

FEDERAL RESERVE BANK
OF NEW YORK

Circular No. 6500
February 27, 1970

INTERPRETATIONS OF REGULATIONS G AND T

To All Persons Extending Securities Credit
in the Second Federal Reserve District:

Printed below is an excerpt from the Federal Register of February 21, containing the text of an interpretation of Regulation T by the Board of Governors of the Federal Reserve System. It concludes that the business of selling certain instruments described as "deep in the money put and call options" involves an extension of credit for the purposes of the Board's regulations governing margin requirements for securities transactions. By reference, the interpretation is also made applicable to Regulation G.

Additional copies of this circular will be furnished upon request.

Alfred Hayes,
President.

Title 12—BANKS AND BANKING
Chapter II—Federal Reserve System

**SUBCHAPTER A—BOARD OF GOVERNORS OF
THE FEDERAL RESERVE SYSTEM**

[Reg. G]

**PART 207—SECURITIES CREDIT BY
PERSONS OTHER THAN BANKS,
BROKERS, OR DEALERS**

Put and Call Options

**§ 207.106 "Deep in the money put and
call options" as extensions of credit.**

For text of the interpretation on this subject, see § 220.122 of this subchapter. (Interprets or applies 15 U.S.C. 78w)

By order of the Board of Governors,
January 28, 1970.

[SEAL]

KENNETH A. KENYON,
Deputy Secretary.

[F.R. Doc. 70-2220; Filed, Feb. 20, 1970;
8:47 a.m.]

[Reg. T]

**PART 220—CREDIT BY BROKERS
AND DEALERS**

Put and Call Options

**§ 220.122 "Deep in the money put and
call options" as extensions of credit.**

(a) The Board of Governors has been asked to determine whether the business of selling instruments described as "deep in the money put and call options" would involve an extension of credit for the purposes of the Board's regulations governing margin requirements for securities transactions. Most of such options would be of the "call" type, such as the following proposal that was presented to the Board for its consideration:

If X stock is selling at \$100 per share, the customer would pay about \$3,250 for a contract to purchase 100 shares of X at \$70 per share within a 30-day period. The contract would be guaranteed by an exchange member, as are standard "puts" and "calls". When the contract is made with the customer, the seller, who will also be the writer of the contract, will immediately purchase 100 shares of X at \$100 per share through the guarantor member firm in a margin account. If the customer exercises the option, the shares will be delivered to him; if the option is not exercised, the writer will sell the shares in the margin account to close out the transaction. As a practical matter, it is anticipated that the customer will exercise the option in almost every case.

(b) An ordinary "put" is an option given to a person to sell to the writer of the put a specified amount of securities at a stated price within a certain time. A "call" is an option given to a person to buy from the writer a specified amount of securities at a stated price within a certain time. To be freely saleable, options must be indorsed, or guaranteed, by a member firm of the exchange on which the security is registered. The guarantor charges a fee for this service.

(c) The option embodied in the normal put or call is exercisable either at the market price of the security at the time the option is written, or some "points away" from the market. The price of a normal option is modest by comparison with the margin required to take a position. Writers of normal options are persons who are satisfied with the current price of a security, and are prepared to purchase or sell at that price, with the small profit provided by the fee. Moreover, since a large proportion of all options are never exercised, a person who customarily writes normal options can anticipate that the fee would be clear profit in many cases, and he will not be obliged to buy or sell the stock in question.

(Over)

(d) The stock exchanges require that the writer of an option deposit and maintain in his margin account with the indorser 30 percent of the current market price in the case of a call (unless he has a long position in the stock) and 25 percent in the case of a put (unless he has a short position in the stock). Many indorsing firms in fact require larger deposits. Under § 220.3(a) of Regulation T, all financial relations between a broker and his customer must be included in the customer's general account, unless specifically eligible for one of the special accounts authorized by § 220.4. Accordingly, the writer, as a customer of the member firm, must make a deposit, which is included in his general account.

