

CHAPTER 1**Cash Accounts**

Most security transactions take place in the customer's cash account. Regulation T of the board of governors of the Federal Reserve System (the Fed)¹ states that funds sufficient for the purchase of the securities should be in the account prior to the purchase. In the event that funds are not on hand, there is an agreement between the broker and the customer that the customer will deposit the full cash payment "promptly."

Promptly is an important word. The Fed defines it to mean three (3) business days. Consequently, full cash payment should be received by the third business day—the settlement date. This would be an ideal or optimum situation, since the broker would be using the customer's money to pay for the purchase on the settlement date. The broker is required to pay the seller on the settlement date, whether or not the customer has paid for the purchase. If the customer has not paid by the settlement day, the broker would have to borrow from the bank, incurring an interest expense, which is not passed on to the customer.

Although the regulation states that payment should be received by the third business day, it goes one step further and states that payment must be received no later than the fifth (5th) business day. As you can see, while payment received on the fifth business day satisfies Regulation T, the broker has incurred an expense of two days' interest charged by the bank. (The interest rate charged the broker by the bank is known as the broker's *call rate*.)

¹See Appendix A for a detailed discussion of the Federal Reserve System.

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What happens in the event payment is not received by the fifth business day?

1. In the event an exceptional circumstance exists—for example, the customer was called out of town unexpectedly or became ill—the broker may request an extension of time from one of the exchanges or the NASD.

The extension of time is requested electronically, giving the customer's name, the quantity, description of the security purchased, total dollar amount involved, the reason for the delay, number of days requested, and the customer's Social Security number.

The request for an extension of time is submitted to the exchange or the NASD. That is classified as the *designated examining authority* (DEA). If granted, the customer now has more time to pay. The maximum number of extensions that a customer can receive is five in any 12-month period.

2. Should payment not be received within the approved period, or if the extension was denied, the broker would be required to liquidate or sell out the customer's securities to pay for this purchase.

At this point, what has happened in the customer's account? The proceeds of the sale have been used to pay for the purchase. This is a violation of Regulation T, and the customer's account is frozen for the next 90 calendar days. The effect of this 90-day penalty is to require the customer to have sufficient funds on hand prior to any new purchase. No longer may the customer call the broker, purchase a security, and then send in a check in payment.

Keep in mind that the Federal Reserve is concerned with the amount of credit outstanding. The cash account is specifically designed for customers wishing to buy and pay in full for their securities. By buying and selling without full cash payment, the customer is, in effect, trading on 100 percent margin.

Regulation T also allows for an exception. Should a customer purchase a security one day and sell that very same security two days later, this customer's cash account would immediately become frozen for 90 calendar days. However, should the customer make full cash payment within five business days, the restriction is automatically lifted. The Federal Reserve's reasoning is that, while the customer did buy and sell before making full cash payment, full cash payment (not just the difference between the purchase and the sale) was eventually made within the prescribed time. Should payment be received after the fifth business day, the broker must make written application to an exchange or NASD to have the freeze lifted.

SALE OF SECURITIES

The sale of a security in the customer's cash account has requirements similar to those for a purchase.

The securities to be sold should be held in the customer's account (long), or there must be an agreement that the customer will deliver the security "promptly." Again, *promptly* is defined as three business days. This will enable the broker to deliver the security to the buying broker and obtain the payments.

Until January 15, 1973, the final settlement of the sale of a security was vague at best. Effective that date, the Securities Exchange Act of 1934 was amended to include Rule 15c 3-3-(M) and (N). This rule now requires that the sold securities be delivered no later than ten (10) business days after settlement. Should an exceptional circumstance arise, an extension of time may be requested from a national securities exchange or association such as the NASD. At the expiration of the extension, if the security is still not delivered, the broker is required to buy in the security. Unlike the purchase side, this would not freeze the account. However, many brokerage firms impose a 90-day freeze in this situation. This is not a Regulation T requirement, but it is commonly known as a *house requirement*.

PAYING FOR SECURITIES BY THE SALE OF OTHER SECURITIES

If a security is to be paid for by the sale of another security, the sale should take place in time for sufficient funds to be on hand by the settlement date. Therefore, the purchase and the sale should be completed the same day.

