

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 80-133

July 10, 1980

AMENDMENT TO REGULATION T

TO ALL MEMBER BANKS
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has amended, effective August 11, 1980, its Regulation T, "Credit for Brokers and Dealers".

Printed on the following pages is the press release and the text of the Board's order as submitted for publication in the Federal Register. Enclosed is the final copy of the amendment in slip sheet form. It should be inserted into your Regulations Binders.

Any questions concerning Regulation T should be directed to the Consumer Affairs Section of our Bank Supervision and Regulations Department, Ext. 6171.

Sincerely yours,

Robert H. Boykin

First Vice President

Enclosure

Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank: 1-800-442-7140 (intrastate) and 1-800-527-9200 (interstate). For calls placed locally, please use 651 plus the extension referred to above.

FEDERAL RESERVE press release



For immediate release

June 12, 1980

The Federal Reserve Board today announced adoption of an amendment to its Regulation T -- margin requirements for brokers and dealers -- affecting specialists and options market-makers.

The amendment, which reflects comment received on a proposal for public comment, is effective August 11.

The principal features of the amendment, as adopted, are:

1. In general, the amendment permits good faith financing of positions in securities in which a specialist makes a market, but requires a 25 percent margin for positions in the related security acquired for hedging or covering purposes and the generally applicable margin (50 percent) for other securities.

2. Creditors extending credit to a specialist's joint account will no longer be required to participate in the account.

3. Specialists and options market-makers will be able to use securities issued by the United States Government or its agencies as collateral in their specialist accounts.

4. Several other changes, including: a rule restricting "free-riding" on underlying stock positions carried in an options market-maker's account which will apply only to market-makers whose own exchange has not adopted a rule on "free riding" approved by the Securities and Exchange Commission; a rule affecting the withdrawal of cash or securities from their accounts by specialists and market-makers; and a rule defining positions that may be carried on preferential credit terms in the accounts of specialists and market-makers.

The Board today rescinded, effective August 11, suspension of the effective date of a rule, as it applies to options specialists, establishing uniform margin requirements for the writing of options. The suspension was adopted in January 1977 until the Board could consider a separate, self-contained rule for options specialists. This has now been done, making the suspension no longer necessary.

The Board's orders in these matters are attached.

Final Rulemaking
Title 12 - Banks and Banking
Chapter II - FEDERAL RESERVE SYSTEM
SUBCHAPTER A - BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
[Regulation T; Docket No. R-0054]
PART 220 - CREDIT BY BROKERS AND DEALERS
Credit extended to Exchange Specialists

AGENCY: Board of Governors of the Federal Reserve System

ACTION: Final rule

SUMMARY: This amendment revises a proposed amendment published by the Board in the Federal Register on August 15, 1979 (44 F.R. 47775) to reflect comments received. It will permit stock specialists and option market-makers to finance with a broker/dealer certain offsetting positions in related securities on more advantageous terms than are available to the ordinary customer. This concession is given to those exchange-registered dealers who are obliged to promote fair and orderly markets in their specialty securities. The present rule limits margin concessions to the financing of specialty securities only. This action derives from the advent of exchange-traded options in 1973.

EFFECTIVE DATE: August 11, 1980

FOR FURTHER INFORMATION CONTACT: Laura Homer, Chief Attorney or Patsy Abelle, Senior Attorney, Securities Regulation Section, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, (202) 452-2781.

SUPPLEMENTARY INFORMATION: The final rule includes a number of revisions to the August 15, 1979 proposal, based upon comments received. These include:

(1) In response to comments received from the Securities and Exchange Commission ("SEC") and the National Association of Securities Dealers, Inc. ("NASD") references to a "registered securities association" are being deleted from the rule. These agencies noted that it may be inappropriate to include broker-dealers making markets in the over-the-counter market within the definition of "specialist" since under the Securities Exchange Act of 1934 that term is used only in connection with securities exchange markets. As an alternative they suggested that the financing of the market-making activities of these firms be treated in a separate section of Regulation T.

(2) The rule has also been revised to permit a specialist to purchase or sell short in the account securities other than the specialist securities or the permitted offset positions if the regular margin requirements are met. This revision was made at the request of the Chicago Board Options Exchange, Inc. ("CBOE") which noted that the August 15 proposal required creditors "to perform the time consuming and burdensome

task of manually transferring certain stock positions from a specialist's account to a general account." The Board believes this revision will substantially reduce this operational problem.

