

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: Final rule.

SUMMARY: The Department of the Treasury is publishing a final rule that, on and after the effective date, will govern Treasury bonds, notes, and bills (Treasury securities) in book-entry form held in the commercial book-entry system. The rule incorporates recent and significant changes in commercial law addressing the holdings of securities in book-entry form through financial intermediaries. The rule replaces existing Treasury regulations that contain outdated legal concepts.

EFFECTIVE DATE: January 1, 1997. The incorporation by reference of certain publications listed in the regulations is approved by the Director of the Federal Register as of January 1, 1997.

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<http://www.ustreas.gov/treasury/bureaus/pubdebt/pubdebt.html>.

SUPPLEMENTARY INFORMATION:**I. Background**

On March 4, 1996, the Department published a proposed rule that would govern securities held in the commercial book-entry system, now referred to as the Treasury/Reserve Automated Debt Entry System ("TRADES"). 61 FR 8420. Eleven written comment letters were received in response to that proposed rule. All but one of the comment letters were very supportive of the proposed rule. Most commenters recommended adoption of the proposed rule with various suggested clarifications. The Department found the comments extremely useful in making the revisions described herein. Although some minor comments are not addressed, all comments have been considered in the formulation of this final rule.

As indicated in the March 4 release, Treasury will include commentary on

TRADES in the Code of Federal Regulations. This commentary can be found in Appendix B.

Comments from several persons overlapped and those comments addressed three general areas:

(1) The scope of federal preemption and related issues involving state variations on Revised Article 8 of the UCC as well as Treasury procedures and notice regarding acceptance of state enactments of Revised Article 8;

(2) Coordination as to timeframes and notices to facilitate revision and issuance of parallel rules for book-entry securities of Government Sponsored Enterprises (GSEs) to conform to the final TRADES rule; and

(3) The need for further explanation and clarification, especially the inclusion of hypotheticals, to illustrate how TRADES will apply to a variety of transaction scenarios of varying complexity, including the application of the federal law to transactions involving clearing banks.

II. General Comment Discussion

In the March 4 proposal, Treasury set forth its conclusion that, because of the size and importance of the Treasury market, uniformity of treatment of holders of interests in Treasury securities was essential. In addition, Treasury set forth in some detail the reasons it had concluded that Revised Article 8 was an appropriate vehicle to use to obtain that uniformity. As of March 4, 13 states had adopted Revised Article 8. As of the date of this release 28 states¹ have adopted Revised Article 8 and it has been introduced in 4 additional states and the District of Columbia.² This remarkable progress reflects strong support for the legal concepts set forth in Revised Article 8 and supports Treasury's decision to base TRADES on Revised Article 8, which is incorporated by reference in this final rule.

In the March 4 release, Treasury proposed achieving uniformity for Treasury securities in two ways. First, Section 357.10(a) established a rule of Federal preemption in describing the rights and obligations of Treasury and the Federal Reserve Banks. Second, TRADES established a choice of law rule that mandated use of Revised Article 8 in the event the state determined by the application of the

choice of law rule had not adopted Revised Article 8.

Commenters generally supported Treasury's conclusion that uniformity was important for the market and investors in Treasury securities. In addition commenters were supportive of the use of Revised Article 8 to achieve this uniformity. Three different questions, however, were raised about the manner in which Treasury achieved uniformity and used Revised Article 8.

A. Federal Preemption

First, 5 commenters questioned whether §§ 357.10(c) and 357.11(d) were intended to be a complete or limited preemption of a state's law if the state had not adopted Revised Article 8. As set forth in the March 4 release, the preemption in TRADES is limited. See the commentary in Appendix B. In order to clarify this issue, Treasury has adopted language in both §§ 357.10(c) and 357.11(d) suggested by a commenter to make the limited nature of the preemption clearer. This language provides that, if a state has not adopted Revised Article 8, that state's laws shall be viewed as though that state had adopted Revised Article 8.

Second, 4 commenters noted that while in the discussion section of the March 4 release Treasury stated that minor variations made by a state in adopting Revised Article 8 would not affect Treasury's conclusion that a state had adopted Revised Article 8, the language of the proposed rule had no similar qualification. Further, commenters noted that while the standard in the commentary seemed appropriate, determination of what constituted minor variations could be difficult. In response to these comments, and in an attempt to provide certainty, Treasury is taking the following actions. Treasury has reviewed the form of Revised Article 8 adopted by the 28 states³ that have adopted Revised Article 8 as of the date of this release and has concluded that the changes made by these states indeed are minor. Therefore, Treasury has concluded that they all are substantially similar to Revised Article 8. Accordingly, if either § 357.10(b) or 357.11(a) directs a person to one of these 28 states, the provisions of §§ 357.10(c) and 357.11(d) are not applicable. In addition, as additional states adopt Revised Article 8, Treasury will, after review of the statute, publish in the Federal Register a notice setting forth its conclusion as to whether §§ 357.10(c) and 357.11(d) remain applicable to those states.

¹ Alabama, Alaska, Arizona, Arkansas, Colorado, Idaho, Iowa, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Nebraska, New Mexico, Oklahoma, Oregon, Pennsylvania, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wyoming.

² California, District of Columbia, Hawaii, New York, Ohio.

³ See Note 1 *supra*.

Third, a commenter raised a question of what Treasury would do in the event a state adopted Revised Article 8 and then subsequently amended Revised Article 8 in a fashion that resulted in an unsatisfactory lack of uniformity. Treasury believes such an event is unlikely. In addition, once Treasury has announced its determination that a state has adopted Revised Article 8, the market is entitled to rely on that decision.⁴ Nonetheless, if such an unlikely event were to occur, Treasury has the authority to take the action that would result in §§ 357.10(c) and 357.11(d) (or their equivalent) being reapplied. Any such action would be published in the Federal Register.