(e) In order to prevent the deposit from being available against other margin purchases, and in effect counted twice, § 220.3(d)(5) requires that in computing the customer's adjusted debit balance, there shall be included "the amount of any margin customarily required by the creditor in connection with his endorsement or guarantee of any put, call, or other option". No other margin deposit is required in connection with a normal put or call option under Regulation T.

(f) Turning to the "deep in the money" proposed option contract described above, the price paid by the buyer can be divided into (1) a deposit of 30 percent of the current market value of the stock, and (2) an additional fixed charge, or fee. To the extent that the price of the stock rose during the 30 ensuing days the proposed instrument would produce results similar to those in the case of an ordinary profitable call, and the contract right would be exercised. But even if the price fell, unlike the situation with a normal option, the buyer would still be virtually certain to exercise his right to purchase before it expired, in order to minimize his loss. The result would be that the buyer would not have a genuine choice whether or not to buy. Rather, the instrument would have made it possible for him, in effect, to purchase stock as of the time the contract was

written by depositing 30 percent of the stock's current market price.

(g) It was suggested that the proposed contract is not unusual, since there are examples of ordinary options selling at up to 28 percent of current market value. However, such examples are of options running for 12 months, and reflect expectations of changes in the price of the stock over that period. The 30-day contracts discussed above are not comparable to such 12-month options, because instances of true expectations of price changes of this magnitude over a 30-day period would be exceedingly rare. And a contract that does not reflect such true expectations of price change, plus a reasonable fee for the services of the writer, is not an option in the accepted meaning of the term.

(h) Because of the virtual certainty that the contract right would be exercised under the proposal described above, the writer would buy the stock in a margin account with an indorsing firm immediately on writing the contract. The indorsing firm would extend credit in the amount of 20 percent of the current market price of the stock, the maximum permitted by the current § 220.8 (supplement to Regulation T). The writer would deposit the 30 percent supplied by the buyer, and furnish the remaining 50 percent out of his own working capital. His account with the indorsing firm would thus be appropriately margined.

(i) As to the buyer, however, the writer would function as a broker. In effect, he would purchase the stock for the account, or use, of the buyer, on what might be described as a deferred payment arrangement. Like an ordinary broker, the writer of the contract described above would put up funds to pay for the difference between the price of securities the customer wished to purchase and the customer's own contribution. His only risk would be that the price of the securities would decline in excess of the customer's contribution. True, he would be locked in, and could not liquidate the customer's collateral for 30 days even if the market price should fall in excess of 30 percent, but

the risk of such a decline is extremely slight.

(j) Like any other broker who extends credit in a margin account, the writer who was in the business of writing and selling such a contract would be satisfied with a fixed predetermined amount of return on his venture, since he would realize only the fee charged. Unlike a writer of ordinary puts and calls, he would not receive a substantial part of his income from fees on unexercised contract rights. The similarity of his activities to those of a broker, and the dissimilarity to a writer of ordinary options, would be underscored by the fact that his fee would be a fixed predetermined amount of return similar to an interest charge, rather than a fee arrived at individually for each transaction according to the volatility of the stock and other individual considerations.

(k) The buyer's general account with the writer would in effect reflect a debit for the purchase price of the stock and, on the credit side, a deposit of cash in the amount of 30 percent of that price, plus an extension of credit for the remaining 70 percent, rather than the maximum permissible 20 percent.

(l) For the reasons stated above, the Board concluded that the proposed contracts would involve extensions of credit by the writer as broker in an amount exceeding that permitted by the current supplement to Regulation T. Accordingly, the writing of such contracts by a brokerage firm is presently prohibited by such regulation, and any brokerage firm that indorses such a contract would be arranging for credit in an amount greater than the firm itself could extend, a practice that is prohibited by § 220.7(a).

(Interprets and applies 15 U.S.C. 78w)

By order of the Board of Governors,
January 28, 1970.

[SEAL] KENNETH A. KENYON,
Deputy Secretary.

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