

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 81-134
July 7, 1981

REGULATION T

Proposed Amendments

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

The Board of Governors of the Federal Reserve System has published for comment two proposed amendments to Regulation T which would provide a separate margin requirement for options on debt securities issued or guaranteed by government entities. Comments, which should refer to Docket No. R-0082 and be received by August 3, 1981, should be mailed to the Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

Printed on the following pages is a copy of the Board's press release dated June 16, 1981 and a copy of the text of the Federal Register is enclosed. These pages more fully explain the Board's action. Questions regarding the proposal should be directed to this Bank's Legal Department, Ext. 6662.

Sincerely yours,



William H. Wallace
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 16, 1981

The Federal Reserve Board today published for comment two alternative proposed amendments to its Regulation T--Credit by Brokers and Dealers--concerning margin requirements for trading of options on government and government agency debt issues.

The Securities and Exchange Commission recently approved trading on the Chicago Board Options Exchange (CBOE) in options contracts^{1/} on Government National Mortgage Association (GNMA) securities. The New York Stock Exchange, the American Stock Exchange and the CBOE have proposed trading in options contracts on Treasury bills, notes and bonds.

The proposed amendments to Regulation T--on which the Board asked comment by August 3, 1981--would affect margin requirements in options contracts on such securities.

Under one proposed amendment to Regulation T, the Board would permit brokers and dealers to give "good faith" loan value to an option which has been purchased and would permit a "good faith" margin when an option contract is written. Since all of the securities exchanges proposing the trading of option contracts would have maintenance margin requirements applicable to their members, the exchanges' requirements--which are subject to review by the SEC--would be expected to apply.

Under an alternate proposed amendment the Board would set a uniform margin requirement of 130 percent of the option premium,^{2/} plus \$1,000,

1/ An option contract gives the holder of the contract the right to buy or sell the security which is the subject of the contract at a specified price at any time during the life of the contract.

2/ A fee paid by an option buyer to the writer of an option contract.

it should be noted that an option, unlike the underlying security, is a disappearing asset that ceases to exist on its expiration date.

(3) Would Board specification of an initial margin requirement be an unnecessary regulatory burden or an aid in the development of these new option contracts?

(4) Is the level of margin proposed by the Board appropriate for options on all exempt debt securities, regardless of maturities or likelihood of exercise, or are adjustments to the basic formula necessary? If they are necessary, how can they be designed to minimize the complexity of the regulation?

The text of the Board's proposals is attached.

Attachment

for the initial writing of all uncovered option contracts on exempt debt securities. Under this amendment no option contract would be permitted to have loan value. Exchanges would continue to be free to set maintenance margin requirements.

Under either proposal, no margin would be required where the option is covered; that is, where the security that can be delivered upon exercise of the option or an offsetting option position is held in the option writer's account. The proposed amendments specify what the Board regards as adequate cover.

In the absence of an amendment, the Board's current margin rules relating to options on corporate equity securities would apply to options on government debt issues. The current margin requirement--30 percent of the value of the underlying security with additional adjustment for unrealized losses and gains--would impair the usefulness of these contract markets, since the underlying securities can be purchased, under current industry practice, on a much lower margin.

In addition to soliciting general comment on the proposed alternative amendments, the Board asked specifically for comment on the following questions:

(1) If the Board adopts a "good faith" approach, is it likely that the exchanges would set different margin requirements on the same or similar option contracts? If so, would this cause serious difficulties?

(2) Even if the Board should provide a good faith requirement for the writing of options, should it (as is now provided for options on equity securities) deny any loan value to a long contract? In this connection,

corporate equity securities. Absent an amendment to Regulation T, it will be automatically applicable to a new type of option on exempted debt securities for which filings have been made with the Securities and Exchange Commission (SEC) by the Chicago Board Options Exchange (CBOE), the American Stock Exchange (AMEX) and the New York Stock Exchange (NYSE). It is the Board's view that the existing margin requirements would not be appropriate for this type of option contract.

