Federal Reserve Banks will be available upon request to the Bureau. The Federal Reserve Banks, as fiscal agents of the United States, are authorized to perform such functions as may be delegated to them by the Department in order to carry out the provisions of this part.

Subpart D—Additional Provisions

§ 357.40 Additional requirements.

In any case or any class of cases arising under these regulations, the Secretary of the Treasury (''Secretary'') may require such additional evidence and a bond of indemnity, with or without surety, as may in the judgment of the Secretary be necessary for the protection of the interests of the United States.

§ 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.

[61 FR 43630, Aug. 23, 1996]

§ 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.

[61 FR 43630, Aug. 23, 1996]

§ 357.43 Liability for transfers to and from Legacy Treasury Direct®.

A depository institution or other entity that transfers to, or receives, a security from Legacy Treasury Direct is deemed to be acting as agent for its customer and agrees thereby to indemnify the United States and the Federal Reserve Banks for any claim, liability, or loss resulting from the transaction.

§ 357.44 [Reserved]

§ 357.45 Supplements, amendments, or revisions.

The Secretary may, at any time, prescribe additional supplemental, amendatory or revised regulations with respect to securities, including charges and fees for the maintenance and servicing of securities in book-entry form.

Appendix A to Part 357—Discussion of Final Rule

Background

Twenty-four written comments were received to the notice of proposed rulemaking from various sources, including Federal agencies, trade associations, as well as financial and commercial investment institutions. With the exception of one bank, all commentators endorsed the concept of a certificateless security.

The grouping and identification of the comments received have been made on a section-by-section basis, with an explanation of the action taken with respect thereto. As circumstances necessitated the publication of the rule in two segments, in order to make each part more understandable, certain definitions, such as those for ''Department'' and ''securities'', have appeared in the proposed rule for both Legacy Treasury Direct® and TRADES, and were slightly modified in the proposed rules on TRADES. Because these modifications represent non-substantive clarifications, and to avoid confusion as between the two portions of the rules, the definitions as used in TRADES have been adopted.

Section-By-Section Analysis

Section 357.21 Registration.

The forms of registrations provided for securities to be held in Legacy Treasury Direct have different legal effect from those currently provided for in the case of definitive Treasury securities and for the Treasury's book-entry Treasury bill system. A comment was received that, as a result, this could lead to some confusion, and that the Treasury bill forms of recordation currently offered should be changed, particularly since Treasury bills will be phased into Legacy Treasury Direct gradually. The Bureau believes that

the benefits of uniformity of rights and interests that Legacy Treasury Direct investors will derive far outweigh any possible confusion. As for confusion with the current Treasury bill book-entry system, given the fact that Treasury bills have a term of not more than a year, it is believed that the problem, if any, will be short-lived.

Given the importance of the change that Legacy Treasury Direct provides as to registration, the discussion thereof that accompanied the Notice of Proposed Rulemaking is re-published below.

''*Forms of Registration.* The proposed rule provides the investor with a variety of registration options. They are essentially similar to those provided for registered, definitive marketable Treasury securities. Investors should be particularly aware that, where the security is held in the names of two individuals, the registration chosen may establish rights of survivorship.

''The reason for establishing the rights of ownership for securities held in Legacy Treasury Direct is that it will give investors the assurance that the forms of registration they select will establish conclusively the rights to their book-entry securities. It will also serve to eliminate some of the uncertainties, as well as possible conflicts, between the varying laws of the several States.

''A Federal rule of ownership is being adopted by the Treasury for Legacy Treasury Direct securities. This regulatory approach is consistent with the one previously taken in the case of United States Savings Bonds. It will have the effect of overriding inconsistent State laws. See, *Free v. Bland,* 369 U.S. 663 (1962).

''In the case of individuals (who are likely to be by far the majority of holders of securities in Legacy Treasury Direct), the options offered will permit virtually all the preferred forms of ownership. At the investor's option, it will be possible to provide for the disposition of the securities upon death through rights of survivorship.