B. Action With Respect to GSEs

Several commenters noted that market participants and practitioners were concerned about coordination among Treasury and other GSEs that issue book-entry securities. The assumption is that the substance of any such regulations will be substantially identical to the Treasury proposed rule. Treasury is working with the GSEs and their regulators toward the goal of having the effective dates of all final book-entry regulations timed to coincide. One commenter specifically suggested delaying the effective date of the final TRADES rule to provide sufficient lead time to GSE issuers. Treasury understands the market's desire for simultaneous adoption of book-entry rules substantially similar to TRADES for GSEs. While adoption of rules for GSEs is subject to the control of the various GSEs and the entities that promulgate their rules, Treasury has taken several steps to facilitate the simultaneous adoption of parallel GSE rules. These steps have included meetings with representatives of the GSEs and their regulators to inform them of the actions Treasury was taking with respect to TRADES and the timetable for adoption of TRADES. Consistent with this supportive approach, Treasury has determined that it will, at the request of the Federal Farm Credit Banks Funding Corporation, delay the effectiveness of TRADES until January 1. That should permit sufficient time for rules similar to TRADES to be in place for GSEs by the effective date of TRADES.

⁴One commenter noted that Article 9 is currently being revised, which could lead to the result that a state could adopt different Article 9 provisions than are included in the Article 8 conforming amendments. Treasury does not anticipate that such an event would result in the need to reapply §§ 357.10(c) and 357.11(d). If that were necessary, Treasury would take the same action, after notice, as described herein.

C. Request for Hypotheticals

Several commenters suggested that Treasury include in the Commentary to the final regulations various hypotheticals to illustrate the manner in which selected transactions would be treated under the TRADES regulations.

Initially, Treasury notes that Revised Article 8 provides numerous hypotheticals that explain the operation of Revised Article 8. Treasury has studied those hypotheticals carefully and believes that they are very useful in understanding Revised Article 8. In light of those hypotheticals, and since TRADES is based, in large measure, on Revised Article 8, Treasury has concluded that developing hypotheticals explaining the operation of Revised Article 8 is unnecessary. On the other hand, TRADES does provide for an interaction of federal and state law. Since the results in a particular factual situation could depend on which law is applicable, Treasury has concluded that hypotheticals that illustrate what law would apply in different situations would be useful. Accordingly, the Commentary contains hypotheticals to explain the interaction of federal and state law.

III. Other Comments

In addition to the general comments described above, Treasury received a number of other comments. Many of these included technical drafting suggestions.

One commenter noted concerns with the tiered nature of the commercial book-entry system and indicated that investors may not be aware of how the commercial book-entry system works. Treasury agrees that it is important that investors understand the operation of both the book-entry system and TRADES. The discussion in the March 4 Proposed Rule was designed to promote that understanding. In addition, the inclusion of a commentary on TRADES in the Code of Federal Regulations is another effort to promote an understanding of both TRADES and the book-entry system. Furthermore, Treasury plans to continue its investor education efforts in the coming months.

One commenter questioned the use of the term "Security Entitlement" to describe the interest of a Participant in a Treasury book-entry security. The commenter noted that the term "Security Entitlement" is used in Revised Article 8 and its use in TRADES to describe the interest of a Participant could be confusing. Treasury considered using different terms to describe this interest but concluded that Security Entitlement was the most useful. In

order to avoid confusion, there was language in the commentary in the March 4 release that attempted to make it clear that the term "Security Entitlement" has a special meaning in TRADES. Additional language has been added to the commentary to clarify this further. Due to Treasury's obligation to pay a Participant (see § 357.13(b)), the interest of a Participant and a person holding in TREASURY DIRECT are, in practical terms, the same since both the Participant and the person holding in TREASURY DIRECT have a direct claim against the United States.

One commenter proposed adding a new defined term, "State," and made certain other drafting changes to the definitions. Those suggestions mainly clarify the meaning intended by Treasury in the March release and were adopted. In adopting these drafting suggestions, Treasury concluded that a new defined term, "Adverse Claim" was needed. This definition is based on the definition of that term in Revised Article 8. By adding this term, Treasury is able to adopt the suggestions that it delete the general incorporation reference in the definition section that appeared in the March release. Section 357.2 is complete and reference to other definitions is unnecessary.

One commenter found the language of § 357.10(b) unclear and proposed drafting suggestions to clarify its meaning. Section 357.10(b) describes the law that governs security interests granted to Federal Reserve Banks. The Commentary, and hypotheticals included in the commentary, explain how § 357.10(b) works. In addition Treasury has redrafted § 357.10(b) in order to make its meaning clearer.

Several comments stated that § 357.11(c) should be modified to conform to the choice of law rule in Section 9-103(6)(f) of Revised Article 8. Treasury agrees with this comment and has made changes to § 357.11(c). In particular, Treasury agrees that it is appropriate to delete reference to priority so that, as provided in § 357.11(a)(5), the law of the Securities Intermediary's jurisdiction governs on this issue.

Procedural Requirements

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

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 was 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 final 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, Incorporation by reference, Securities.

For the reasons set forth in the preamble, title 31, chapter II, subchapter B, part 357 is 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. 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 of this part 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 § 357.20. Such accounts may be accessed by investors in accordance with subpart C of this part through any Federal Reserve Bank or the Bureau of the Public Debt. See subpart C of this part 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 § 357.22(a).

§ 357.1 Effective date.