Two alternative amendments are being considered by the Board. One, which will be identified herein as the "good faith proposal," would require a broker or dealer to obtain from a customer writing uncovered options on exempted debt securities the amount of margin determined by the broker or dealer "in good faith" to be adequate. This presumes that, at a minimum, the margin required would be that specified as maintenance margin in the rules of the self-regulatory organization (SRO) to which the creditor belongs. The Board's present rules for certain corporate bonds and industry practice for exempted securities use the "good faith" margin concept. The "good faith proposal" would also permit the creditor to assign good faith loan value to this new type of exchange-traded option. The second proposed amendment, identified as the "premium-based proposal," would require an initial margin deposit of 130 percent of the option premium plus \$1000 for the writing of uncovered options. It would continue the Board's present policy of not granting loan value to a long position in an option.

DATE: Comments should be received on or before August 3, 1981.

ADDRESS: Comments, which should refer to Docket No. R-0082, may be mailed to the Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551, or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments received may also be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).

FOR FURTHER INFORMATION CONTACT: Laura Homer, Securities Credit Officer, or Bruce Brett, Securities Regulation Analyst, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202-452-2781).

FEDERAL RESERVE SYSTEM

12 CFR Part 220

[Docket No. R-0082]

Proposal to Amend Regulation T to Establish Margin Requirements for Options on Exempted Debt Securities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rulemaking.

SUMMARY: The Board proposes to amend Regulation T (12 CFR Part 220) to provide a separate margin requirement for options on debt securities issued or guaranteed by government entities (exempted debt securities). The Board's existing margin requirement for options was adopted to cover options written on

SUPPLEMENTARY INFORMATION: The Board of Governors proposes to amend its Regulation T to provide a separate margin for options on exempted debt securities. Public comment is requested by August 3, 1981, on two alternative proposals, particularly with respect to issues identified in this notice.

An option contract on mortgage pass-through certificates guaranteed by the Government National Mortgage Association (GNMA options) was recently approved by the SEC for trading on the CBOE (Securities Exchange Act Release No. 17577, February 26, 1981.) and option contracts on Treasury bills, notes and bonds that have been proposed by the NYSE, Amex and CBOE are currently being considered by the SEC (Securities Exchange Act Release No. 17995, May 11, 1981). One of the SEC's requirements for the approval of trading of the GNMA option contract was that CBOE margin rules conform with the Board's margin requirements.

There are several reasons why the Board is considering a "good faith" margin for these new options. One is that the Board does not set margins for the government securities underlying the options because they are defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(12)) as "exempted securities" and are, therefore, not subject to the Board's regulation. The margin which is required by rules of the self-regulatory organizations (SRO's) or industry practice for the purchase of government securities in the cash market is regarded as a "good faith" margin. In general, this "good faith" margin approximates five percent. The "good faith proposal" would permit an option margin for the derivative security comparable to that used in the cash market. This proposal would minimize constraints on market activity and appear to involve the least regulatory burden. However, the SEC has indicated its concern that having different methods of calculating margins on similar options "may constitute an inappropriate burden on market participants." The NYSE has pointed out that if different requirements for different exchanges are approved, problems will be created for brokers belonging to more than one exchange. Commenters are asked to express their views on the potential seriousness of these difficulties.

The "good faith proposal" would also allow a broker to extend "good faith" loan value on an exchange-traded option on exempted debt securities. The Board denied loan value to options in 1973 when the exchange-trading of these

contracts was first started. At that time the Board noted that, unlike the underlying security, an option is a disappearing asset. The public is asked to comment separately on this part of the "good faith proposal."

The "premium based proposal" for uncovered writing of options follows the general format proposed by the three exchanges for maintenance margin for uncovered option contracts, that is, a percentage of the premium plus a fixed sum. Each exchange, however, proposed different values for each component. The percentage of premium set forth by the exchanges range from 100 percent to 130 percent; the fixed sum ranges from \$1500 to \$3500. Most have some additional adjustments to provide for deviations from the basic format when options are deep in or out of the money. The Board's "premium based proposal" is 130 percent of the premium plus \$1000, and adjustments to the format have been avoided in order to keep the regulation as simple as possible. In addition, the Board's proposal does not take into account the maturity of the underlying securities, a component of some of the exchange proposals. Comments are requested on the absence of these specific features. If the Board's proposed rule is thought to be inappropriate for certain classes of options or in certain situations, commenters are invited to suggest the least complicated way to accomplish the desired results. The "premium based proposal" does not contemplate according loan value to long positions in options.

