnecessary changes in market practice.

The most problematic issue raised in the March 1986 proposal, however, was the resolution of competing claims to interests in the same securities when held through intermediaries (''book-entry custodians,'' now referred to as ''Securities Intermediaries''). In other words, under some circumstances (particularly in scenarios involving failures of intermediaries), more than one person (e.g., owner or secured creditor) could claim entitlement to a Treasury security. How should such disputes be sorted out? After considering several different alternatives to deal with this issue, all of which had some disadvantages, the initial proposal of TRADES left the resolution of questions involving competing claims to state law.

Comments on the first TRADES proposal were wide-ranging in their content and helpful. Most of the detailed comments dealt with the issue of competing claims and urged some form of bona fide purchaser rule (providing that an innocent purchaser would take a security free of prior adverse claims) and some form of a priority clearing lien for entities that perform the critical function of extending credit as a part of a clearing function in the government securities market. These and other new areas suggested by commenters were added to the second regulatory proposal published in November 1986.[19]

Another difficult issue that was raised in the TRADES rulemaking was the interaction between Federal and State law and the extent to which the Federal regulations should preempt State law. The opinions of the commentators on this point varied. The preamble to the second TRADES proposal in November, 1986 noted that:

> * * * With respect to book-entry securities, there is not an accepted body of principles [uniform state laws] that operates to provide predictable results * * * Even where such rules [the 1978 UCC Article 8] have been adopted, some of the litigation arising from recent failures of government securities dealers suggests that important legal issues are yet to be resolved that stem from some of the concepts and relationships that arise where interests in securities are transferred without the transfer of a certificate.[19a]

Because of the difficulties in drawing lines between coverage of Federal and State law, the November 1986 proposal adopted an approach of complete preemption of State law. Like the first TRADES proposal, the second proposal generated a large volume of detailed and helpful comments.

Another significant development that had an impact on the TRADES rulemaking was the passage, at about the time the November 1986 proposal was issued, of the Government Securities Act of 1986 (''GSA'').[19b] The GSA granted Treasury rulemaking authority over the government securities market, including custodial holding of government securities. It also required the registration of government securities brokers and dealers for the first time and imposed a regulatory framework that had not previously existed for those entities. Treasury exercised its authority by promulgating rules in July 1987 in the areas of financial responsibility, protection of investor securities and balances, recordkeeping, and reporting and audit. In addition, the GSA rules imposed, for the first time, standards for the safeguarding and use of government securities by depository institutions that hold such obligations in custody for the account of customers. This new regulatory framework addressed many of the practices that had been involved in dealer failures and increased customer protection for securities held in the commercial book-entry system. It also provided, for the first time, comprehensive Federal regulation of the custody practices for government securities.

In the next few years, other groups also explored many of the same issues raised in the proposed TRADES regulations. In 1988, in response to concerns raised about securities clearance and settlement as a result of the stock market break of 1987, the American Bar Association established an Advisory Committee on Settlement of Market Transactions. In addition, the Market Transactions Advisory Committee was established by the Securities and Exchange Commission under the Market Reform Act of 1990. Finally, and most significantly, a major effort to revise existing Article 8 commenced in 1991.

Under the aegis of the ALI and NCCUSL, a group of scholars and

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[16] As set forth in the May 1988 Interim Report of the Working Group on Financial Markets, ''the laws of the various states do not have uniform requirements for * * * transfers and pledges of certificated and uncertificated stocks * * * investors, market professionals and their lenders should have a single, clear set of rules for the transfer and pledge of securities similar to those being developed by the United States Treasury.'' The working group consisted of the chairpersons of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission and the Commodity Futures Trading Commission and the Department of the Treasury Under Secretary for Finance.

[17] Remarks by Alan Greenspan at the Financial Markets Conference of the Federal Reserve Bank of Atlanta, Coral Gables, Florida, March 3, 1995.

[18] 51 FR 8846 (March 14, 1986).

[19] 51 FR 43027 (November 28, 1986).

[19a] 51 FR 43029 (November 28, 1986).

[19b] Pub. L. No. 99–571, October 28, 1986, 100 Stat. 3208.

practitioners began work on a multi-year process that by 1994 produced Revised UCC Article 8. The importance of their work cannot be overstated. Representatives of Treasury, the Federal Reserve Banks and the Federal Reserve Board participated in virtually all of their drafting sessions. It soon became obvious that the drafters of Revised Article 8 were dealing with many of the issues that Treasury had considered in its earlier versions of TRADES, including the difficult questions involving the resolution of competing claims. While Treasury continued to work on TRADES and produced a third draft in 1992, Treasury ultimately concluded that it made sense to wait for work to be completed on Revised Article 8 so that Treasury would have the benefit of their final product.[19c] Treasury believes that decision was prudent.

The many difficult issues resolved by the drafters of Revised Article 8 have been of significant benefit to Treasury as it has worked on this proposal for TRADES. Based on its participation in the many drafting sessions that produced Revised Article 8, and after a detailed study, Treasury has concluded that Revised Article 8 represents a major advance in commercial law. For the first time, there is a comprehensive set of rules to govern the modern book-entry systems. Treasury agrees with Professor Rogers when he notes that, ''The present version of Article 8 [the 1978 version], which is based on legal concepts adopted to the paper-based systems of the past, is not adequate to that task in the modern world of computerized recordkeeping and global securities trading.'' [20] Accordingly, as set forth in detail below, Treasury has concluded that it is appropriate to rely on Revised Article 8 in a significant way in this proposal for TRADES.[21]

IV. Comparison of Trades and Treasury Direct

A person can hold interests in marketable Treasury book-entry securities either in TRADES [22] or TREASURY DIRECT. The following summarizes the major differences between the two systems.