Subpart B of this Part, the definitions of "Adverse Claim," "Book-entry Security," "Entitlement Holder," "Federal Reserve Bank Operating Circular," "Funds Account," "Issue," "Participant," "Participant's Securities Account," "Person," "Revised Article 8," "Securities Intermediary," "Security Entitlement," "State," and "Transfer Message" and revisions to the definitions of "Security" and

"TRADES," and §§ 357.42 and 357.44 and the revisions to § 357.41 are effective January 1, 1997. All other provisions in effect prior to January 1, 1997, remain in effect.

3. Section 357.3 is redesignated § 357.2, in the definition of "depository institution" paragraphs (a) through (f) are redesignated as paragraphs (1) through (6), the definition of "security interest and pledge" is removed, the definitions of "Security" and "TRADES" are revised, and the remaining definitions are added in alphabetical order as follows:

§ 357.2 Definitions.

* * * * *

Adverse Claim means a claim that a claimant has a property interest in a Security and that it is a violation of the rights of the claimant for another Person to hold, transfer, or deal with the Security.

* * * * *

Book-entry Security means, in subpart B of this part, a Treasury Security maintained in TRADES and, in subpart C of this part, a Treasury Security maintained in TREASURY DIRECT.

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

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Federal Reserve Bank Operating Circular means the 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.

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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.

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Issue means a group of securities, as defined in this section, that is identified by the same CUSIP (Committee on Uniform Securities Identification Practices) 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, representative 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, 3, 4, 5, 9, and 10) 1994 Official Text. Revised Article 8 of the Uniform Commercial Code is incorporated by reference in this Part pursuant to 5 U.S.C. 552(a) and 1 CFR part 51. Article 8 was adopted by the American Law Institute and the National Conference of Commissioners On Uniform State Laws and approved by the American Bar Association on February 14, 1995. Copies of this publication are available from the Executive Office of the American Law Institute, 4025 Chestnut Street, Philadelphia, PA 19104, and the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, IL 60611. Copies are also available for public inspection at the Department of the Treasury Library, Room 5030, Main Treasury Building, 1500 Pennsylvania Avenue, NW., Washington DC 20220, and at the Office of the Federal Register, 800 North Capitol Street, NW., Suite 700, Washington DC.

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.

* * * * *

State means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other territory or possession of the United States.

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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.

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4. Subpart B, consisting of §§ 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.

§ 357.12 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 in a Security Entitlement that is in favor of Federal Reserve Bank from a Participant and that is not recorded on the books of a Federal Reserve Bank pursuant to § 357.12(c)(1), 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. A security interest in a Security Entitlement that is in favor of a Federal Reserve Bank from a Person that is not a Participant, and that is not recorded on the books of a Federal Reserve Bank pursuant to § 357.12(c)(1), is governed by the law determined in the manner specified in § 357.11.

(c) If the jurisdiction specified in the first sentence of paragraph (b) of this section is a State that has not adopted Revised Article 8 (incorporated by reference, see § 357.2) then the law specified in paragraph (b) of this section shall be the law of that State as though Revised Article 8 had been adopted by that State.

§ 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) of this section, 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) of this section, 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) of this section, 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) of this section and an account statement does not identify an office serving the Entitlement Holder's account as provided in paragraph (b)(3) of this section, 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 and how the security interest may be perfected automatically or by filing a financing statement.

(d) If the jurisdiction specified in paragraph (b) of this section is a State that has not adopted Revised Article 8 (incorporated by reference, see § 357.2), then the law for the matters specified in paragraph (a) of this section shall be the law of that State as though Revised Article 8 had been adopted by that State. For purposes of the application of the matters specified in paragraph (a) of this section, the Federal Reserve Bank maintaining the Securities Account is 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, such 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 § 357.10(b) or § 357.11. The perfection, effect of perfection or non-perfection and priority of a security interest are governed by that 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 that law, including with respect to the effect of perfection and priority of the 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 the United States; no Adverse Claims.

(a) Except in the case of a security interest in favor of the United States or a Federal Reserve Bank or otherwise as provided in § 357.12(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 the 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 the 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 the 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.

5. In subpart D, § 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.

6. Appendix B to part 357 is added to read as follows:

Appendix B to Part 357—TRADES Commentary

Introduction

The adoption of regulations for the Treasury/Reserve Automated Debt Entry System ("TRADES") is the culmination of a multi-year Treasury process of moving from issuing securities only in definitive (physical/certificated/paper) form to issuing securities exclusively in book-entry form. The TRADES regulations provide the legal framework for all commercially-maintained Treasury book-entry securities. For a more detailed explanation of the procedural and legal development of book-entry and the TRADES regulations, see the preamble to the rule proposed March 4, 1996 (61 FR 8420), as well as the earlier proposals cited therein 51 FR 8846 (March 14, 1986); 51 FR 43027 (November 28, 1986); 57 FR 12244 (April 9, 1992).

Comparison of TRADES and Treasury Direct

A person may hold interests in Treasury book-entry securities either in TRADES¹ or TREASURY DIRECT. The following summarizes the major differences between the two systems.

Persons holding 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, recognizes 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 Treasury book-entry securities, there are many beneficial owners of such interests that are not Participants. Such

¹ In TRADES a Person's interest in a Treasury book-entry security is a Security Entitlement, as described in TRADES. A Participant's interest in a marketable Treasury book-entry security also is a Security Entitlement. A Participant's Security Entitlement is different than a Security Entitlement as described in Revised Article 8, with respect to the Participant's rights against the issuer. A non-Participant's Security Entitlement is described in Revised Article 8.

beneficial owners hold their interests through one or more Securities Intermediaries such as banks, brokerage firms or securities clearing organizations.