(3) The definition of an "in or at the money" option has been broadened to permit specialists to offset their options positions with the underlying security provided the price of the security is within one standard exercise interval of the option being offset. The August 15 proposal required the underlying security to be within \$2.50 or 5 percent of the option being offset. This change is intended to provide greater flexibility to specialists in employing hedging and spreading strategies to reduce the risk associated with making a market in options. It will also reduce an operational problem. The CBOE in commenting on this aspect of the August 15 proposal noted that it did not provide sufficient opportunities for hedging with the underlying security.

(4) The requirement has been deleted that the creditor call for additional margin whenever securities no longer serving as permitted offset positions continue to be retained in the account. Several commenters, including the New York Stock Exchange, Inc. ("NYSE"), the American Stock Exchange, Inc. ("ASE") and the CBOE, noted that this provision constitutes a maintenance margin requirement and that historically the Board has left the promulgation of rules governing maintenance margins to the exchanges. The Board in reviewing this matter was satisfied that the 25 percent initial margin requirement on the purchase of permitted offset positions, when viewed together with the limitations on the withdrawal of equity contained in the rule, provided a reasonable cushion against adverse variations in market prices.

(5) The "free-riding" penalty has been relaxed to exempt the acquisition or liquidation of permitted offset positions and to reduce the number of days the "free-riding" penalty must be in effect from 30 to 15 calendar days. Those commenting on the August 15 proposal stated that the "free-riding" penalty was unduly harsh and recommended it be deleted and that the exchanges be allowed to adopt "anti-free-riding" rules of their own. The Board notes that the SEC in its "Report of the Special Study of the Options Markets" (the "Option Study") cited "free-riding" as one of the practices prevalent in the options markets and recommended that the Board consider adopting rules curtailing it. The Board recognizes that the exchanges through their surveillance and enforcement program are in a better position to police this activity, and this revised amendment provides a means through which these agencies may adopt their own rules to limit this activity. If the level of enforcement of the exchange rule is not sufficient to curtail the practice, the Board will consider eliminating the exemption.

The Board continues to believe that a 25 percent margin is appropriate for permitted offset positions. Three option exchanges asked that it be changed to a "good faith" margin. Under the rule being adopted, the 25 percent initial margin requirement on permitted offset positions

in concert with the limitations on the withdrawal of equity serve as the basis for accommodating market needs without permitting the excessive use of credit for purchasing or carrying securities.

Accordingly, pursuant to sections 7 and 23 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78g and w), the Board revises section 220.4(g) of Regulation T (12 CFR 220.4(g)) to read as follows:

220.4 - SPECIAL ACCOUNTS

* * * * *

Title 12—Banks and Banking

CHAPTER II—FEDERAL RESERVE SYSTEM

SUBCHAPTER A—BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

PART 220—CREDIT BY BROKERS AND DEALERS

[Docket No. R-0004]

Notice of Termination of Suspension of Uniform
Margin Requirements for Options Specialists

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Rescission of order of suspension.

SUMMARY: In January, 1977, the Board of Governors suspended, for options specialists, the effective date of a new rule establishing uniform margin requirements for the writing of options (42 Fed. Reg. 752). The suspension was put into effect until the Board could consider a separate, self-contained rule for options specialists. Since the Board has adopted such a separate rule today by a final amendment of section 220.4(g) of Regulation T, the suspension order is no longer necessary. Lifting the suspension is a housekeeping matter that will have no practical effect.

EFFECTIVE DATE: August 11, 1980

FOR FURTHER INFORMATION CONTACT: Robert Lord, Securities Regulation Section, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D. C. 20551, (202-452-2781).

SUPPLEMENTARY INFORMATION: On September 27, 1976, the Board adopted an amendment to Regulation T, effective January 1, 1977, which established a uniform margin requirement for the writing of options. (41 Fed. Reg. 43895) Although this rule was intended generally to apply to customer accounts, it also affected Specialists' accounts under the then-existing terms of Section 220.4(g) of Regulation T, which required, with two exceptions, that credit terms to Specialists conform to those available to public customers in a general account.

On December 15, 1976, the Board proposed an amendment to § 220.4(g) which would have allowed options specialists to calculate required margin differently from that provided in the new uniform margin rule applicable to public customers. (41 Fed. Reg. 55552) The Board was, however, unable to act on the proposed alternate method of calculation by January 1, 1977, the effective date of the new uniform rule. It therefore suspended, for options specialists, the effective date of the uniform rule. (42 Fed. Reg. 752, January 4, 1977) In effect, the suspension permitted options specialists to use the pre-existing provisions of § 220.3(d)(5) instead of the new general account provisions.