As previously described, persons holding marketable Treasury book-entry securities in TRADES hold their interests in such securities in a tiered system of ownership accounts. In TRADES, Treasury, through its fiscal agents, the Federal Reserve Banks, knows the identity only of Participants (persons with a direct account relationship with a Federal Reserve Bank). While Participants may be beneficial owners of interests in marketable Treasury book-entry securities, there are many beneficial owners of such interests that are not Participants. Such beneficial owners hold their interests through one or more Securities Intermediaries such as banks, brokerage firms or securities clearing organizations.

The rights of non-Participant beneficial owners can be exercised only through Securities Intermediaries. Neither Treasury nor the Federal Reserve Banks have any obligations to a non-Participant beneficial owner of an interest in a marketable Treasury book-entry security. Two examples illustrate this principle. First, Federal Reserve Banks, as Treasury's fiscal agents, will act only on instructions of the Participant in whose Securities Account the marketable Treasury book-entry security is maintained in recording transfers of an interest in a marketable Treasury book-entry security. A beneficial owner of such an interest that is a non-Participant has no ability to direct a transfer on the books of a Federal Reserve Bank. Second, Treasury discharges its payment obligation with respect to a marketable Treasury book entry security when payment is credited to a Participant's account or paid in accordance with such Participant's instructions. Neither Treasury nor a Federal Reserve Bank has any payment obligation to a non-Participant beneficial owner of an interest in a marketable Treasury book-entry security. A non-Participant beneficial owner receives its payment when its Securities Intermediary credits such owner's account.

Persons holding marketable Treasury book-entry securities in TREASURY DIRECT, on the other hand, hold their securities accounts on records maintained by Treasury through its fiscal agents, the Federal Reserve Banks. The primary characteristic of TREASURY DIRECT is a direct account relationship between the beneficial owner of a marketable Treasury book-entry security and Treasury. In TREASURY DIRECT, Treasury discharges its payment obligation when payment is credited to the depository institution specified by the beneficial owner of the marketable Treasury book-entry security. Unlike TRADES, TREASURY DIRECT does not provide a mechanism for the exchange of cash in a sales transaction, nor are pledges of marketable Treasury book-entry securities generally recognized. Accordingly, TREASURY DIRECT is suited for persons who plan to hold their Treasury securities until maturity, and provides an alternative for investors who are concerned about holding securities through intermediaries and who do not wish to hold their interests in Treasury securities indirectly in TRADES.

V. Scope of Proposed Regulation

Just as the scope of Revised Article 8 is limited,[23] the scope of this regulation is limited. It is not a comprehensive codification of the law governing securities, transactions in securities or the law of contracts for the purchase or sale of securities. Similarly, it is not a codification of all laws that could affect a person's interest in a marketable Treasury book-entry security. For example, state laws regarding divorce or intestate succession could well affect which persons have rights in the interest in a marketable Treasury book-entry security. This regulation does not displace such laws—with the sole exception that such laws cannot affect either Treasury or the Federal Reserve Banks.

VI. Section by Section Analysis

A. Dual Book-Entry Systems

Section 357.0 sets forth that Treasury provides two systems for maintaining marketable Treasury book-entry securities—TRADES and TREASURY DIRECT. Subpart A of Part 357 of 31 CFR contains general information about TRADES and TREASURY DIRECT. Subpart B will contain the TRADES

[19c] The third TRADES proposal was published in April 1992 (57 FR 12244, April 9, 1992). In response to the comments on the second proposal, Treasury reexamined and articulated the Federal interest in the regulations. That interest was described as ''to provide that degree of certainty in the law that is needed by participants in the Government securities market to facilitate transactions in book-entry securities and to assure the continued liquidity and efficiency of the market.'' In that proposal, the extent of Federal preemption was cut back from the prior proposal, and some areas that had been included in prior proposals (e.g., warranties) were left to state law. The 1992 proposal retained provisions dealing with competing claims, while recognizing that the examination of legal principles in this area was continuing. The overall content of the rules, however, was not significantly different from the prior two proposals. Commenters to this third proposal urged Treasury to suspend its efforts and await the completion of the Revised Article 8 project. On November 12, 1993, Treasury agreed to that suggestion. (58 FR 59972, November 12, 1993).

[20] Letter from James Rogers, Reporter, Drafting Committee to Revise U.C.C. Article 8, to James Wong, Chief Consultant, (California) Senate Judiciary Committee (April 10, 1995).

[21] Copies of Article 8 are available upon request from the Bureau of the Public Debt's Public Affairs Officer, (202) 219–3302.

[22] In TRADES a person's interest in a marketable Treasury book-entry security is a Security Entitlement. See the discussion at VI.D.4. below.

[23] Prefatory Note at 12.

regulations. Subpart C contains the TREASURY DIRECT regulations. Subpart D contains miscellaneous provisions. Thus, in its totality, Part 357 sets forth in one place the complete set of governing rules for marketable Treasury securities issued in book-entry form.

B. Effective Date

Section 357.1 establishes the effective date for TRADES. Treasury contemplates that TRADES will apply to outstanding securities currently governed by 31 CFR Part 306, Subpart O. Conforming changes to Part 306 will be made with the publication of TRADES in final form. Consistent with the approach set forth in Revised Article 8 (see § 8–603 and the official comment thereto), on and after the effective date these regulations will apply to all transactions, including transactions commenced prior to the effective date.