In TRADES, the rights of non-Participant beneficial owners may be exercised only through their Securities Intermediaries. Neither Treasury nor the Federal Reserve Banks have any obligation to a non-Participant beneficial owner of an interest in a Treasury book-entry security. Two examples illustrate this principle. First, except where a pledge has been recorded directly on the books of a Federal Reserve Bank pursuant to § 357.12(c)(1), Federal Reserve Banks, as Treasury's fiscal agents, will act only on instructions of the Participant in whose Securities Account the Treasury book-entry security is maintained in recording transfers of an interest in a Treasury book-entry security. A beneficial owner of the 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 Treasury book-entry security when payment is credited to a Participant's account or paid in accordance with the 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 Treasury book-entry security. A non-Participant beneficial owner receives its payment when its Securities Intermediary credits the owner's account.

Persons holding 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 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 Treasury book-entry security, paid directly to the beneficial owner by check, or paid in accordance with the beneficial owner's instructions. Unlike TRADES, TREASURY DIRECT does not provide a mechanism for the exchange of cash to settle a secondary market transaction, nor are pledges of Treasury book-entry securities held in TREASURY DIRECT 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.

Scope of Regulation

Just as the scope of Revised Article 8 is limited,² 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

² U.C.C. Revised Article 8, Prefatory Note at 12.

interest in a 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 Treasury book-entry security. Moreover, the regulations deal with certain aspects of transactions in Treasury securities, such as perfection of a security interest and its effects and not other aspects, such as the contractual relationship between a debtor and its secured party, which are left to applicable law.³ See the discussion under § 357.10 of the Section-by-Section Analysis.

Section-by-Section Analysis

Section 357.0 Dual Book-entry Systems

Section 357.0 sets forth that Treasury provides two systems for maintaining 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 contains the TRADES 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 Treasury securities issued in book-entry form.

Section 357.1 Effective Date

Section 357.1 establishes the effective date for TRADES. TRADES applies to outstanding securities formerly governed by 31 CFR part 306, subpart O. Conforming changes to parts 306, 356, and 358 are being made to coincide 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. Revised Article 8, in Section 8-603, gave secured parties four months after the effective date to take action to continue the perfection of their security interests. TRADES, through its delayed effectiveness, provides a similar period. In TRADES, January 1, 1997, becomes the date by which such actions must be completed.

The effective date for TRADES is January 1, 1997. 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

³ The regulations in 31 CFR 306.118(b), which are being supplanted by TRADES, state that "applicable law" covers how a transfer or pledge is "effected" as well as perfected. Except with respect to security interests marked on the books of a Federal Reserve Bank, TRADES does not address how a security interest in a Treasury book-entry security is created or what law governs the creation of a security interest. Section 357.11(a) of TRADES, which establishes the choice of law for interests other than those covered by § 357.10, addresses the choice of law with respect to the perfection, effect of perfection or non-perfection, and priority of security interests, but does not address the law governing creation or attachment of a security interest. This is consistent with the scope and choice of law provisions of Revised Article 8.

28 states,⁴ Treasury has determined that TRADES will be effective on January 1, 1997, to ensure a smooth transition to TRADES. In making that determination, Treasury has taken into account the time required by other Government-Sponsored Enterprises (GSEs) to promulgate similar regulations for their securities. Such an effective date, when combined with TRADES having been published in proposed form with a 60-day comment period, should provide sufficient time for an orderly transition to the new TRADES rules.

Section 357.2 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.

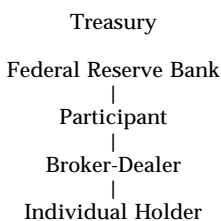
(a) Participant

A Participant is a person that has a securities 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 Treasury book-entry securities held in these accounts.

(b) Securities Intermediary

Securities Intermediaries are persons (other than individuals, except as described below) that are in the business of holding interests in 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.



(c) Entitlement Holder

An Entitlement Holder is any person for whom a Securities Intermediary holds an interest in a 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. See also the commentary on "Security Entitlement."

(d) Security Entitlement

A Security Entitlement is the interest that an Entitlement Holder has in a 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 § 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 § 357.11. It should also be noted that while a Participant's rights have Federal law components under § 357.10(a), the nature of a Security Entitlement held by a lower tier intermediary on the books of a Participant is determined pursuant to applicable law as provided in § 357.11.

Section 357.10 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 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 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.⁵ Prior to March 1, 1993, the terms of each offering of Treasury securities, except for Treasury bills were set forth in an offering circular published in the Federal Register.⁶ Since March 1, 1993, all 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 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.⁷ In addition, neither the United States nor Federal Reserve Banks have any obligations to persons holding their interests in a Treasury book-entry security at levels below the level of a Participant or to any other person claiming an interest in a Treasury book-entry security (with the limited exception set out in § 357.12(c)(1)). Thus, there are no derivative rights against either the United States or the Federal Reserve Banks.

In interpreting this section, it is important to note that the scope of TRADES, like that of Revised Article 8, is limited. Accordingly, the governing law set forth in § 357.10(a) is applicable only to the matters set forth in § 357.10(a). Other laws remain applicable and could affect the holders of book-entry securities.

For example, the tax treatment of Securities Entitlements is outside the scope of TRADES and other law (the Federal income tax code) is applicable in determining such tax treatment. Similarly, nothing in § 357.10(a) limits the applicability of other laws to matters such as whether the activities of Participants or Securities Intermediaries with respect to interests in Treasury book-entry securities are subject to banking or securities laws.