''*Coownership registration.* One option is the coownership form of registration, i.e., ''A or B.'' Unlike the current Treasury bill book-entry system being administered by the Bureau of the Public Debt, a security held in Legacy Treasury Direct registered in this form will be transferable upon the written request of *either* coowner. Other changes in the account may also be made upon the request of *either* party. While this form of registration will facilitate the receipt of payments and provide ease in conducting transactions, care should obviously be exercised in designating a coowner.

''*Joint ownership.* For those who would prefer to have the transferability of a security held in two names contingent upon the request of both, the joint form of registration will be appropriate. This form of registration, i.e., ''A and B, with [without] the right of survivorship,'' will require the agreement of both parties to conduct any authorized transaction.

''*Beneficiary form.* The beneficiary form, i.e., ''A payable on death to (POD) B,'' will permit the owner to have sole control of the account during his/her lifetime, but in the event of death, the account will pass by right of survivorship to the beneficiary.''

One commentator questioned the ''natural guardian'' and ''voluntary guardian'' forms of registration provided in the regulations, pointing out that financial institutions are reluctant to establish an account in the name of a natural guardian of a minor because of the uncertainties as to who might be entitled to the funds on the death of the natural guardian or minor, or when the minor reached majority. It was mentioned that a bank would be reluctant to open an account in the name of a voluntary guardian, or to release funds from an existing account to a voluntary guardian because of the potential risk in the event of a claim from a court-appointed guardian. It seems apparent that the comment was prompted by the provision that appeared in the proposed rule that the account held in Legacy Treasury Direct and the deposit account to which payments are to be directed should be in the same form. As hereafter pointed out in the discussion under the payment section, this is not a requirement.

While parents are universally recognized as the natural guardians of the person of minors, they have generally not been recognized as entitled to control the estates of these minors, except perhaps in the case of small amounts. Traditionally, the guardian of the estate of a minor involves judicial appointment and supervision. In order to provide a means of dealing with the problem of disposing of securities inadvertently registered in the name of minors without requiring the appointment of a legal guardian and to provide a means for investing funds of a minor, which did not technically qualify for investment under the Uniform Gifts to Minors Act, the Department decided to provide recognition for natural guardians.

The voluntary guardianship procedure is wholly a creature of the Department's regulations. It was established in recognition of the burden placed on an incompetent's estate and his/her family by requiring the appointment of a legal guardian to receive the interest on, or to redeem securities for, the account of an individual who has become incompetent, at least where the incompetent's estate is relatively modest. This form of registration is not available on original issue and is limited to an aggregate of $20,000 (par amount) of Legacy Treasury Direct securities. The $20,000 limit in connection with the use of the voluntary guardianship procedure

is in keeping with the limits used in connection with the summary administration of decedents' estates under the laws of many States.

Section 357.23 Judicial proceedings.

No comments were received regarding the provisions on judicial proceedings. Given their importance, the discussion that accompanied the publication thereof in proposed form is included here.

Judicial proceedings. Under the principle of sovereign immunity, neither the Department nor a Federal Reserve Bank, acting as fiscal agent of the United States, will recognize a court order that attempts to restrain or enjoin the Department or a Federal Reserve Bank from making payment on a security or from disposing of a security in accordance with instructions of the owner as shown on the Department's records.

''The Department will recognize a final court order affecting ownership rights in Legacy Treasury Direct securities provided that the order is consistent with the provisions of subpart C and the terms and conditions of the security, and the appropriate evidence, as described in §357.23(c), is supplied to the Department. For example, the Department may recognize final orders arising from divorce or dissolution of marriage, creditor or probate proceedings, or cases involving application of a State slayer's act. The Department will also recognize a transaction request submitted by a person appointed by a court and having authority under an order of a court to dispose of the security or payment with respect thereto, provided conditions similar to those above are met.''