Treasury proposes that the effective date for TRADES will be 90 days following the publication of TRADES in final form in the Federal Register. While TRADES is based in large part on Revised Article 8 that has received widespread attention in the financial community and already has been adopted in 13 states,[24] Treasury is proposing that TRADES will become effective 90 days following publication of the final TRADES rule to ensure a smooth transition to TRADES. Such an effective date, when combined with TRADES being published in proposed form with a 60-day comment period, should provide sufficient time for an orderly transition to the new TRADES rules. Treasury specifically seeks comments on whether the proposed effective date of TRADES is sufficient to permit an orderly transition.

C. Definitions

Section 357.2 contains definitions for use in Subparts B and C. While most of the definitions are straightforward, four terms—Participant, Entitlement Holder, Security Entitlement and Securities Intermediary—are critical to an understanding of the proposed TRADES regulations.

1. Participant

A Participant is a person that has an account relationship in its name with a Federal Reserve Bank. Accordingly, the Federal Reserve Bank and Treasury know both the identity of the persons maintaining these accounts and the marketable Treasury book-entry securities held in these accounts.

2. Securities Intermediary

Securities Intermediaries are persons (other than individuals, except as described below) that are in the business of holding interests in marketable Treasury book-entry securities for others. Participants can be, and usually are, Securities Intermediaries. In addition, entities such as clearing corporations, banks, brokers and dealers can be Securities Intermediaries in a single chain of ownership of a Treasury security. An individual, unless registered as a broker or dealer under the federal securities laws, cannot be a Securities Intermediary. As an illustration of a possible chain of ownership, in the following chart, the Federal Reserve Bank, Participant and Broker-Dealer are all Securities Intermediaries.

Treasury

Federal Reserve Bank

Participant

Broker-Dealer

Individual Holder

3. Entitlement Holder

An Entitlement Holder is any person for whom a Securities Intermediary holds an interest in a marketable Treasury book-entry security. In the above example Individual Holder, Broker-dealer and Participant are all Entitlement Holders. Thus, a person can be both a Securities Intermediary and an Entitlement Holder.

4. Security Entitlement

A Security Entitlement is the interest that an Entitlement Holder has in a marketable Treasury book-entry security. In the example, Participant, Broker-Dealer and Individual Holder all hold Security Entitlements. The rights and property interests associated with a Security Entitlement of a Participant held on the books of a Federal Reserve Bank (''Participant's Security Entitlement'') are, however, different from the rights and property interests associated with other Security Entitlements. As provided in Section 357.10(a), Federal law defines the scope and nature of a Participant's Security Entitlement. While TRADES is based in large part on Revised Article 8, the meaning of Security Entitlement under federal law is different than under Revised Article 8. For example, Participants have a direct claim against the United States for interest and principal even though, under state law, an Entitlement Holder would only have a claim against its Securities Intermediary for such payment. To the extent not inconsistent with this regulation, the scope and nature of a Security Entitlement of an Entitlement Holder below the level of a Participant (Broker-dealer and Individual Holder in the example above), is defined by applicable state law, as determined pursuant to Section 357.11.

D. Law Governing the United States and Reserve Banks

Section 357.10(a) provides that the rights and obligations of the United States and the Federal Reserve Banks (with one exception detailed below), with respect to both the TRADES system and marketable Treasury book-entry securities maintained in TRADES are governed solely and exclusively by Federal law. Thus, claims against the United States and Federal Reserve Banks of both Participants and all other persons with an interest (or claiming an interest) in a marketable Treasury book-entry security maintained in TRADES are governed by Federal law. Federal law is defined to include TRADES, the offering circulars pursuant to which the Treasury securities are sold, the offering announcements and Federal Reserve Bank Operating Circulars. Prior to March 1, 1993, the terms of each offering of marketable Treasury securities, except for Treasury bills, were set forth in an offering circular published in the Federal Register.[25] Since March 1, 1993, all marketable Treasury book-entry securities have been offered pursuant to a uniform offering circular set forth at 31 CFR Part 356.

While TRADES is based in large measure on Revised Article 8, a fundamental principle of these regulations (and a divergence from Revised Article 8) is that the obligations of the issuer (the United States) and the Federal Reserve Banks, as well as all claims with respect to TRADES or a marketable Treasury book-entry security against Treasury or a Federal Reserve Bank, are governed solely by Federal law. Thus, for example, those parts of Revised Article 8 that detail obligations of issuers (or their agents) of securities are not applicable to either the United States or Federal Reserve Banks. In addition, neither the United States nor Federal Reserve Banks have any obligations to persons holding their interests in a marketable Treasury book-entry security at levels below the level

[24] As of January 1, 1996, those states are: Arizona, Arkansas, Idaho, Illinois, Indiana, Louisiana, Minnesota, Nebraska, Oklahoma, Oregon, Texas, Washington and West Virginia.

[25] Treasury bills were issued pursuant to one master offering circular (31 CFR Part 349, removed, and replaced by 31 CFR Part 356) effective March 1, 1993. (58 FR 412)

of a Participant or to any other person claiming an interest in a marketable Treasury book-entry security (with the limited exception set out in Section 357.12(c)(1)). Thus, there are no derivative rights against either the United States or the Federal Reserve Banks.

Section 357.10(b) sets forth the law applicable with respect to security interests granted to Federal Reserve Banks. There are three possible ways that such security interests are granted. First, security interests granted to a Federal Reserve Bank by a Participant in which such Bank does not mark its books are governed by the law of the state in which the head office of the Federal Reserve Bank is located. If the state in which the head office of a Federal Reserve Bank is located has not adopted Revised Article 8, the law of such jurisdiction is deemed to include Revised Article 8. (See discussion of federal pre-emption below). Second, if a Federal Reserve Bank does not mark its books, a security interest granted by a non-Participant is governed by the law specified in the agreement with a Federal Reserve Bank. Third, if a Participant or non-Participant grants a Federal Reserve Bank a security interest and the Federal Reserve Bank marks its books, Section 357.12(c)(1) governs.