While TRADES in § 357.10(a) defines what law governs the contract between the United States, as issuer, and the holder of a Security Entitlement, it is not a complete statement of the contract law applicable to the United States or Federal Reserve Banks. For example, if a Participant obtains a discount window loan from a Federal Reserve Bank and agrees to pledge collateral, including Treasury book-entry securities, to the Federal Reserve Bank as security for the loan, § 357.10(a) does not establish the law for determining the validity or enforceability of the contract or the law applicable to the creation and perfection of security interests in property that is not a Treasury book-entry security. Section 357.10(a) does provide the law applicable for how a security interest in Treasury book-entry securities is perfected, the priority of such interest and, if § 357.12(c)(1) is applicable, how such security interest is created. Similarly, nothing in § 357.10(a) affects the continuing applicability or enforceability of Federal Reserve Bank operating circulars such as the circular setting forth provisions regarding

⁷The regulations in subpart C of this part set out other obligations of the United States and the Federal Reserve Banks for securities held in TREASURY DIRECT. These regulations preempt applicable state law.

⁴ As of August 1, 1996, those states are: Alabama, Alaska, Arizona, Arkansas, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Nebraska, New Mexico, Oklahoma, Oregon, Pennsylvania, Texas, Utah, Vermont, Virginia, Washington, West Virginia and Wyoming. See discussion accompanying footnote 11.

⁵ A "Federal Reserve Bank Operating Circular" is defined in § 357.2 as the 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.

⁶ 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)

electronic access to services provided by Federal Reserve Banks and agreements executed in connection with such circulars.

The law applicable with respect to interests granted to a Federal Reserve Bank depends on the manner in which the security interest is granted.

Where a security interest in favor of a Federal Reserve Bank is marked on the books of the Federal Reserve Bank under Section 357.12(c)(1), § 357.10(a) establishes the applicable law. A security interest in favor of a Federal Reserve Bank would be recorded on the Federal Reserve Bank's books where, for example, the Federal Reserve Bank made a discount window loan to a depository institution and any Treasury book-entry securities provided by the depository institution as collateral have been deposited to a pledge account on the books of the Federal Reserve Bank. For a borrowing depository institution that is not a Participant, the book-entry securities used as collateral generally would be deposited to the Federal Reserve Bank pledge account by the borrowing institution's Securities Intermediary. See Hypothetical 5.

Section 357.10(b) sets forth law applicable with respect to security interests in favor of a Federal Reserve Bank that have not been marked on the books of a Federal Reserve Bank. A security interest in the Securities Entitlement of a Participant in favor of a Federal Reserve Bank that is not marked on the books of the Federal Reserve Bank is governed by the law of the state in which the head office of the Federal Reserve Bank is located. Such a security interest could arise, for example, where the delivery of book-entry securities to the securities account of the Participant results in an overdraft in the Participant's Funds Account. The extent to which the Federal Reserve Bank has an interest in the Participant's book-entry securities to secure the overdraft therefore would be determined under the law of the state in which the Reserve Bank's head office is located. If the State in which the head office of the Federal Reserve Bank is located has not adopted Revised Article 8, under § 357.10(c) that State is deemed to have adopted Revised Article 8.

In certain very limited circumstances, a Federal Reserve Bank also may have a security interest in the book-entry securities of a non-Participant that is not marked on the books of the Federal Reserve Bank. Section 357.10(b) provides a separate rule for such a security interest, which would be governed by the law of the non-Participant's Securities Intermediary, as determined under § 357.11. Under § 357.11, the perfection, effect of perfection, and priority of a security interest created under such an agreement would be governed by the law of the Securities Intermediary's jurisdiction, as determined under § 357.11(b). Under § 357.11(d), if the jurisdiction specified in § 357.11(b) has not adopted Revised Article 8, jurisdiction would be deemed to have adopted Revised Article 8.⁸

⁸ An interest in book-entry securities of a non-Participant that is not marked on the books of the Federal Reserve Bank, while uncommon, could arise where the Federal Reserve Bank lends to a

For purposes of applying the state law chosen under the rules of § 357.10(b), Federal Reserve Banks are treated as clearing corporations. As a result, a security interest in a Securities Entitlement of a Participant in favor of a Federal Reserve Bank under § 357.12(c)(2) has the same priority as security interests granted to other clearing corporations under state law. This is consistent with the treatment accorded to Federal Reserve Banks generally under Revised Article 8.

Section 357.11 Law Governing Other Interests

(a) 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 § 357.11(a). The matters set forth in § 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 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 these choice of law rules Participants are Securities Intermediaries.

Section 357.11(b) adopts Revised Article 8's general choice of law rule. Section 357.11(c) sets forth a special choice of law rule with respect to security interests perfected automatically or by filing, which also is included in Revised Article 8. 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 perfection of security interests automatically or by filing. In those cases, the law of the jurisdiction in which the debtor is located 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.⁹ The language "person creating a security interest" is used in lieu of the term "debtor" in this provision to avoid any confusion. The word "debtor" has two meanings in the Uniform Commercial Code and the expression "person creating a security interest" provides clarity with respect to who is covered by this section. The term does not refer to a creditor. The language "is located" is intended to conform to its meaning under applicable law, as it may be amended from time to time. See, e.g., U.C.C. section 9-103(3)(d). Section 357.11(d) provides for the application of

non-Participant depository institution and enters into a triparty agreement with the depository institution and its Securities Intermediary rather than requiring the deposit of the book-entry securities in a pledge account on the books of the Federal Reserve Bank through an instruction given by the non-Participant depository institution to its Securities Intermediary.

⁹ 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.

Revised Article 8 if the choice of law analysis required by § 357.11(b) results in the choice of the law of a State that has not yet adopted Revised Article 8. As noted elsewhere, in such a situation, the State's law is viewed as if it had 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.