The question now arises: What happens if a customer buys a security on day one and sells another security to pay for that purchase on day three? If such a transaction happened occasionally, there would be no problem. However, this transaction will cost the broker two days' interest, since the purchase transaction will settle two days before the funds become available. In addition, if such transactions occur with any degree of regularity, many firms, while not required to freeze the account for 90 days, will impose such a restriction as a house policy. Infractions of this type should be monitored by the margin clerks and should be brought to management's attention for corrective action. Keep in mind that these transactions are costly because of the interest being charged.

Normal settlement for equity and debt (exclusive of U.S. government obligations) instruments is three business days from the trade date

(often referred to as a regular way trade basis or settlement). On occasion, if an individual requires immediate funds, such an arrangement may be accomplished by a cash sale. Such sales settle on the same day at 2:30 P.M. Any trade executed at 2:00 P.M. or later settles 30 minutes after the trade.

DELIVERY AGAINST PAYMENT

Another type of transaction also takes place in the customer's cash account—the C.O.D. (cash on delivery) or D.V.P. (delivery versus payment). This transaction is normally reserved for large institutional customers. However, any account could, at least in theory, transact business on this basis. The procedure works as follows.

When a customer purchases a security, the security is physically delivered to the customer, and the customer then pays for the purchase. Two conditions are attached to such a transaction. First, the customer must advise the broker prior to the purchase that the method of payment is going to be *delivery versus payment*, and the broker must agree to the procedure. Second, in the event the broker is unable to obtain the security to accomplish delivery, the broker has up to 35 calendar days to complete the delivery. That is, if the broker is unable to obtain the security by the fifth business day, the broker is not obligated to liquidate the customer's account or obtain an extension of time. The broker has 35 calendar days from the trade date to accomplish delivery.

As a matter of information, transactions of this type normally settle on the third business day. This is so for two reasons. First, should delivery not be accomplished promptly, a good chance exists that the broker has part, but not all, of the securities for delivery. Consequently, the broker has paid for some of the securities out of his or her own pocket, financed by a bank. Since a large portion of the broker's transactions are of this sort, special emphasis is placed on this area. Separate sections in the margin department only work on these types of transactions, ensuring proper delivery instructions to the cashiers department. Second, there is an organization known as Depository Trust Clearing Corp. (DTCC) that has immobilized many stock certificates, eliminating the physical movement of certificates from broker to bank or to another broker.

Most institutional customers set up what are called *standing instructions* to deliver versus payment to a particular agent (usually a bank). The bank accepting the securities assigns an individual to handle and process the securities for this account. Anytime the institutional customer makes a

purchase, a duplicate confirmation is sent to the receiving bank so it can anticipate that 1,000 shares of IBM will be delivered on settlement versus \$93,000. Upon delivery, the bank will pay the broker. Depository Trust Clearing Corp. established a service a number of years ago called Institutional Delivery System (ID System) that enables brokers/dealers to confirm and settle trades electronically. This process enables brokers to process the huge volume of today.

Should the receiving agent be another broker, then upon delivery of the security, the receiving broker must present the delivering broker with a free funds letter. This letter merely states that the funds for payment of this purchase do not represent the proceeds of the sale of the security. Should the delivering broker not obtain this letter, the account must be frozen for 90 calendar days. As you can see, it would be extremely easy to buy using one broker and then sell using another and issue instructions for delivery versus payment. In order to prevent what is commonly referred to as *free riding*, a *free funds letter* must be obtained.

On occasion, delivery of securities is made and the delivery is rejected (DK'd). The receiving agent must attach a form called a DK (*don't know*) notice and advise the delivering party of the reason for rejection—for example, delivery versus wrong amount of money, securities not in good delivery form, a mutilated coupon, or no knowledge of the trade. When this occurs, the 35-day period is immediately canceled and you must request an extension of time. The New York Stock Exchange will normally grant you two days to clear up this problem.

As previously mentioned, C.O.D. and D.V.P. transactions are normally reserved for institutional clients such as pension plans, banks, broker/dealers, insurance companies, charitable and other not for profit companies, hedge funds, and investment companies. As you can imagine, customers such as these can and often are large organizations trading millions of dollars per transaction.

As these types of transactions grew over the years, additional regulatory requirements were needed. Consequently, effective June 7, 1971, The New York Stock Exchange adopted Rule 387 governing C.O.D./D.V.P./P.O.D. (payment on delivery).