For purposes of applying the state law specified in Section 357.10(b), Federal Reserve Banks are treated as clearing corporations. As a result, security interests granted under Section 357.12(c)(2) in favor of a Federal Reserve Bank have the same priority as security interests granted to other clearing corporations under state law.

E. Law Governing Other Interests

1. Law Governing the Rights and Obligation of Participants and Third Parties

Section 357.11 is a choice of law rule. The substantive matters subject to this choice of law rule are set forth in Section 357.11(a). The matters set forth in Section 357.11(a) are meant to be coextensive with those matters covered by Revised Article 8 with respect to a person's interest in a marketable Treasury book-entry security (other than those related to a person's relationship to Treasury or a Federal Reserve Bank which are governed solely by federal law). For purposes of this choice of law rules, both Participants and Federal Reserve Banks are Securities Intermediaries.

Section 357.11(b) adopts Revised Article 8's choice of law rule. Section 357.11(c) sets forth a special choice of law rule with respect to security interests perfected by filing. Generally, the law applicable to the Securities Intermediary will govern matters involving an interest in a book-entry security held through that intermediary. This approach is not followed with respect to security interests created by filing. In those cases, the law applicable to the debtor is the governing law. Since filing systems are based on the location of the debtor, this approach should reduce uncertainty and preserve the normal practice of searching records based on the debtor's location.[26]

Section 357.11(d) provides for the application of Revised Article 8 if the choice of law analysis required by Section 357.11(b) results in the choice of the law of a jurisdiction that has not yet adopted Revised Article 8. This section also provides that, for purposes of applying state law, the Federal Reserve Banks are clearing corporations and Participants' interests in book-entry securities are Security Entitlements.

2. Limited Scope of Federal Preemption

As noted above, in an earlier TRADES proposal Treasury contemplated adopting a comprehensive regulation governing the rights of all persons in marketable Treasury book-entry securities held in TRADES. Such an approach was proposed because Treasury believed that a uniform rule was necessary to preserve the efficiency and liquidity of the market for Treasury securities—the most liquid and efficient market in the world. Treasury believed then, and believes now, that the material rights of a holder in the United States of an interest in a Treasury security should not vary solely by virtue of such holder's geographic location or the location of the financial institution through which it holds its interest in Treasury securities. In light of Revised Article 8, Treasury has determined that it is possible to achieve this uniformity without developing an independent system of Federal commercial law.[27] The questions inherent in a tiered system of ownership have been analyzed, and, in Treasury's view, satisfactorily addressed by Revised Article 8.

As of the date of this release, 13 states have adopted Revised Article 8 and Treasury understands that it will soon be adopted in additional states. As with all uniform laws, the adoption process takes several years. In order to assure uniformity, in light of the unavoidable delays in the state-by-state adoption process of Revised Article 8, Treasury is proposing a limited form of preemption. As provided in both Sections 357.10(c) and 357.11(d), if the choice of law rules set forth in TRADES would lead to the application of the law of a state that has not yet adopted Revised Article 8, TRADES will apply Revised Article 8 (with conforming and miscellaneous amendments to other Articles) in the form approved by the ALI and NCCUSL. Treasury expects that these provisions will be operative only during the state-by state adoption process and would plan to amend TRADES to delete reference to these provisions once the adoption process has been completed.

While Revised Article 8 is defined to mean the official text of Article 8 as approved by the ALI and NCCUSL, Treasury recognizes that states may make minor changes in that text when adopting Article 8. Treasury has concluded that minor changes should not prevent Revised Article 8, as adopted by a state, from being the appropriate law. In other words, if a state passes a version of Article 8 that is substantially identical to Revised Article 8, reference to Revised Article 8 (as defined) would no longer be required. This approach represents a significantly reduced form of preemption of state law from former versions of TRADES and preserves Treasury's preeminent interest in a uniform system of rules applicable to all holders of interests in marketable Treasury book-entry securities.

F. Obtaining an Interest in a Book-Entry Security

1. Creation of a Participant's Security Entitlement

A Participant's interest in a marketable Treasury book-entry security is a Securities Entitlement. Section 357.12(a) provides that a Participant's Securities Entitlement is created when a Federal Reserve Bank indicates by book entry that a Book-entry Security has been credited to a Participant's Securities Account. Instead of the concept of initial credit and transfer of a marketable Treasury book-entry security, as set forth in the existing regulations, this proposal focuses on the creation of a Participant's Securities Entitlement and, in this way, is similar to Section 8–501 of Revised Article 8.

The regulation focuses on the creation of a Participant's Security Entitlement because Security Entitlement is the term used to describe the Participant's interest in a marketable Treasury book-

[26] The substantive effect of filing is limited and applies only in states which have adopted Revised Article 8. Since the effect of filing is a unique state law matter, in this one area, Treasury has determined that possible lack of uniformity does not justify altering state law.

[27] As noted previously, the substantive scope of this regulation is limited.

entry security. Once a Participant obtains that interest, the regulation sets forth what that interest is. Thus, as provided in Section 357.10, federal law describes a Participant's rights against the United States and the Federal Reserve Bank where it maintains its Securities Account. To the extent not inconsistent with Section 357.10, Section 357.11 describes the applicable law to determine Participants' rights and obligations with respect to all other persons. Under these regulations, Participants can still transfer their interests in a marketable Treasury book-entry security as they do today—by issuing a Transfer Message to the Federal Reserve Bank where they hold such interest. Transfer of interests between Participants can occur by a Participant holding such interest issuing a Transfer Message. As a result of such message, the Federal Reserve Bank will make a book entry in favor of the receiving Participant (thereby creating a Security Entitlement in favor of such Participant) and also will make a book entry deleting the initiator Participant's interest in such marketable Treasury book-entry security (thereby eliminating that Participant's Security Entitlement). In addition, if authorized under applicable state law, Participants may enter into agreements with other Participants that, as to the Participants, constitute a transfer. Such action is without effect to either the United States or a Federal Reserve Bank.