(b) Limited Scope of Federal Preemption

In an earlier TRADES proposal Treasury contemplated adopting a comprehensive regulation governing the rights of all persons in 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.⁹ 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 August 1, 1996, 28 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 promulgating regulations with a limited form of preemption. As provided in both §§ 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. Treasury has determined that the

⁹ As noted previously, the substantive scope of this regulation is limited.

versions of Article 8 passed by 28 states¹⁰ that have enacted Article 8 as of the date this rule is published in the Federal Register meet this standard. Accordingly, §§ 357.10(c) and 357.11(d) would not be applicable if the choice of law provisions of TRADES directed a person to one of those states. As additional states adopt Revised Article 8, Treasury will provide notice in the Federal Register as to whether the enactments are "substantially identical" to the uniform version for purposes of these regulations and on an annual basis, the Commentary will be amended to reflect subsequent enactments. 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 Treasury book-entry securities.

Section 357.12 Obtaining an Interest in a Book-entry Security

(a) Creation of a Participant's Security Entitlement

A Participant's interest in a 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 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 Treasury book-entry security. Once a Participant obtains that interest, the regulation sets forth what that interest is. Thus, as provided in § 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 § 357.10, § 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 Treasury book-entry security as they did before—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 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.

(b) Creation and Priority of a Security Interest

(i) 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 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. Ordinarily, an authorized representative of the United States would take such action under circumstances such as the default or insolvency of the pledgor.

(ii) Security Interests on the Books of a Reserve Bank. Where required by Federal law or regulation or pursuant to a specific agreement with a Federal Reserve Bank, a security interest in favor of a Federal Reserve Bank or other person may be created or perfected by a Federal Reserve Bank marking its books to record the security interest under § 357.12(c)(1). An example of a security interest that is marked on the books of a Federal Reserve Bank would be the pledge in favor of a Federal Reserve Bank of a Participant's book-entry securities as collateral for a discount window loan.¹¹ For limited categories of pledges, Federal Reserve Banks may agree to record a security interest in favor of a third party on their books. For example, in some circumstances a Federal Reserve Bank may permit the establishment of a pledge account to hold book-entry securities pledged to governmental entities other than the United States government. 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, except as required by Federal law or regulation. 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 Treasury book-entry security except an interest of the United States.

(iii) Other Security Interests. As provided in § 357.12(c)(2), a security interest in a book-entry security may be perfected by any method available under applicable state law, as determined under § 357.10(b) or § 357.11.¹² The perfection and priority of such interests shall be governed by applicable law. Security interests under this section may include security interests in favor of a Federal Reserve Bank, such as a clearing lien or pledge by a non-participant of book-entry securities held through a Securities Intermediary where the securities have not been deposited to a Federal Reserve Bank pledge account. Consistent with Revised Article 8, a Federal Reserve Bank would be treated as a clearing corporation under the applicable state law.

If a Person perfects a security interest pursuant to § 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 § 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 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.

Section 357.13 Rights and Obligations of Treasury and the Reserve Banks

(a) Adverse Claims

Section 357.13(a) sets forth the general rule that, with limited exceptions, Treasury and the Federal Reserve Banks will recognize only the interest of a Participant in a Treasury book-entry security in whose Securities Account such interest is maintained.

As noted previously, 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 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 in the limited case where a security interest is marked on the books of a Federal Reserve Bank pursuant to § 357.12(c)(1), neither the Treasury nor a Federal Reserve Bank will recognize the claims of any other person asserting a claim

¹⁰ Alabama, Alaska, Arizona, Arkansas, Colorado, Idaho, Iowa, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Nebraska, New Mexico, Oklahoma, Oregon, Pennsylvania, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wyoming.

¹¹ Book-entry securities pledged by a non-Participant to a Federal Reserve Bank generally would be deposited by the non-Participant's Securities Intermediary to a pledge account at the Federal Reserve Bank, and therefore also would be marked on the books of the Federal Reserve Bank. See the discussion under D. (§ 357.10).

¹² Under both of these sections, if the state has not yet adopted Revised Article 8, the applicable law would be that state's law as it would be amended by Revised Article 8.

in a Treasury book-entry security. Persons at levels below the Participant level must present their claims to their Securities Intermediary.

(b) *Payment obligations*

Section 357.13(b) contains a corollary to the rule set forth in § 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 some other manner specified by the Participant. This is consistent with existing law and the first TRADES proposal.¹³ 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. Although the Federal Reserve Banks are treated as clearing corporations under both Revised Article 8 and TRADES, Treasury remains liable until payment is made to, or in accordance with the instructions of, a Participant. Section 357.13(b)(2) establishes the mechanism of how Treasury book-entry securities are paid at maturity. It is intended to cover a variety of procedures, including where the proceeds of pledged securities are credited to a suspense account pending substitution or release. This paragraph makes clear that the payment takes place automatically and that, unlike with physical certificates, there is no act of presentment required by the Participant.

Section 357.14 Authority of Reserve Banks

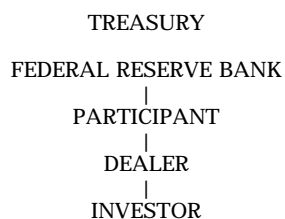
Section 357.14 provides that Federal Reserve Banks are authorized, as fiscal agents of Treasury, to operate the commercial book-entry system for Treasury.

Section 357.44 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 section 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.