Under either proposal, no margin would be required where the option is covered; that is, where the security that can be delivered upon exercise of the option or an offsetting option position is held in the option writer's account. The proposed amendments specify what the Board regards as adequate cover.

Accordingly, pursuant to sections 7 and 23 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78g, 78w) the Board proposes to adopt either of the following amendments to § 220.4 and § 220.8 of Regulation T (12 CFR Part 220):

Good Faith Proposal

The Board proposes the following amendments to § 220.4(i) and § 220.8(b) and (j) of Regulation T (12 CFR Part 220):

1. To revise § 220.4(i) to read as follows:

§ 220.4 Special accounts.

(i) *Special bond accounts.* (1) 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.

(2) Put and call options on exempted non-equity securities may be issued, endorsed, or guaranteed in this account provided the amount of margin for such options as prescribed by the Board from time to time in § 220.8 (the Supplement to Regulation T) is included in the adjusted debit balance of this account. The amount of margin need not be included in the adjusted debit balance where there is held in the account any of the following:

(i) The underlying security in the case of a call or a short position in the underlying security in the case of a put;

(ii) An agreement under which a bank, which is holding the underlying security or the required cash, is obligated to deliver, in the case of a call, or accept, in the case of a put, the underlying security against payment of the exercise price upon exercise of the option;

(iii) A long position in a call for the same nominal principal amount of the same underlying security which does not expire before the expiration date of the call issued, endorsed, or guaranteed: *Provided*, That there is also added to the adjusted debit balance the amount, if any, by which the exercise price of such long position exceeds the exercise price of the call issued, endorsed, or guaranteed or, in the case of GNMA options, such additional amount as required by exchange rules.

(iv) A long position in a put on the same nominal principal amount of the same underlying security which does not expire before the expiration date of the put issued, endorsed, or guaranteed: *Provided*, That there is also added to the adjusted debit balance the amount, if any, by which the exercise price of the put issued, endorsed, or guaranteed exceeds the exercise price of such long position or, in the case of GNMA options, such additional amount as required by exchange rules.

(3) When a security held in the account serves in lieu of the margin required for a call, such security shall be valued at no greater than the exercise price of the call.

(4) A short position may be held in this account to serve in lieu of the margin required for a put. The amount to be added to the adjusted debit balance

in respect of such short sale shall be increased by any unrealized loss on the position.

(5) When both a put and a call are issued, endorsed or guaranteed in this account on the same nominal principal amount of the same underlying security, the amount of margin required shall be the margin on either the put or the call, whichever is greater, plus any unrealized loss on the other option.

(6) Any security position held in the account which serves in lieu of the margin required for a put or a call shall be unavailable to support any other option transaction in the account.

(7) The customer may either designate at the time the option order is entered which security position held in the account is to serve in lieu of the margin required or have a standing agreement with the creditor as to the method to be used for making the determination on any given day as to which security position will be used in lieu of the margin to support an option transaction.

(8) For the purposes of this paragraph a security shall be deemed to be an "underlying security" if it may be delivered in satisfaction of an exercise notice.

2. To revise § 220.8(b) and (j) to read as follows:

§ 220.8 Supplement.

(b) *Maximum loan value for a special bond account.* The maximum loan value of an exempted security, a put or call on a non-equity exempted security, an OTC margin bond, or a registered non-equity security shall be determined by the creditor in good faith.

(j) *Margin required for the writing of options.* (1) The amount to be included in the adjusted debit balance of a general account, special bond account, or special convertible debt security account pursuant to paragraphs (d)(5) and (i) of § 220.3, as the margin required for the issuance, endorsement, or guarantee of any put or call on an equity security shall be 30 per cent of the current market value of the underlying security with an adjustment for any applicable increase or reduction.