2. Creation and Priority of a Security Interest

Security Interests of the United States.

Section 357.12(b) provides that a security interest in favor of the United States has priority over the interests of any other person in a marketable Treasury book-entry security. The United States obtains security interests in Treasury securities as collateral to secure funds in a variety of situations such as Treasury Tax and Loan accounts; government agency funds or funds under the control of the Federal Courts held at financial institutions; and securities pledged in lieu of surety by contractors and others. The priority provided the United States in these situations is consistent with existing law.

In addition, Federal Reserve Banks do recognize on their books and records security interests in favor of the United States. In that situation, the Federal Reserve Bank will not transfer the security without the permission of the United States. This section provides that a Federal Reserve Bank may rely exclusively on the directions of an authorized representative of the United States to transfer a security and is protected in so relying.

Security Interests on the Books of a Reserve Bank

In a limited number of situations, Federal Reserve Banks will agree to record a security interest on their books. It is important to note that there is no obligation for either Treasury or a Federal Reserve Bank to agree to record a security interest on the books of a Federal Reserve Bank. If they do so, the security interest is perfected when the Federal Reserve Bank records a security interest on its books. In addition, the security interest has priority over all other interests in the marketable Treasury book-entry security except an interest of the United States.

Other Security Interests

As provided in Section 357.12(c)(2), Participants can create security interests in any manner authorized by applicable state law.[28] The perfection and priority of such interests shall be governed by such applicable law. In applying such law, when a Participant grants a Federal Reserve Bank a security interest, the Federal Reserve Bank is treated as a clearing corporation.

If a person perfects a security interest pursuant to Section 357.12(c)(2) obligations of the Treasury and the Federal Reserve Banks with respect to that security interest are limited. Specifically, unless special arrangements are agreed to by the United States or a Federal Reserve Bank pursuant to Section 357.12(c)(1), neither the Federal Reserve Bank nor the United States will recognize the interests of any person other than the person in whose securities account the interest in a marketable Treasury book-entry security is maintained. This does not mean that such a security interest is invalid. Rather, it means that the creditor's recourse will be solely against the debtor Participant or other third party.

G. Rights and Obligations of Treasury and the Reserve Banks

1. Adverse Claims

Section 357.13(a) sets forth the general rule that, except as provided in Section 357.12(c)(1), Treasury and the Federal Reserve Banks will recognize only the interest of a Participant in a marketable Treasury book-entry security in whose Securities Account such interest is maintained.

As noted previously, marketable Treasury book-entry securities maintained in TRADES are held in a tiered system of ownership. The records of a Federal Reserve Bank reflect only the ownership at the top tier. Institutions maintaining a Securities Account with a Federal Reserve Bank frequently will hold interests in marketable Treasury book-entry securities for their customers (which can include broker-dealers and other Securities Intermediaries) and in certain cases those customers will hold interests in securities for their customers. Accordingly, neither Treasury nor a Federal Reserve Bank will know the identity or recognize a claim of a Participant's customer if that customer were to present it to Treasury or a Federal Reserve Bank.

In addition, except as provided in Section 357.12(c)(1), neither the Treasury nor a Federal Reserve Bank will recognize the claims of any other person asserting a claim in a marketable Treasury book-entry security. Persons at levels below the Participant level must present their claims to their Securities Intermediary.

2. Payment Obligations

Section 357.13(b) contains a corollary to the rule set forth in Section 357.13(a). This section provides that Treasury discharges its payment responsibility with respect to a security that it has issued when a Federal Reserve Bank credits the funds account of a Participant with amounts due on that security or makes payment in such other manner specified by the Participant. This is consistent with existing law and the first TRADES proposal.[29] In Revised Article 8, the issuer discharges its obligations when it makes payment to an owner registered on its books. Under common commercial practice, the registered owner in the indirect system may be a clearing corporation or the clearing corporation's nominee. Unlike Revised Article 8, even though Federal Reserve Banks are deemed to be clearing corporations, Treasury remains liable until payment is made to a Participant. Section 357.13(b)(2) establishes the mechanism of how marketable Treasury book-entry securities are paid at maturity. This paragraph makes clear that such payment takes place automatically and that, unlike with physical certificates, there is no act of presentment required by the Participant.

H. Authority of Reserve Banks

Section 357.14 provides that Federal Reserve Banks are authorized, as fiscal agents of Treasury, to operate the

[28] If the state has not yet adopted Revised Article 8, applicable state law would be Revised Article 8.

[29] 51 FR 8846, 8848 (March 14, 1986).

commercial book-entry system for Treasury.

I. Notices

Section 357.44 contains a revised version of a provision that appeared in earlier TRADES proposals. Similar to the rule in Revised Article 8 (see § 8–112), it provides where certain legal process should be directed. While providing instructions on where notice should be directed, it makes clear that the regulations do not establish whether a Federal Reserve Bank is required to honor any such order or notice.

VII. Procedural Requirements

This proposed rule does not meet the criteria for a ''significant regulatory action'' pursuant to Executive Order 12866.

Although this proposed rule is being issued in proposed form to secure the benefit of public comment, the notice and public comment procedures requirements of the Administrative Procedure Act are inapplicable, pursuant to 5 U.S.C. 553(a)(2).