J. Hypotheticals

HYPOTHETICAL 1

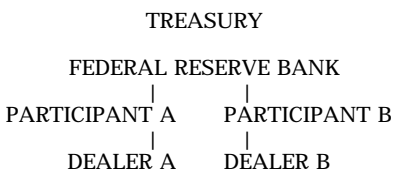


The first hypothetical is designed to show what law applies at different levels of the tiered book-entry system. TRADES provides that federal law, and only federal law (defined in § 357.10(a)), governs the rights

and obligations of the United States and the Federal Reserve Banks (except for those matters involving Federal Reserve Banks set forth in § 357.10(b)). Thus, for example, Treasury discharges its payment obligations with respect to a security it has issued in the manner described in § 357.13(b). Federal law both defines the payment obligation and describes how Treasury fulfills that obligation. Those portions of Revised Article 8 dealing with issuer obligations are not applicable to Treasury or the Federal Reserve Banks.¹⁴ Similarly, with certain limited exceptions as set forth in § 357.12(c)(1), Treasury and the Federal Reserve Banks will recognize only the interest of a Participant in a Treasury book-entry security in whose Security Account the interest is maintained. Accordingly, as a matter of federal law, neither Treasury nor a Federal Reserve Bank will recognize any claim by Dealer or Investor.¹⁵

In the hypothetical above, as between Participant and Dealer, Participant is the Securities Intermediary. With respect to the matters set forth in § 357.11(a), the law of the Securities Intermediary's jurisdiction governs. Thus, with respect to the matters in § 357.11(a), the law of Participant's jurisdiction applies as between Participant and Dealer.¹⁶ If Participant's jurisdiction, as determined under § 357.11(b), has not adopted Revised Article 8, the law of Participant's jurisdiction, as it would be amended by Revised Article 8, applies. Similarly, as between Dealer and Investor, Dealer is a Securities Intermediary, with respect to the matters in § 357.11(a), the law of Dealer's jurisdiction applies as between Dealer and Investor. If Dealer's jurisdiction has not adopted Revised Article 8, the law of Dealer's jurisdiction, as it would be amended by Article 8, applies.

HYPOTHETICAL 2



Assume that Dealer A sells its interest in a Treasury book-entry security to Dealer B. The transaction likely would take the following form. Dealer A will instruct Participant A to transfer its interest in a Treasury security to Participant B against

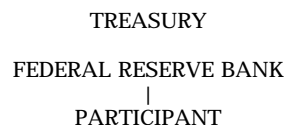
¹⁴ As provided in § 357.14, Federal Reserve Banks, among other things, effect transfers of book-entry securities between Participants' Security Accounts.

¹⁵ One comment questioned whether similar language in the March 4, 1996 release implied that, under Revised Article 8, in the above example Investor could have a claim against Participant. No such implication was intended. The only point of the language is to make it clear that Federal, not state, law governs the rights and obligations of Treasury and the Federal Reserve Banks.

¹⁶ As described in the March 4 Release, the scope of TRADES is limited. As a general rule, if a matter is not covered in § 357.11(a), TRADES is not applicable. One comment questioned whether TRADES covered the creation and attachment of a security interest. The omission of creation and attachment in § 357.11(a) is intentional.

cash payment. Dealer B will instruct Participant B to transfer cash to Participant A against delivery of an interest in the specified securities. Participant A will instruct the Federal Reserve Bank to transfer its interest in the Treasury security to Participant B against simultaneous credit of cash. The Federal Reserve Bank will debit Participant A's security account and credit Participant B's security account and simultaneously credit Participant A's cash account and debit Participant B's cash account. Participant A will mark its books to show that it has debited Dealer A's securities account and credited Dealer A's cash account. Participant B will mark its books to show the Security Entitlement in the Treasury security in favor of Dealer B and a debit against Dealer B's cash account. Federal law, set forth in § 357.12(a) provides that Participant B acquires its interest in the Treasury book-entry security when the Federal Reserve Bank indicates by book-entry that the interest in the security has been credited to Participant B's Securities Account. Pursuant to § 357.11(a), but subject to § 357.11(d), Participant B's jurisdiction governs Dealer B's acquisition of a Securities Entitlement from Participant B.

HYPOTHETICAL 3



Assume Participant wishes to obtain a loan from Federal Reserve Bank and, as part of the transaction, will grant Federal Reserve Bank a security interest in its Securities Entitlement with respect to Treasury book-entry securities. The transaction can be accomplished in one of two ways. Pursuant to § 357.12(c)(1), the Federal Reserve Bank can mark its books to reflect the security interest. As a matter of federal law, that action creates and perfects the Federal Reserve Bank's security interest and grants the Federal Reserve Bank priority over all other claimants (other than the United States pursuant to § 357.12(b)).¹⁷ A second method for completing the transaction, as set forth in § 357.12(c)(2), would be to take whatever actions are authorized by applicable law. In that case, applicable law is the law of the jurisdiction of the head office of the Federal Reserve Bank. If that jurisdiction had adopted Revised Article 8, it would be the law of that jurisdiction. If that jurisdiction had not adopted Revised Article 8, it would

¹⁷ In certain limited circumstances, a Federal Reserve Bank may enter into an agreement under which it agrees to record on its books an interest in Participant's book-entry securities in favor of a non-Participant, such as a governmental entity. Under these circumstances, the non-Participant would have a perfected security interest with priority over other claimants (other than the United States under § 357.12(b)). It should be noted that, as set forth in § 357.12(c)(1), there is no requirement that either the United States or a Federal Reserve Bank agree to creation and perfection of a security interest in this way, except as provided in § 357.12(c)(1).

¹³ 51 FR 8846, 8848 (March 14, 1986).

be the law of that jurisdiction as if the jurisdiction had adopted Revised Article 8. Under Revised Article 8, the Federal Reserve Bank's interest would be that of a clearing corporation.