Today, the Board adopted a final amendment to the specialist's credit rule (section 220.4(g)), effective August 11, 1980. The new rule is self-contained and does not incorporate by reference the conditions of the regulation applicable to general customers, as did the prior rule.

Since the prior order temporarily suspending the applicability of sections 220.3(d)(5) and 220.3(i) to options specialists will no longer be necessary, the Board hereby rescinds that prior order effective August 11, 1980 (the date the amendment to section 220.4(g) becomes effective).

By order of the Board of Governors of the Federal Reserve System, June 11, 1980.

(signed) Griffith L. Garwood

Griffith L. Garwood
Assistant Secretary of the Board

[SEAL]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CREDIT BY BROKERS AND DEALERS

AMENDMENTS TO REGULATION T †

1. Effective July 12, 1978, section 220.4 is amended to read as follows:

SECTION 220.4—SPECIAL ACCOUNTS

* * * * *

(f) **Special miscellaneous account.** In a special miscellaneous account, a creditor may:

* * * * *

(2) * * *

(ii)—Extend and maintain a subordinated loan to another creditor for capital purposes: *Provided*, That

(a) Either the lender or the borrower is a firm or corporation which is a member of a national securities exchange or national securities association, the other party to the credit is an affiliated corporation of such firm or corporation, the credit is not in contravention of any rule of the exchange or association and the credit has the approval of appropriate committees of the exchange or association, or

(b) The lender as well as the borrower is a creditor as defined in section 220.2(b), the subordinated loan agreement has the approval of the appropriate Examining Authority as defined in Securities and Exchange Commission Rule 15c3-1(c)(12) (12 CFR 240.15c3-1(c)(12)) and such Examining Authority is satisfied, in the case of a borrower who would be considered a customer of the lender apart from the subordinated loan, that the loan will not be used to increase the amount of dealing in securities for the account of the borrower, his firm or corporation or an affiliated corporation of such firm or corporation.

2. Effective October 30, 1978, sections 220.2 and 220.4 are amended to read as follows:

SECTION 220.2—DEFINITIONS

* * * * *

(f) The term margin security means any regis-

tered security, OTC margin stock or OTC margin bond.

* * * * *

(i) The term "OTC margin bond" means a debt security not traded on a national securities exchange which meets all of the following requirements:

(1) At the time of the extension of credit, a principal amount of not less than \$25,000,000 of the issue is outstanding.

(2) The issue was registered under section 5 of the Securities Act of 1933 and the issuer either files periodic reports pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 or is an insurance company which meets all of the conditions specified in section 12 (g)(2)(G) of the Act.

(3) At the time of the extension of credit, the creditor has a reasonable basis for believing that the issuer is not in default on interest or principal payments.

SECTION 220.4—SPECIAL ACCOUNTS

* * * * *

(i) **Special bond account.**

In a special bond account a creditor may extend and maintain credit on any exempted security, registered non-equity security or OTC margin bond. The maximum loan value of securities held in this account shall be as prescribed from time to time in § 220.8 (the Supplement to Regulation T). Call options may be issued, endorsed or guaranteed in this account on any underlying equity security which is held in this account because it is an exempted security.

* * * * *

† The complete Regulation comprises:

- 1) Regulation T, as amended effective June 1, 1977, printed in the pamphlet "Securities Credit Transactions."
- 2) The Supplement to Regulation T (section 220.8) dated October 1978, effective October 30, 1978.
- 3) This slip sheet. (Destroy slip sheet dated October 1978.)

3. Effective August 11, 1980, section 220.4(g) is amended to read as follows:

SECTION 220.4—SPECIAL ACCOUNTS

* * * * *

(g) **Specialist's Account.** (1) *Applicability.* In a specialist's account, a creditor may clear and finance for a specialist who is a member of a national securities exchange the member's specialist transactions or transactions of any joint account in which all participants, or all participants other than the creditor, are registered and act as specialists. The provisions of this subsection are available to a specialist who is a member of a national securities exchange which submits to the Board of Governors of the Federal Reserve System reports suitable for supplying current information regarding the use of specialist credit.