As no notice of proposed rulemaking is required, the provisions of the Regulatory Flexibility Act (5 U.S.C. 601, *et seq.*) do not apply.

There are no collections of information contained in this proposed rule. Therefore, the Paperwork Reduction Act does not apply.

List of Subjects in 31 CFR Part 357

Bonds, Electronic funds transfer, Federal Reserve System, Government securities, Securities.

For the reasons set forth in the preamble, Title 31, Chapter II, Subchapter B, Part 357 is proposed to be amended as follows:

PART 357—[AMENDED]

1. The authority citation for Part 357 continues to read as follows:

Authority: 31 U.S.C. Chapter 31; 5 U.S.C. 301; 12 U.S.C. 391.

2–3. Sections 357.0 and 357.1 are added to read as follows:

§ 357.0 Dual book-entry systems.

(a) Treasury securities shall be maintained in either of the following two book-entry systems:

(1) *Treasury/Reserve Automated Debt Entry System (TRADES).* A Treasury security is maintained in TRADES if it is credited by a Federal Reserve Bank to a Participant's Securities Account. See Subpart B for rules pertaining to TRADES.

(2) *TREASURY DIRECT Book-entry Securities System (TREASURY DIRECT).* A Treasury security is maintained in TREASURY DIRECT if it is credited to a TREASURY DIRECT account as described in Section 357.20 of this Part. Such accounts may be accessed by investors in accordance with Subpart C through any Federal Reserve Bank or the Bureau of the Public Debt. *See* Subpart C for rules pertaining to TREASURY DIRECT.

(b) A Treasury security eligible to be maintained in TREASURY DIRECT under the terms of its offering circular or pursuant to notice published by the Secretary may be transferred to or from an account in TRADES from or to an account in TREASURY DIRECT in accordance with Section 357.22(a).

§ 357.1 Effective date.

Subpart B of this Part, and other changes made to this Part with the publication of Subpart B in final form, are effective on and after [insert date 90 calendar days after the date of publication in final form]. Subpart C and other provisions in this Part published in final form on May 16, 1986, or as amended prior to [insert date 90 calendar days after the date of publication in final form] (related to TREASURY DIRECT) remain in effect.

§ 357.3 [Redesignated and § 357.2; amended]

4. Section 357.3 is redesignated § 357.2, the introductory text of the section is designated as paragraph (a) introductory text, the definition of *security interest and pledge* is removed, the definition of *TRADES* is revised, the remaining definitions are added in alphabetical order, and a new paragraph (b) is added to read as follows:

§ 357.2 Definitions.

(a) * * *

* * * * *

Book-entry Security means, in Subpart B, a Treasury Security maintained in TRADES and, in Subpart C, a Treasury Security maintained in TREASURY DIRECT.

* * * * *

Entitlement Holder means a Person to whose account an interest in a Book-entry Security is credited on the records of a Securities Intermediary.

* * * * *

Federal Reserve Bank Operating Circular means the uniform publication issued by each Federal Reserve Bank that sets forth the terms and conditions under which the Reserve Bank maintains Book-entry Securities accounts and transfers Book-entry Securities.

* * * * *

Funds Account means a reserve and/or clearing account at a Federal Reserve Bank to which debits or credits are posted for transfers against payment, book-entry securities transaction fees, or principal and interest payments.

* * * * *

Issue means a group of securities, as defined in this section, that is identified by the same CUSIP (*C*ommittee on *U*niform *S*ecurities *I*dentification *P*ractices) number.

* * * * *

Participant means a Person that maintains a Participant's Securities Account with a Federal Reserve Bank.

Participant's Securities Account means an account in the name of a Participant at a Federal Reserve Bank to which Book-entry Securities held for a Participant are or may be credited.

Person means and includes an individual, corporation, company, governmental entity, association, firm, partnership, trust, estate, and any other similar organization, but does not mean or include the United States or a Federal Reserve Bank.

* * * * *

Revised Article 8 means Uniform Commercial Code, Revised Article 8, Investment Securities (with Conforming and Miscellaneous Amendments to Articles 1, 4, 5, 9, and 10) 1994 Official Text, as set forth in Appendix B of this part.

Securities Intermediary means:

(1) A Person that is registered as a ''clearing agency'' under the federal securities laws; a Federal Reserve Bank; any other person that provides clearance or settlement services with respect to a Book-entry Security that would require it to register as a clearing agency under the federal securities laws but for an exclusion or exemption from the registration requirement, if its activities as a clearing corporation, including promulgation of rules, are subject to regulation by a federal or state governmental authority; or

(2) A Person (other than an individual, unless such individual is registered as a broker or dealer under the federal securities laws) including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.

Security means a bill, note, or bond, each as defined in this section. It also means any other obligation issued by the Department that, by the terms of the applicable offering circular or announcement, is made subject to this Part. Solely for purposes of this Part, it also means:

(1) the interest and principal components of a security eligible for Separate Trading of Registered Interest

and Principal of Securities (''STRIPS''), if such security has been divided into such components as authorized by the express terms of the offering circular under which the security was issued and the components are maintained separately on the books of one or more Federal Reserve Banks; and

(2) the interest coupons that have been converted to book-entry form under the Treasury's Coupons Under Book-Entry Safekeeping Program (''CUBES''), pursuant to agreement and the regulations in 31 CFR Part 358.

Security Entitlement means the rights and property interest of an Entitlement Holder with respect to a Book-entry Security.

* * * * *

TRADES is the Treasury/Reserve Automated Debt Entry System, also referred to as the commercial book-entry system.

* * * * *

Transfer Message means an instruction of a Participant to a Federal Reserve Bank to effect a transfer of a Book-entry Security maintained in TRADES, as set forth in Federal Reserve Bank Operating Circulars.