Section 357.25 Security interests.

Legacy Treasury Direct is not designed to reflect or handle the various types of security interests that may arise in connection with a Treasury bond, note or bill. However, the Treasury has from time to time and to a limited extent held in safekeeping, for such agencies as the Customs Service and Immigration and Naturalization Service, Treasury securities submitted in lieu of surety bonds in accordance with 31 U.S.C. 9303. While the Federal Reserve Banks handle the majority of such pledges and will continue to do so, as this statute requires the Treasury to accept these Government obligations so pledged, a provision has been added for accepting and holding book-entry securities submitted for such purposes.

Section 357.26 Payments.

(a) *General.* Most comments focused on the provisions on payments. A key feature of Legacy Treasury Direct will be the making of payments by the direct deposit method (also known as the electronic funds transfer or ACH method). Checks will be issued only under extraordinary circumstances. A number of comments endorsed the concept of payment by direct deposit as an improvement given the difficulties associated with checks.

One comment expressed concern as to who would have the burden of resolving errors in cases where a receiving financial institution fails to properly credit a payment. The Department has concluded that while the direct deposit payment method is not without risks, it is far superior to the use of checks, in terms of the risks, potential losses, and costs. In a case where a receiving institution fails to act in accordance with the instructions given it, the Bureau intends to use its best efforts to assist investors in rectifying the error.

(b) *Direct deposit.* A number of comments expressed the view that the Legacy Treasury Direct payment system should adopt either the rules governing the direct deposit of Government payments (31 CFR part 210), or the rules of the National Automated Clearing House Association (''NACHA Rules''), but not separate rules. The final rules have adopted some of the existing practices applicable to commercial ACH payments, but it is not possible for the Department of the Treasury to conform to all of these rules. For example, the Treasury has no authority to indemnify recipients of direct deposit payments, although such indemnification by a sender is contemplated in the NACHA rules and was advocated in several comments. It should also be noted that the rules applicable to Legacy Treasury Direct payments are modeled, to some extent, on the rules for Government direct deposit payments in order to take advantage of the large number of entities that are a part of the Government direct deposit network. See the discussion under paragraph (b)(2). Where there are unique rules applicable to Legacy Treasury Direct, however, they are explained here.

Given the variance between the procedures set out in the proposed rules and existing practice, and the increased burdens resulting therefrom, several clearing house associations and financial institutions requested that the implementation of Legacy Treasury Direct be delayed from July 1986 to July 1987. The Treasury is satisfied that the added burdens that would have been imposed on financial institutions to receive Legacy Treasury Direct payments under the proposed rules have been effectively eliminated in the final rule. Thus, Treasury plans to implement the system on or about the original target date. The final rules are being published, however, in advance of actual implementation so as to give financial institutions an opportunity to make whatever remaining, minor procedural changes as may be necessary.

(b)(1) *Information on deposit account at financial institution.* The proposed regulations

provided that the owner of a security in Legacy Treasury Direct, or in the case of ownership by two individuals, the first-named owner, must be an owner of, and so designated, on the account at the receiving financial institution. The regulations also provided that in any case in which a security is held jointly or with right of survivorship, the account at the financial institution should be established in a form that assures that the rights of each joint owner or survivor will be preserved.

The rule requiring the naming of the first-named owner on the receiving financial institution account was based on tax reporting considerations. It has now been determined that the first-named security owner need not be named on the receiving deposit account.

The rule relating to establishment of the receiving account in joint ownership cases in the same form as the registration of the security was intended to be a notice to investors of a potential problem, rather than a requirement. In cases where an investor intends a beneficiary, joint owner or coowner to receive securities after the investor's death, this intention may be defeated if the recipient is not also named on the receiving deposit account. It is up to the investor to examine his or her particular circumstances and determine whether the form in which the deposit account will be held is satisfactory. This matter has been clarified in paragraph (b)(1)(v) of the final rule. Except for the restriction described in paragraph (b)(1)(ii) (see below), the Treasury does not intend to establish any limitations on how the receiving deposit account is held.

