BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Free-Riding in Custody Accounts

TO: Chief Executive Officers of National Banks, Deputy Comptrollers, Department and Division Heads, and Examining Personnel

Several banks and brokerage firms have been investigated recently by the Securities and Exchange Commission for possible securities "free-riding." Free riding occurs when customers buy and sell securities, usually on the same day, in amounts greatly exceeding the amount allowed under margin collateral requirements. Banks, as well as brokerage firms, have incurred losses when these customers failed to pay for their trades.

Free riding often begins when a custodial account is opened with a bank trust department. The customer also establishes brokerage accounts through which the customer directs securities trades. The customer advises the broker-dealer that payment for such trades will be made through the custodial account.

The free-rider attempts to profit from short-term changes in market prices of securities, without placing significant personal funds at risk. Free-riders frequently place a buy order for securities, anticipating a near-term market price increase, and intending to pay for the securities with the proceeds from the sale of the same securities.

Banks that permit such transactions without requiring adequate margin collateral face significant risks when a customer's custody account does not contain enough money to complete a purchase order or enough securities to complete a sale order. These risks include: (1) enforcement actions for violation of the Federal Reserve Board's margin lending standards in Regulation U (12 CFR Part 221) or for aiding and abetting violations of Regulation X (12 CFR Part 224) jor Regulation T (12 CFR Part 220); and (2) loss of bank funds needed to complete the trades of customers who fail to pay.

The OCC wants to alert national banks to the free-riding problem and its potential risks. In this connection, the OCC recommends that national banks review their policies and procedures for accepting custodial agency accounts and clearing securities transactions. Such policies and procedures should:

- set standards for the acceptance of new custodial accounts, including customer background and credit information;

- require identification of broker-dealers sending securities to and receiving funds from customer accounts, and establish systems to track accounts involving numerous broker-dealers;

- disaffirm customer trades where acceptance would result in a violation of Regulation U; and

- determine that each account has sufficient funds to perform any trade or, if a margin credit is extended, that collateral requirements are met.

Questions concerning this issuance may be directed to your supervisory office or Dean Miller or William L. Granovsky of the Compliance Management Department in Washington at (202) 874-4447.

In addition, banks may also refer to the supervisory letter recently issued by the Federal Reserve Board staff discussing the Federal Reserve's margin lending regulations as they apply to free-riding (SR93-13 (March 16, 1993)).

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