(2) *Definitions.* For the purpose of this subsection:

(i) "Joint account" means an account in which the creditor may participate and which by written agreement permits the commingling of the security positions of the participants and provides for a sharing of profits and losses from the account on some predetermined ratio;

(ii) "Underlying security" means the security which will be delivered upon exercise of the option and does not include a security convertible into the underlying security;

(iii) "Overlying option" means (A) a put option purchased or a call option written against an existing long position in a specialist's or market-maker's account, or (B) a call option purchased or a put option written against a short position in a specialist's or market-maker's account.

(iv) "In or at the money," with respect to a call option, indicates that the current market price of the underlying security is not more than one standard exercise interval below the exercise price of the option, and, with respect to a put option, that the current market price of the underlying security is not more than one standard exercise interval above the exercise price of the option.

(v) "In the money," with respect to a call option, indicates that the current market price of the underlying security is not below the exercise price of the option and, with respect to a put option, that the current market price of the underlying security is not above the exercise price of the option.

(3) *Permitted offset positions.* A specialist in options is permitted to establish in this account on a share-for-share basis a long or short position in the securities underlying the options in which the spe-

cialist makes a market, and a specialist in securities other than options is permitted to purchase or write options overlying the securities in which the specialist makes a market, only under one or more of the following conditions (such positions are referred to in this paragraph as "permitted offset positions"):

(i) The account holds a short option position which is "in or at the money" and is not offset by a long or short option position for an equal or greater number of shares of the same underlying security which is "in the money";

(ii) The account holds a long option position which is "in or at the money" and is not offset by a long or short option position for an equal or greater number of shares of the same underlying security which is "in the money";

(iii) The account held a short option position against which an exercise notice was tendered;

(iv) The account held a long option position which was exercised;

(v) The account holds a net long position in a security (other than an option) in which the specialist makes a market; or

(vi) The account holds a net short position in a security (other than an option) in which the specialist makes a market.

(4) *Maximum loan value.* The maximum loan value of securities which may be used as collateral in the account shall be:

(i) No more than 100 per cent of the current market value of any long position in a security in which the specialist makes a market or a wholly-owned margin security;

(ii) 75 per cent of the current market value of any underlying security or overlying option purchased and held in the account as a permitted offset position;

(iii) The maximum loan value prescribed by the Board in section 220.8 (the Supplement to Regulation T) when a security purchased and held in the account does not qualify as a specialist or permitted offset position.

(5) *Adjusted debit balance.* The amount to be included in the adjusted debit balance of the account shall be:

(i) Not less than 100 per cent of the current market value of either a security sold short or an option written where such position qualifies as a specialist transaction;

(ii) 125 per cent of the current market value of any security sold short or option written and held in the account as a permitted offset position;

(iii) The amount prescribed by the Board in section 220.8 (the Supplement to Regulation T) when a security sold short in the account does not qualify as

a specialist or permitted offset position plus, for a short position in a security other than an option, the current market value of the security sold short.

(6) *Additional margin; "free-riding."* Except as required by paragraph (g)(8), on any day when additional margin is required as a result of transactions in the account, the creditor shall issue a call for a deposit of cash or securities having loan value and may allow the specialist a maximum of five full business days to make a deposit sufficient to meet the call. To prevent "free-riding" in the account, a creditor who has not obtained this deposit (and is therefore required to liquidate sufficient securities to meet the call) is prohibited for a 15 day period from extending any further credit in the account to finance transactions in securities in which the specialist is not registered to make a market. The acquisition or liquidation of a permitted offset position shall not be subject to this "free-riding" penalty. The restriction on "free-riding" shall not apply to any national securities exchange adopting a "free-riding" rule applicable to specialists which has been approved by

the Securities and Exchange Commission.

(7) *Withdrawals.* On any day when a specialist requests a withdrawal of cash or securities from the account, the creditor shall compute the status of the account for non-specialist securities positions in accordance with the provisions of section 220.8 (the Supplement to Regulation T), permitted offset positions in accordance with the provisions of paragraphs (g)(4)(ii) and (g)(5)(ii), and specialist positions on a "good faith" basis. Withdrawals shall be permitted to the extent that the adjusted debit balance in the account does not exceed the maximum loan value of all of the collateral held in the account after the withdrawal has been made.

(8) *Deficit accounts.* On any day when the account would liquidate to a deficit, the creditor shall not extend any further credit in the account, and shall issue a call for additional cash or collateral, which shall be met by noon of the following business day. In the event sufficient cash or collateral is not deposited the creditor shall liquidate existing positions in the account.