Several comments addressed the issue of the registration of the security versus the title of the deposit account. Two comments pointed out that if the deposit account must be in the same form as the registration of the security, then existing traditional forms of ownership for bank accounts, which do not include all the forms of registration for securities held in Legacy Treasury Direct, would not suffice. Concerns were also expressed that with multiple forms of ownership, financial institutions could become involved in disputes with investors. As noted above, there is no requirement that the Legacy Treasury Direct account and the deposit account be identical. The responsibility to choose the title of the deposit account rests with the investor.

Another comment objected to the rule that the first-named security owner be named on the receiving deposit account because the rule would eliminate the possibility of payment to an account at a financial institution in the name of a mutual fund, security dealer, or insurance company. Although the change in the tax reporting rule described above permits payment to such accounts, as well as to trust accounts, since it appears that there is a question as to the capability of some receiving institutions to handle such payments, investors are strongly urged to consult their financial institution before requesting such payment arrangements. See paragraph (b)(1)(iii).

It should be emphasized that any payments that must be made by check will be made in the form in which the Legacy Treasury Direct account is held, which may be different than the form of the deposit account. Investors should be aware that this may result in checks being issued, and thus payment being made, in a form different than they intended the direct deposit payments to be made. For example, if Investor A purchases a security in his or her name alone with instructions that payments be directed to a financial institution for the account of a money market fund, any checks that must be issued will be drawn in the name of Investor A. This could happen if Investor A furnishes erroneous payment instructions and the problem cannot be resolved before a payment date, in which case a check would be issued.

The one restriction on the form of the deposit account that appears in paragraph (b)(1)(ii) of the final regulations is a rule that where the Legacy Treasury Direct account is in the name of individual(s), and the receiving deposit account is also in the name of individual(s), one of the individuals on the Legacy Treasury Direct account must be named on the deposit account. This rule is intended to provide a means to determine the disposition of the payment, if necessary. The Treasury does not expect financial institutions to monitor this rule.

Provision has been made in paragraph (b)(1)(vii) to permit financial institutions to request ''mass changes'' of deposit account numbers without the submission of individual requests from investors to Legacy Treasury Direct. This procedure is intended for use where an institution changes all or an entire group of its account numbers, typically as a result of an organizational change. Legacy Treasury Direct will honor requests from a financial institution to change deposit account numbers under such circumstances, with the understanding that the institution agrees to indemnify the Treasury and the security owners for any losses resulting from errors made by the institution. If the institutions does not wish to use the ''mass change'' procedure, then the change in account number must be requested by the investor, using the authorized transaction request form. See §357.28.

Some institutions voiced concern in general about investor errors in furnishing the Legacy Treasury Direct a deposit account number and the financial institution's routing number. Although the Treasury plans to provide as much assistance to investors as possible, the investor must bear the responsibility for securing accurate payment information. Investors are urged to consult with

their receiving institution to verify the accuracy of the payment information, since neither the Treasury nor the receiving financial institution would be responsible for payment errors resulting from erroneous information provided by investors.

The proposed rule provided in §357.26(b)(1)(iii) that the designation of a financial institution by a security owner to receive payments from Legacy Treasury Direct would constitute the appointment of the financial institution as agent for the owner for the receipt of payments. The crediting of a payment to the financial institution for deposit to the owner's account, in accordance with the owner's instructions, would discharge the United States of any further responsibility for the payment. One comment noted that, in contrast, the rule in 31 CFR 210.13 for Federal recurring payments is that the United States is not acquitted until the payment is credited to the account of the recipient on the books of a financial institution.