Fortunately, this particular rule is very straightforward and easy to understand. The following is Rule 387 in its entirety:

COD Orders

Rule 387. (a) No member or member organization shall accept an order from a customer pursuant to an arrangement whereby payment for securities purchased or delivery of securities sold is to be made to

or by an agent of the customer unless all of the following procedures are followed:

1. *The member or member organization shall have received from the customer prior to or at the time of accepting the order, the name and address of the agent and the name and account number of the customer on file with the agent.*
2. *Each order accepted from the customer pursuant to such an arrangement has noted thereon the fact that it is a payment on delivery (POD) or collect on delivery (COD) transaction.*
3. *The member or member organization delivers to the customer a confirmation, or all relevant data customarily contained in a confirmation with respect to the execution of the order, in whole or in part, not later than the close of business on the next business day after such execution, and*
4. *The member organization has obtained an agreement from the customer that the customer will furnish his agent instructions with respect to the receipt or delivery of the securities involved in the transaction promptly upon receipt by the customer of each confirmation, or the relevant data as to each execution, relating to such order (even though such execution represents the purchase or sale of only a part of the order), and that in any event the customer will assure that such instructions are delivered to his agent no later than:*
 - i. *in the case of a purchase by the customer where the agent is to receive the securities against payment (COD), the close of business on the second business day after the date of execution of the trade as to which the particular confirmation relates; or*
 - ii. *in the case of a sale by the customer where the agent is to deliver the securities against payment (POD), the close of business on the first business day after the date of execution of the trade as to which the particular confirmation relates.*
5. *The facilities of a Clearing Agency shall be utilized for the book-entry settlement of all depository eligible transactions.*

EMPLOYEE STOCK OPTIONS

A popular compensation for executives, as well as other employees, is the issuance of stock options. Most employee stock options are in fact exercised in the customer's margin account, enabling the customer to finance

a portion of the cost of exercising such option. However, employee stock options may be exercised in the customer's cash account. The customer must finance 100 percent of the transaction.

CHAPTER ONE QUESTIONS

1. Under Regulation T a purchase in a cash account must be paid for:
 - a. by the settlement date.
 - b. within five business days.
 - c. within seven calendar days.
 - d. within three business days.
2. A cash account becomes frozen for 90 calendar days when a customer:
 - a. pays for a purchase after the settlement date.
 - b. sells a security and delivers it after the seventh business day.
 - c. has been granted more than five extensions of time.
 - d. buys a security and sells the same security and has not paid for it.
3. The Securities Act of 1934 requires a customer to deliver sold securities to the broker no later than:
 - a. 10 calendar days after trade date.
 - b. 10 business days after settlement date.
 - c. 35 calendar days.
 - d. 90 calendar days.
4. In order to qualify for the 35-day provision for a C.O.D. or D.V.P. transaction under Regulation T, the customer must issue instructions prior to the trade and:
 - a. the securities cannot be obtained by the broker for delivery.
 - b. request permission from the NYSE.
 - c. request delivery after settlement date.
 - d. there is no other requirement.
5. Extension of time may be requested from which organization?
 - a. the Federal Reserve
 - b. the NYSE
 - c. the SEC
 - d. all of the above
6. Extension of time should be requested:
 - a. on the settlement date.
 - b. on the seventh calendar day.
 - c. on the fifth business day after the trade date.
 - d. as soon as you know there will be a delay in payment.

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7. A broker may remove a 90-day freeze if:
 - a. the loss incurred is deposited by the seventh business day.
 - b. under no circumstances.
 - c. full cash payment is received by the fifth business day after purchase.
 - d. the broker makes written application to the Federal Reserve Bank.
8. A regular way basis or settlement means the trade settles:
 - a. 90 calendar days later.
 - b. 35 calendar days later.
 - c. on the seventh business day.
 - d. on the third business day.
9. When a delivery of securities is DK'd, the rejecting broker must:
 - a. advise the registered representative.
 - b. advise the delivery broker why the item is being DK'd.
 - c. cancel the trade.
 - d. accept delivery if it is for less than \$10,000.
10. A cash trade settles:
 - a. on the fifth business day.
 - b. the same day.
 - c. on the seventh business day.
 - d. at 2:30 P.M. on the next business day.