* * * * *

(b) Unless the context requires otherwise, terms not defined in this section have the meanings as set forth in Revised Article 8.

5. Subpart B, consisting of Sections 357.10 through 357.14, is added to read as follows:

Subpart B—Treasury/Reserve Automated Debt Entry System (TRADES)

357.10 Law governing rights and obligations of United States and Federal Reserve Banks; rights of any Person against United States and Federal Reserve Banks.
357.11 Law governing other interests.
157.12 Creation of Participant's Security Entitlement; security interests.
357.13 Obligations of United States; no adverse claims.
357.14 Authority of Federal Reserve Banks.

Subpart B—Treasury/Reserve Automated Debt Entry System (TRADES)

§ 357.10 Law governing rights and obligations of United States and Federal Reserve Banks; rights of any Person against United States and Federal Reserve Banks.

(a) Except as provided in paragraph (b) of this section, the rights and obligations of the United States and the Federal Reserve Banks with respect to: a Book-entry Security or Security Entitlement and the operation of the Treasury book-entry system; and the rights of any Person, including a Participant, against the United States and the Federal Reserve Banks with respect to: a Book-entry Security or Security Entitlement and the operation of the Treasury book-entry system; are governed solely by Treasury regulations, including the regulations of this Part, the applicable offering circular (which is 31 CFR Part 356, in the case of securities issued on and after March 1, 1993), the announcement of the offering, and Federal Reserve Bank Operating Circulars.

(b) A security interest granted to a Federal Reserve Bank, in the manner described in Section 357.12(c)(2), is governed by the law (not including the conflict-of-law rules) of the jurisdiction where the head office of the Federal Reserve Bank maintaining the Participant's Securities Account is located. For purposes of the application of such law, the Federal Reserve Bank shall be deemed a clearing corporation. A security interest granted to a Federal Reserve Bank by a Person that is not a Participant, is governed by the law specified in the agreement between the Federal Reserve Bank and the non-Participant.

(c) If the jurisdiction specified in paragraph (b) of this section is a State or territory or possession of the United States that has not adopted Revised Article 8, then the law specified in paragraph (b) shall be Revised Article 8.

§ 357.11 Law governing other interests.

(a) To the extent not inconsistent with these regulations, the law (not including the conflict-of-law rules) of a Securities Intermediary's jurisdiction governs:

(1) the acquisition of a Security Entitlement from the Securities Intermediary;

(2) the rights and duties of the Securities Intermediary and Entitlement Holder arising out of a Security Entitlement;

(3) whether the Securities Intermediary owes any duties to an adverse claimant to a Security Entitlement;

(4) whether an adverse claim can be asserted against a Person who acquires a Security Entitlement from the Securities Intermediary or a Person who purchases a Security Entitlement or interest therein from an Entitlement Holder; and

(5) except as otherwise provided in paragraph (c), the perfection, effect of perfection or non-perfection and priority of a security interest in a Security Entitlement.

(b) The following rules determine a ''Securities Intermediary's jurisdiction'' for purposes of this section:

(1) If an agreement between the Securities Intermediary and its Entitlement Holder specifies that it is governed by the law of a particular jurisdiction, that jurisdiction is the Securities Intermediary's jurisdiction.

(2) If an agreement between the Securities Intermediary and its Entitlement Holder does not specify the governing law as provided in paragraph (b)(1), but expressly specifies that the securities account is maintained at an office in a particular jurisdiction, that jurisdiction is the Securities Intermediary's jurisdiction.

(3) If an agreement between the Securities Intermediary and its Entitlement Holder does not specify a jurisdiction as provided in paragraph (b)(1) or (b)(2), the Securities Intermediary's jurisdiction is the jurisdiction in which is located the office identified in an account statement as the office serving the Entitlement Holder's account.

(4) If an agreement between the Securities Intermediary and its Entitlement Holder does not specify a jurisdiction as provided in paragraph (b)(1) or (b)(2) and an account statement does not identify an office serving the Entitlement Holder's account as provided in paragraph (b)(3), the Securities Intermediary's jurisdiction is the jurisdiction in which is located the chief executive office of the Securities Intermediary.

(c) Notwithstanding the general rule in paragraph (a)(5) of this section, the law (but not the conflict-of-law rules) of the jurisdiction in which the Person creating a security interest is located governs whether such security interest may be perfected by filing a financing statement and the effect of perfection or nonperfection and priority of such security interest.

(d) If the jurisdiction specified in paragraph (b) of this section is a State or territory or possession of the United States that has not adopted Revised Article 8, then the law for the matters specified in paragraph (a) of this section shall be Revised Article 8. For purposes of the application of the matters specified in paragraph (a) of this section, the Federal Reserve Bank maintaining the Securities Account shall be deemed a clearing corporation, and the Participant's interest in a Book-entry Security is a Security Entitlement.

§ 357.12 Creation of Participant's Security Entitlement; security interests.

(a) A Participant's Security Entitlement is created when a Federal

Reserve Bank indicates by book entry that a Book-entry Security has been credited to a Participant's Securities Account.

(b) A security interest in a Security Entitlement of a Participant in favor of the United States to secure deposits of public money, including without limitation deposits to the Treasury tax and loan accounts, or other security interest in favor of the United States that is required by Federal statute, regulation, or agreement, and that is marked on the books of a Federal Reserve Bank is thereby effected and perfected, and has priority over any other interest in the securities. Where a security interest in favor of the United States in a Security Entitlement of a Participant is marked on the books of a Federal Reserve Bank, the Reserve Bank may rely, and is protected in relying, exclusively on the order of an authorized representative of the United States directing the transfer of the security. For purposes of this paragraph, an ''authorized representative of the United States'' is the official designated in the applicable regulations or agreement to which a Federal Reserve Bank is a party, governing the security interest.