Although, in principle, the same rules should apply to all Government payments, the proposed Legacy Treasury Direct rule has been retained in the final regulations on the basis of the major differences in the procedures to be used in Legacy Treasury Direct. Most significantly, the Treasury will not be securing any written verification (*i.e.*, an enrollment form) from a financial institution as to the accuracy of the deposit account number and other payment information, as is now the practice in the case of payments under 31 CFR part 210. Under these circumstances, the Treasury cannot, in effect, guarantee that a payment will be credited by a financial institution to the correct account. It should also be noted that this rule on acquittance of the United States is consistent with the provision in §357.10(c) of the proposed regulations on TRADES. In practice, however, the Treasury plans to participate actively in seeking to locate and recover any payments that have been misdirected.

(b)(2) *Agreement of financial institution.* The proposed rule provided, in §357.26(b)(2), that a financial institution which has agreed to accept payments under 31 CFR part 210 shall be deemed to have agreed to accept payments from Legacy Treasury Direct. The rule further provided that an institution could not be designated to receive Legacy Treasury Direct payments unless it had agreed to accept direct deposit payments under 31 CFR part 210.

One financial institution commented that a receiving institution that has already agreed to accept part 210 payments should have the choice as to whether to accept payments from Legacy Treasury Direct. The basis for this comment was the perception that the receipt of Legacy Treasury Direct payments would require the implementation of special procedures by the financial institution and expose it to additional risks. As explained earlier, the Treasury has significantly modified the procedures and reduced the requirements imposed upon a financial institution in order to receive Legacy Treasury Direct payments, and decreased as well the risks an institution will incur in the receipt of such payments. Thus, the proposed rule on eligibility of receiving institutions has been retained in the final rule in essentially the same form.

Two other comments were made to the effect that the category of institutions receiving payments should be broadened. In deciding to authorize payments to all institutions receiving part 210 payments, the Treasury considered the fact that many more institutions are designated endpoints for Government (direct deposit) payments than for commercial ACH payments. In order to afford investors the widest choice of recipient institutions, all institutions that had agreed to accept part 210 payments were designated as authorized recipients. Treasury has now broadened the rule further to also authorize those financial institutions that are willing to agree to accept part 210 payments in the future. This rule will permit investors to designate institutions that are not now receiving Government direct deposit payments as the recipients of their Legacy Treasury Direct payments if the institutions make appropriate arrangements with the Federal Reserve Bank of their District.

(b)(3) *Pre-notification.* A significant feature of the Legacy Treasury Direct payment procedure will be the use of a pre-notification message sent to the receiving financial institution in advance of the first payment. This procedure, already in use for commercial ACH payments, alerts the institution that a payment will be made and provides an opportunity for verification of the accuracy of the account information.

The proposed regulations provided that the financial institution would be required to reject the pre-notification message within four calendar days after the date of receipt if the information contained in the message did not agree with the records of the institution or if for any other reason the institution would not be able to credit the payment. The rules also stated that a failure to reject the message within the specified time period would be deemed an acceptance of the pre-notification and a warranty that the information in the message was accurate.

Because there was some confusion over when the pre-notification message woud be sent, the final rules clarify, in paragraph (b)(3)(i), that in most cases, this will occur shortly after establishment of a Legacy Treasury Direct account. The Treasury has under consideration a system change that would permit a second pre-notification to be sent closer to the time of the payment if the

first payment is to occur a substantial length of time after account establishment.

One of the items of information contained in a pre-notification message is the name the investor has indicated appears on the deposit account. Comments were received that existing procedures and software do not permit automatic verification of the account name. Although there is apparently some variation in practice, and some institutions undertake to verify the account name information manually, the Treasury has decided to drop the account name verification requirement in the final rules. This means that under paragraph (b)(3)(ii), a financial institution need only verify the account number and type designations on the pre-notification message. However, the Treasury urges institutions which are able to verify account names to do so and encourages the development of software that would have this capability.