(2) The amount to be included in the adjusted debit balance of an account pursuant to § 220.4(i) as the margin required for the issuance, endorsement, or guarantee of any put or call on an exempted debt security shall be as determined by the creditor in good faith.

Premium-Based Proposal

The Board proposes the following amendments to § 220.4(i) and § 220.8(b) and (j) of Regulation T (12 CFR Part 220):

1. To revise § 220.4(i) to read as follows:

§ 220.4 Special accounts.

(i) *Special Bond Accounts.* (1) 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.

(2) Put and call options on exempted non-equity securities may be issued, endorsed, or guaranteed in this account provided the amount of margin for such options as prescribed by the Board from time to time in § 220.8 (the Supplement to Regulation T) is included in the adjusted debit balance of this account. The amount of margin need not be included in the adjusted debit balance where there is held in the account any of the following:

(i) The underlying security in the case of a call or a short position in the underlying security in the case of a put;

(ii) An agreement under which a bank, which is holding the underlying security or the required cash, is obligated to deliver, in the case of a call, or accept, in the case of a put, the underlying security against payment of the exercise price upon exercise of the option;

(iii) A long position in a call for the same nominal principal amount of the same underlying security which does not expire before the expiration date of the call issued, endorsed, or guaranteed: *Provided*, That there is also added to the adjusted debit balance the amount, if any, by which the exercise price of such long position exceeds the exercise price of the call issued, endorsed, or guaranteed or, in the case of GNMA options, such additional amount as required by exchange rules.

(iv) A long position in a put on the same nominal principal amount of the same underlying security which does not expire before the expiration date of the put issued, endorsed, or guaranteed: *Provided*, That there is also added to the adjusted debit balance the amount, if any, by which the exercise price of the put issued, endorsed, or guaranteed exceeds the exercise price of such long position or, in the case of GNMA options, such additional amount as required by exchange rules.

(3) When a security held in the account serves in lieu of the margin

required for a call, such security shall be valued at no greater than the exercise price of the call.

(4) A short position may be held in this account to serve in lieu of the margin required for a put. The amount to be added to the adjusted debit balance in respect of such short sale shall be increased by any unrealized loss on the position.

(5) When both a put and a call are issued, endorsed or guaranteed in this account on the same nominal principal amount of the same underlying security, the amount of margin required shall be the margin on either the put or the call, whichever is greater, plus any unrealized loss on the other option.

(6) Any security position held in the account which serves in lieu of the margin required for a put or a call shall be unavailable to support any other option transaction in the account.

(7) The customer may either designate at the time the option order is entered which security position held in the account is to serve in lieu of the margin required or have a standing agreement with the creditor as to the method to be used for making the determination on any given day as to which security position will be used in lieu of the margin to support an option transaction.

(8) For the purposes of this paragraph a security shall be deemed to be an "underlying security" if it may be delivered in satisfaction of an exercise notice.

2. To revise § 220.8(b) and (j) to read as follows:

§ 220.8 Supplement.

(b) *Maximum loan value for a special bond account.* The maximum loan value of an exempted security, an OTC margin bond, or a registered non-equity security which is not a put, call or combination thereof shall be as determined by the creditor in good faith.

(j) *Margin required for the writing of options.* (1) The amount to be included in the adjusted debit balance of a general account, special bond account, or special convertible debt security account pursuant to paragraphs (d)(5) and (i) of § 220.3, as the margin required for the issuance, endorsement, or guarantee of any put or call on an equity security shall be 30 per cent of the current market value of the underlying security with an adjustment for any applicable increase or reduction.

(2) The amount to be included in the adjusted debit balance of an account pursuant to § 220.4(i) as the margin

required for the issuance, endorsement, or guarantee of any put or call on an exempted debt security shall be 130 percent of the premium plus \$1000.

By the order of the Board of Governors of the Federal Reserve System, June 10, 1981.

James McAfee,

Assistant Secretary of Board.

(FR Doc. 81-18238 Filed 6-18-81; 8:45 am)

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