HYPOTHETICAL 4

TREASURY

FEDERAL RESERVE BANK

PARTICIPANT A PARTICIPANT B

Assume that Participant A wishes to borrow from Participant B and grant Participant B a security interest in its Security Entitlement in Treasury book-entry securities. As provided in § 357.12(c)(2), the transaction would be completed pursuant to applicable law determined in accordance with 357.11. Although such an interest could be recorded on the books of a Federal Reserve Bank under § 357.12(c)(1), Federal Reserve Banks generally do not mark their books to record this type of security interest for Participants.

HYPOTHETICAL 5

TREASURY

FEDERAL RESERVE BANK

PARTICIPANT A

DEALER A

BANK A

Assume that Bank A wishes to borrow from the Federal Reserve Bank and will pledge its interest in Treasury book-entry securities held at Dealer A to collateralize that loan. The transaction could be accomplished in two ways. Pursuant to § 357.12(c)(1), the interest could be created and perfected on the books of a Federal Reserve Bank. Such a transaction would take place in the following fashion. Bank A could have Dealer A instruct Participant A to deposit securities to a pledge account specified by the Federal Reserve Bank. The Federal Reserve Bank likely would create an account on its books and specify that account to Bank A as the account to receive Bank A's interest in Treasury book-entry securities. Participant A, upon receiving Dealer A's instructions, would then instruct the Federal Reserve Bank to debit its account at the Federal Reserve Bank and credit the account created by the Federal Reserve Bank. The second way the transaction could take place is by any method permitted by the law of Dealer A's (Bank A's Securities Intermediary) jurisdiction. This could involve a tri-party agreement among the Federal Reserve Bank, Dealer A, and Bank A. As set forth in § 357.11(b)(1), that agreement likely would specify which jurisdiction's law is to govern the transaction and could specify that such choice of law supersedes any other choice of law agreement previously entered into by Dealer A and Bank A. If Dealer A's jurisdiction has not adopted Revised Article 8, the applicable law would be the law of Dealer A's jurisdiction as it would be amended by Revised Article 8.

Dated: August 16, 1996.
Gerald Murphy,
Fiscal Assistant Secretary.
[FR Doc. 96-21469 Filed 8-20-96; 1:29 pm]
BILLING CODE 4810-39-P

DEPARTMENT OF THE TREASURY

Fiscal Service

31 CFR Parts 306, 350, 356, and 358

Conforming Book-entry Changes

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

ACTION: Final rule.

SUMMARY: The Department of the Treasury is publishing final regulations to conform existing miscellaneous regulatory provisions to new regulations governing book-entry Treasury Bonds, Notes and Bills that are being published as a separate rulemaking document on this date. The changes are technical and non-substantive.

EFFECTIVE DATE: January 1, 1997.

FOR FURTHER INFORMATION CONTACT: Walter T. Eccard, Chief Counsel (202) 219-3320, or Cynthia E. Reese, Deputy Chief Counsel, (202) 219-3320. Copies of the final regulations are being made available for downloading from the Bureau of the Public Debt home page at the following address: <http://www.ustreas.gov/treasury/bureaus/pubdebt/pubdebt.html>.

SUPPLEMENTARY INFORMATION: In a separate publication in this Federal Register, the Department of the Treasury is publishing a final rule that, on and after the effective date, will govern Treasury bonds, notes, and bills (Treasury securities) in book-entry form held in the commercial book-entry system (31 CFR Part 357). That rule incorporates by reference recent and significant changes in commercial law addressing the holding of securities in book-entry form through intermediaries. The rule replaces existing Treasury regulations that contain outdated legal concepts.

In this rulemaking document, existing Treasury regulations are being amended to conform to the changes in Part 357. No other changes of a substantive nature are being made. These various technical changes are summarized below.

Part 306

Subpart O of Part 306 contains the provisions governing book-entry Treasury securities that have been in effect for over twenty years. Almost all of these provisions, including those dealing with transfer and pledge, are

being supplanted by the new regulations in 31 CFR Part 357, Subpart B (the "TRADES" regulations). The only provisions that will continue to have any force on and after the effective date are those dealing with the procedures for withdrawal of securities from book-entry. Those provisions only apply to securities issued before August 15, 1986, which were offered in definitive (certificated) form.

In revised § 306.115, a new definition of "Eligible book-entry Treasury security" has been added and the definition of "Definitive Treasury security" is being retained, but otherwise the definitions in 31 CFR § 357.3 will apply. Revised § 306.117 contains the rules for withdrawal of Eligible book-entry Treasury securities for conversion to definitive form. It is based on provisions in former §§ 306.118(d) and (f) and 306.119. All other provisions of current Subpart O are covered by TRADES or are obsolete.

Part 350

This Part contained the regulations governing Treasury bills that were offered exclusively in book-entry form, beginning in 1976.¹ Subpart C of Part 350, which related to direct access Treasury bill accounts, was superseded by the TREASURY DIRECT regulations in Part 357, Subpart C. Subpart B of Part 350, which related to Treasury bills held in the commercial book-entry system, was applicable until promulgation in 1993 of the uniform offering circular, 31 CFR Part 356 (Sale and Issue of Book-Entry Treasury Bills, Notes, and Bonds, Department of the Treasury Circular, Public Debt Series No. 1-93). Under §§ 356.3 and 356.5, Treasury bills were made subject to 31 CFR Part 306 and 357. Because Treasury bills have a maturity of no longer than one year, there are currently no unmaturing Treasury bills subject to Part 350. Therefore, Part 350 is being removed.

Part 356

All of the changes in this Part either replace references to 31 CFR Part 306 with Part 357, or add references to TRADES.

Part 358

One change is being made to Section 358.3 to delete language that will no longer apply as a result of the publication of TRADES.

Procedural Requirements

This rulemaking does not meet the criteria for a "significant regulatory

¹ (Subpart D of Part 350 provided for issuance of definitive bills on an exception basis for a limited period of time.)