A number of comments urged that the four-day period provided for an institution to reject a pre-notification message be lengthened. After consideration of the various alternatives proposed, the Treasury has concluded that an eight-day period will meet the needs of most institutions. See paragraph (b)(3)(ii) of the final rule. In responding to a pre-notification message, an institution may use the NACHA's ''notification of change'' procedure, standardized automated rejection codes, or any other similar standard procedure. Upon receipt of such notification, the Treasury will either make the necessary changes in the Legacy Treasury Direct account or contact the investor, depending on the circumstances.

One commentator objected to the warranty by the receiving institution as to the accuracy of the pre-notification information, particularly in view of the manual verification or changes in procedures that would be required, and the resulting possibility of error. As previously noted, the requirement to verify an account name has been eliminated. In addition, language has been added to make it clear that the verification is limited to the time of pre-notification. The Treasury is of the view that the warranty is a useful concept in encouraging institutions to respond to pre-notification messages and will benefit all concerned by increasing the likelihood that payments will be made accurately and to the appropriate party.

(b)(5) *Responsibility of financial institution.* The proposed regulations provided, in §357.26(b)(5)(ii), that a financial institution that receives a Legacy Treasury Direct payment on behalf of a customer would be required to promptly notify the Treasury when it has made a change in the status or ownership of the customer's deposit account, such as the deletion of the first-named owner of the security from the title of the account, or when the institution is on notice of the death or incompetency of the owner of the deposit account.

Several financial institutions objected to this requirement on the grounds that it would be burdensome and would require the development of new procedures to monitor the changes in deposit accounts. Specifically, several institutions indicated they would be unable to relate the receipt of Legacy Treasury Direct payments, which would be handled in a centralized area of the institution, to the changes being made in a deposit account, which are handled in another operational area of the institution. These institutions said they would not necessarily be aware of who is the first-named owner of the security in Legacy Treasury Direct, and that more responsibility should be placed on the security owner in reporting changes.

In response to these comments, the Treasury has narrowed the notification rule, in paragraph (b)(5)(ii) of the final rule, to require a financial institution to notify Legacy Treasury Direct only in cases where it is on notice of the death or legal incapacity of an individual named on the deposit account, or where it is on notice of the dissolution of a corporation named in the deposit account. Upon receipt of notice by the area of the institution that receives credit payments, the institution will be required to return any Legacy Treasury Direct payments received thereafter.

(b)(6) *Payments in error/duplicate payments.* The proposed regulations, in §357.26(b)(6), set out rules describing the procedure that would be followed in cases where the Treasury or a Federal Reserve Bank has made a duplicate payment or a payment in error. First, the financial institution to which the payment was directed would be provided with a notice asking for the return of the amount of the payment remaining in the deposit account. If the financial institution were unable to return any part of the payment, it would be required to notify the Treasury or its Federal Reserve Bank, and provide the names and addresses of the persons who withdrew funds from the deposit account after the date of the duplicate payment or the payment in error. If the financial institution did not respond to the notice within 30 days, the financial institution's account at its Federal Reserve Bank could be debited in the amount of the duplicate or improper payment.

Several institutions raised objections about various aspects of the above procedures. One stated that 30 days was an insufficient time to respond and urged conformity with the rules in 31 CFR part 210 permitting a 60-day response time. Some objected to furnishing information about the persons who withdrew money from an account. Several objected in principle to the provision authorizing the debiting of their accounts. Several

comments indicated that if a payment is returned by a financial institution using an automated payment reversal procedure, then only the full amount of the payment (not a partial amount) can be reversed.

In the final rule, the Treasury has clarified the procedures. The requirement to provide the names of persons who withdrew funds from an account has been changed. In paragraph (b)(6)(i), financial institutions are asked to provide only such information as they have about the matter. The debiting of an institution's account at a Federal Reserve Bank is intended to be simply a last resort if the institution fails totally to respond to the notice of a duplicate payment or payment made in error. See paragraph (b)(6)(iii). The time provided for response to this notice has been lengthened to 60 days.

