

January 17, 1997

Mr. Kurt Wilhelm
Acting Chief National Bank Examiner
for Capital Markets
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Dear Mr. Wilhelm:

The Department of the Treasury (the Treasury) is offering a new type of marketable security, referred to as a Treasury inflation indexed security. The security will be based, with some modifications, on the model of the Real Return Bonds currently issued by the Government of Canada. The principal amount of the Treasury inflation-indexed security will be adjusted for changes in the level of inflation as measured by the U.S. Government. The interest rate will remain fixed throughout the term of the security, and semiannual interest payments will be based on the inflation-adjusted principal amount.¹

The purpose of this interpretive letter is to provide market participants with guidance and clarification regarding the treatment of the inflation-indexed security under the regulations implementing the Government Securities Act of 1986 (GSA regulations, 17 CFR 400 et seq.), as amended. This letter also intended to: (1) foster consistent application of the GSA rules to the affected entities, including government securities broker-dealers, conducting transactions in the security, and (2) clarify that the regulatory treatment of the security is consistent with the regulatory treatment of existing Treasury fixed-principal securities.

¹ For a more detailed description of the structure, terms, and conditions of the new Treasury inflation-indexed security, see the amendment to the uniform offering circular (31 CFR Part 356), published as a final rule on January 6, 1997 (62 FR 846).

Large Position Rules

The Treasury recently issued final rules prescribing recordkeeping and reporting requirements pertaining to holdings of large positions in certain Treasury securities.² With very limited exception, these rules apply to all entities -- not just government securities broker-dealers -- that hold or control specified large positions. Under section 420.2(d) and paragraph 420.3(c)(3), a reportable position must be computed on the basis of the par amount³ of the inflation-indexed security.

Capital Treatment

Treasury inflation-indexed security transactions of specialized government securities broker-dealers registered with Securities and Exchange Commission (SEC) under Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5) (Firms) subject to the Treasury's capital rules, including the market risk haircuts. Given the absence of information regarding the price behavior of the inflation-indexed security at this time, the Treasury has determined that the market risk haircut of the security will be identical to the market risk haircut for a Treasury fixed-principal security with the same maturity.⁴

Under section 402.2(f)(1) of the GSA capital rules, the market risk haircut for the inflation-indexed security, including the stripped principal and interest components thereof, would be determined by first classifying the security into the appropriate haircut maturity category. For example, a 10-year Treasury inflation-indexed note will have a "category G" maturity classification, the same classification as a 10-year Treasury fixed-principal note.

Financial and Operational Reporting

In accordance with section 405.2 of the GSA rules, which adopts SEC Rule 17a-5 (17 CFR 240.17a-5), with modifications, 15C firms

² 61 FR 48338 (September 12, 1996), 61 FR 52498 (October 7, 1996), and 61 FR 53996 (October 16, 1996).

³ In all cases, the par amount means the stated value of the security at original issuance, not the inflation-adjusted principal.

⁴ See 17 CFR 402.2a (Appendix A), including Schedules B

through E.

are required to submit Form G-405 (the FOGS report) periodically. Consistent with current requirements for Treasury fixed-principal securities, the FOGS reports should reflect the inflation-indexed security at its mark-to-market value.

Recordkeeping

Pursuant to section 404.2 of the GSA regulations, which adopts SEC Rule 17a-3 (17 CFR 240.17a-3), with modifications, 15C firms are required to make and keep, among other things, blotters or other records of original entry, securities position records (i.e., stock records), and order tickets. To foster uniform recordkeeping practices in the government securities market with respect to the inflation-indexed security, the Treasury believes that certain clarifications of these requirements are warranted. Under paragraphs (a)(1), (a)(5), (a)(6), and (a)(7) of SEC Rule 17a-3, as adopted by section 404.2 of the GSA rules, the inflation-indexed security must be recorded as follows: (1) Blotters or other records of original entry (paragraph (a)(1)) must include the par amount⁵ and the purchase or sale price;⁶ (2) the securities position record (paragraph (a)(5)) must include the par amount; and (3) order tickets (paragraphs (a)(6) and (7)) must include the purchase or sale price and other terms and conditions of the order.

Financial institutions that have filed, or are required to file, notice as government securities broker-dealers (noticed banks) must make and keep securities position records pursuant to 17 CFR 404.4(a)(3)(i)(A). Consistent with the requirement for 15C firms, the noticed banks' securities position record must include the par amount of the inflation-indexed security.

Confirmations/Safekeeping Receipts

17 CFR 403.4(e), which adopts paragraph (b)(4) of SEC Rule 15c3-3 (17 CFR 240.15c3-3(b)(4)), with modifications, requires 15C firms

⁵ See *supra* note 3.

⁶ The staff of the Securities and Exchange Commission has issued a letter clarifying, among other things, how firms can satisfy the requirement to record the purchase or sale price of a Treasury inflation-indexed security under 17 CFR 240.17a-3(a)(1), (a)(6), and (a)(7). See letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Securities and Exchange

Commission, to Paul Saltzman, Senior Vice President and General Counsel, PSA The Bond Market Trade Association (January 17, 1997).

to include the par amount⁷ and the market value of the inflation indexed security on confirmations for hold-in-custody repurchase agreement transactions (HICs). Also, paragraph 403.5(d)(2)(i) requires all banks conducting HICs to include the par amount and the market value of the security on confirmations.

Section 450.4(b), which applies to the custodial holdings of depository institutions, requires such entities to issue confirmations or safekeeping receipts that would include the par amount of the inflation-indexed security.

Consultation With Other Regulators

We have consulted with the staffs of the SEC and the appropriate regulatory agencies (ARAs) for banks in considering the issues in this letter. Based on discussions with the SBC staff, the treatment of the inflation-indexed security under the SEC's capital, recordkeeping, reporting, and HIC confirmation rules would be consistent with the treatment pursuant to the GSA regulations discussed above. The SEC has clarified the application of SEC rules, including the application of SEC Rule 10b-10 (17 CFR 240.10b-10, which applies to customer confirmations), to the security.⁸ Any questions regarding the application of SEC rules to the security should be directed to the staff of the SEC.

Based on discussions with the staffs of the bank ARAs, the treatment of the inflation-indexed security under the bank ARA recordkeeping rules would be consistent with the GSA and SEC recordkeeping rule treatment. Similarly, the application of the bank ARA confirmation rules would parallel SEC Rule 10b-10. Questions regarding the application of bank ARA rules to the inflation-indexed security should be directed to the staffs of the bank ARAs. Any questions concerning margin requirements should be directed to the staff of the Board of Governors of the Federal Reserve System.

Conclusion

This interpretive letter reflects the regulatory treatment of the Treasury inflation-indexed security at this time. Any changes in the facts and circumstances regarding the security, such as new knowledge about its price behavior, could lead to a different interpretation or to an amendment of the appropriate regulations. Any questions pertaining to this letter or other issues involving

⁷ See *supra* note 3.

⁸ See *supra* note 6.

the regulatory treatment of inflation-indexed securities should be directed to the Government Securities Regulations Staff at 202-219-3632.

Pursuant to 17 CFR 400.2(c)(7)(i), this letter will be made immediately available to the public.

Sincerely,

Richard L. Gregg
Commissioner

cc: Caite McGuire (SEC)
Larry Clark (OTS)
Stephanie Wolf (PSA)