(c)(1) The United States and the Federal Reserve Banks have no obligation to agree to act on behalf of any Person or to recognize the interest of any transferee of a security interest or other limited interest in favor of any Person except to the extent of any specific requirement of Federal law or regulation or to the extent set forth in any specific agreement with the Federal Reserve Bank on whose books the interest of the Participant is recorded. To the extent required by such law or regulation or set forth in an agreement with a Federal Reserve Bank, or the Federal Reserve Bank Operating Circular, a security interest in a Security Entitlement that is in favor of a Federal Reserve Bank or a Person may be created and perfected by a Federal Reserve Bank marking its books to record the security interest. Except as provided in paragraph (b) of this section, a security interest in a Security Entitlement marked on the books of a Federal Reserve Bank shall have priority over any other interest in the securities.

(2) In addition to the method provided in paragraph (c)(1) of this section, a security interest, including a security interest in favor of a Federal Reserve Bank, may be perfected by any method by which a security interest may be perfected under applicable law as described in Section 357.10(b) or Section 357.11. The perfection, effect of perfection or non-perfection and priority of a security interest are governed by such applicable law. A security interest in favor of a Federal Reserve Bank shall be treated as a security interest in favor of a clearing corporation in all respects under such law, including with respect to the effect of perfection and priority of such security interest. A Federal Reserve Bank Operating Circular shall be treated as a rule adopted by a clearing corporation for such purposes.

§ 357.13 Obligations of United States; no adverse claims.

(a) Except as provided in Section 357.12(b) and (c)(1), for the purposes of this Subpart B, the United States and the Federal Reserve Banks shall treat the Participant to whose Securities Account an interest in a Book-entry Security has been credited as the person exclusively entitled to issue a Transfer Message, to receive interest and other payments with respect thereof and otherwise to exercise all the rights and powers with respect to such Security, notwithstanding any information or notice to the contrary. Neither the Federal Reserve Banks nor Treasury is liable to a Person asserting or having an adverse claim to a Security Entitlement or to a Book-entry Security in a Participant's Securities Account, including any such claim arising as a result of the transfer or disposition of a Book-entry Security by a Federal Reserve Bank pursuant to a Transfer Message that the Federal Reserve Bank reasonably believes to be genuine.

(b) The obligation of the United States to make payments of interest and principal with respect to Book-entry Securities is discharged at the time payment in the appropriate amount is made as follows:

(1) Interest on Book-entry Securities is either credited by a Federal Reserve Bank to a Funds Account maintained at such Bank or otherwise paid as directed by the Participant.

(2) Book-entry Securities are redeemed in accordance with their terms by a Federal Reserve Bank withdrawing the securities from the Participant's Securities Account in which they are maintained and by either crediting the amount of the redemption proceeds, including both principal and interest, where applicable, to a Funds Account at such Bank or otherwise paying such principal and interest as directed by the Participant. No action by the Participant is required in connection with the redemption of a Book-entry Security.

§ 357.14 Authority of Federal Reserve Banks.

(a) Each Federal Reserve Bank is hereby authorized as fiscal agent of the United States to perform functions with respect to the issuance of Book-entry Securities offered and sold by the Department to which this Subpart applies, in accordance with the terms of the applicable offering circular and with procedures established by the Department; to service and maintain Book-entry Securities in accounts established for such purposes; to make payments of principal and interest, as directed by the Department; to effect transfer of Book-entry Securities between Participants' Securities Accounts as directed by the Participants; and to perform such other duties as fiscal agent as may be requested by the Department.

(b) Each Federal Reserve Bank may issue Operating Circulars not inconsistent with this Part, governing the details of its handling of Book-entry Securities, Security Entitlements, and the operation of the book-entry system under this Part.

6. In Subpart D, Section 357.41 is revised and the text of §§ 357.42 and 357.44 are added, to read as follows:

Subpart D—Additional Provisions

* * * * *

§ 357.41 Waiver of regulations.

The Secretary reserves the right, in the Secretary's discretion, to waive any provision(s) of these regulations in any case or class of cases for the convenience of the United States or in order to relieve any person(s) of unnecessary hardship, if such action is not inconsistent with law, does not adversely affect any substantial existing rights, and the Secretary is satisfied that such action will not subject the United States to any substantial expense or liability.

§ 357.42 Liability of Department and Federal Reserve Banks.

The Department and the Federal Reserve Banks may rely on the information provided in a tender, transaction request form, or Transfer Message, and are not required to verify the information. The Department and the Federal Reserve Banks shall not be liable for any action taken in accordance with the information set out in a tender, transaction request form, or Transfer Message, or evidence submitted in support thereof.

* * * * *

§ 357.44 Notice of attachment for securities in TRADES.

The interest of a debtor in a Security Entitlement may be reached by a creditor only by legal process upon the Securities Intermediary with whom the debtor's securities account is maintained, except where a Security Entitlement is maintained in the name of a secured party, in which case the debtor's interest may be reached by legal process upon the secured party. These regulations do not purport to establish whether a Federal Reserve Bank is required to honor an order or other notice of attachment in any particular case or class of cases.

* * * * *

7. Appendix B and Appendix C to Part 357 are added and reserved as follows:

Appendix B to Part 357—Revised Article 8 [Reserved]

Appendix C to Part 357—TRADES Commentary [Reserved]

Dated: February 22, 1996.

Gerald Murphy,

Fiscal Assistant Secretary.

[FR Doc. 96–4481 Filed 3–1–96; 8:45 am]

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