The final rule has also been clarified in paragraph (b)(6)(i) to provide that the amount that should be returned is an amount equal to the payment. The Treasury reserves the right, however, to request the return by other than automated means of a partial amount of a payment made in error. It is anticipated that such a procedure would occur only if the notice of a payment made in error is not issued immediately after the payment was made.

(d) *Handling of payments by Federal Reserve Banks.* Some of the comments raised a question about the liability of the Federal Reserve Banks in making payments. The proposed rule, in §357.26(d)(2), provided that each Federal Reserve Bank would be responsible only to the Department and would not be liable to any other party for any loss resulting from its handling of payments. This rule was taken from the existing regulations in 31 CFR part 210 (see §210.3(f)), and is simply a restatement of existing law.

In making payments, the Federal Reserve Banks are acting in the capacity as fiscal agents of the United States, pursuant to 12 U.S.C. 391. They are not acting in an individual (banking) capacity. If a Federal Reserve Bank misdirects a payment contrary to instructions provided by the investor, the United States, as principal, may remain liable to the investor for the payment. The United States could seek to recover any loss from its agent, the Fedeal Reserve Bank. However, because the proposed rule simply stated a legal conclusion and tended to create the impression that the rule was broader than intended, it has been omitted from the final regulations.

Section 357.31 Certifying individuals.

For clarity, the warranties which accompany the use of a ''Signature guaranteed'' stamp have been set out.

Section 357.42 Preservation of existing rights.

This section has been deleted. The same subject-matter will be covered in §357.1, as finally adopted.

Section 357.43 Liability of Department and Federal Reserve Banks.

This section was published as §357.42 in the notice of proposed rulemaking for TRADES. The final version will be published after all the comments on the rulemaking for TRADES have been reviewed and considered.

Section 357.46 Supplements, amendments, or revisions.

Provision for ''charges and fees for services and maintenance of book-entry Treasury securities'' has been added in the event circumstances should dictate their imposition.

[51 FR 18260, May 16, 1986; 51 FR 18884, May 23, 1986]

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 LEGACY TREASURY DIRECT

A person may hold interests in Treasury book-entry securities either in TRADES[1] or Legacy Treasury Direct. The following summarizes the major differences between the two systems.

[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.

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 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 Legacy 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 Legacy Treasury Direct is a direct account relationship between the beneficial owner of a Treasury book-entry security and Treasury. In Legacy 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, Legacy 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 Legacy Treasury Direct generally recognized. Accordingly, Legacy 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 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 Legacy Treasury Direct. Subpart A of part 357 of 31 CFR contains general information about TRADES and Legacy Treasury Direct. Subpart B contains the TRADES regulations.

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

[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.

Subpart C contains the Legacy 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 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.

Treasury

Federal Reserve Bank
|
Participant
|
Broker-Dealer
|
Individual Holder

(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

[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.

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 electronic access to services provided by Federal Reserve

[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)

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

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]

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

[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 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.

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 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.[10] 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 versions of Article 8 passed by 50[11] states that have enacted Article 8 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.

[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.

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

[11] Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

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.[12] 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,

[12] 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).

as determined under §357.10(b) or §357.11.[13] 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 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.[14] 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

TREASURY

[13] 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.

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

FEDERAL RESERVE BANK
|
PARTICIPANT
|
DEALER
|
INVESTOR

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.[15] 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.[16]

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.[17] 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 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

TREASURY

FEDERAL RESERVE BANK
|
PARTICIPANT

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

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

[16] 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.

[17] 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.

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)).[18] 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 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

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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.

[61 FR 43631, Aug. 23, 1996, as amended at 62 FR 43284, Aug. 13, 1997; 63 FR 69191, Dec. 16, 1998]

[18] 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).

PART 358—REGULATIONS GOVERNING BOOK-ENTRY CONVERSION OF BEARER CORPORA AND DETACHED BEARER COUPONS

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