FEDERAL RESERVE BANK OF NEW YORK

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INTERPRETATION OF REGULATION T
Questions and Answers on Same-Day Substitution Rule

To All Brokers and Dealers, and Members of National Securities Exchanges, in the Second Federal Reserve District:

Printed below is an excerpt from the *Federal Register* of June 25, containing the text of an interpretation of Regulation T, "Credit by Brokers and Dealers," adopted June 15 by the Board of Governors of the Federal Reserve System. The interpretation is in the form of questions and answers, and relates to the same-day substitution rule in connection with undermargined accounts, specifically those accounts subject to section 220.8(g) of the regulation.

Additional copies of this circular will be furnished upon request.

Alfred Hayes,
President.

PART 220—CREDIT BY BROKERS AND DEALERS

Same-day Substitutions of Securities

§ 220.129 Applicability of same-day substitution rule to accounts subject to section 220.8(g).

(a) The Board has been asked numerous questions regarding the use of the same-day substitution privilege in section 220.3(b) of Regulation T in connection with accounts subject to § 220.8(g), generally, accounts having less than 40 percent equity. Prior to the Board's amendments, effective September 18, 1972 (37 FR 13972, 3, 4, July 15, 1972), a customer whose account was undermargined to any extent was allowed to substitute one security for another on the same day, usually through a sale and purchase for like amounts, without being required to improve his equity in the account. The 1972 amendments limit this privilege to accounts with an equity of 40 percent or more; as presently set by the Board. Accordingly, if a customer's equity is below 40 percent, he is not eligible for the same-day substitution privilege, but is required to put up margin on any new commitment, and retention requirements are applied to any liquidation, even though the transactions are effected on the same day.

(b) The questions raised with the Board touch upon other provisions of regulation T as well that are affected by the September 1972 amendment to the same-day substitution rule and the impact of the amendment on these provisions is also reflected in the examples stated below. In making computations in similar situations it should be borne in mind that the examples are based on a current loan value of 35 percent for margin securities (margin requirements of 65 percent), and 50 percent loan value for exchange-listed convertible bonds, while the retention requirement for all accounts is 70 percent (release 30 percent).

QUESTIONS AND ANSWERS ON THE SAME-DAY SUBSTITUTION RULE IN CONNECTION WITH ACCOUNTS SUBJECT TO SECTION 220.8(g)

Based on margin requirements as of November 24, 1972 of 65 percent (35 percent loan value) in the general account and 50 percent (50 percent loan value) in the special convertible debt security account, and retention requirements with respect to withdrawals in each account of 70 percent (30 percent release).

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1. Q. Customer is long $10,000 margin securities in his general account, which has an adjusted debit balance of $7,000. Customer has an $8,000 balance in his special miscellaneous account. The general account is subject to section 8(g). The customer wishes to purchase margin securities worth $1,000 and sell securities worth $1,000 on the same day. What is the regulation T margin call if any?

A. $350, the margin required on the purchase ($650) minus the margin released on the sale ($300) (net $350). The call may be met by a debit to the customer's special miscellaneous account.

2. Q. Customer is long $10,000 margin securities in his general account which has an adjusted debit balance of $9,000. Customer has an $8,000 balance in his special miscellaneous account. The general account is subject to section 8(g). May the creditor reduce the special miscellaneous account balance to a level at which time the general account would no longer be subject to section 8(g)?

A. Yes; before such a debit to the special miscellaneous account is made, however, the creditor may wish to obtain the written consent of the customer. The customer should be fully aware of the procedure to be followed by the creditor and that such an amount could not be transferred back from the general account to the special miscellaneous account at a later date, unless an excess over 65 percent margin in the general account would permit another transfer.

3. Q. Customer's account has a regulation T margin call which was outstanding (and not overdue) as of the close of business on the preceding business day. In computing the account to determine if it is subject to section 8(g), may the creditor consider the outstanding regulation T margin call as collected?

A. Yes, for the purpose of computing an account to determine whether it is subject to section 8(g), the creditor may give credit to such an outstanding regulation T margin call which would reduce the adjusted debit balance.

4. Q. Customer is long $10,000 margin securities in his general account which has an adjusted debit balance of $6,075. The account is subject to section 8(g) by an amount less than $100. He wishes to purchase margin securities valued at $1,000 and sell securities valued at $1,000 in the account on the same day. What regulation T margin call if any should be issued?

A. $350. Once the determination has been made that an account is subject to section 8(g), purchases in the general account are charged the margin required, currently 65 percent, and sales currently release 30 percent. The $100 rule in section 220.3(g)(3) does not apply to the 8(g) computation.

5. Q. Customer's account has an outstanding maintenance margin call. In computing the account to determine if it is subject to section 8(g), may the creditor consider the

outstanding maintenance margin call as collected?

A. No; maintenance margin calls are generally credited to the customer's special miscellaneous account, and accordingly, the collection of the maintenance margin call would not change the adjusted debit balance.

6. Q. Customer is long $10,000 margin securities in his general account which is subject to section 8(g) by $100 and is in a so-called regular restricted status by $2,600. He wishes to sell securities worth $9,000 and buy margin securities worth $9,000 on the same day. The purchase would require margin of $5,850 and the sale would release $2,700 (net $3,150). In what amount should the creditor issue a regulation T margin call?

A. $2,600. The customer would not be required to deposit more than is needed to eliminate the so-called regular restriction.

7. Q. Does a debit to the general account and a credit to the special miscellaneous account (SMA) increase the customer's adjusted debit balance?

A. Yes; the reference to "net debit balance" in section 220.3(d)(1) of regulation T, in connection with the adjusted debit balance computation, includes any amounts debited to the general account and credited to the SMA. It is quite possible for an account to be subject to section 8(g) as a result of such entries. For regulatory purposes, the balances of the two accounts should be separately stated, whether the creditor maintains the SMA by journal or memorandum entry methods.

Section 220.4(a) provides that a creditor may establish an SMA, the purpose of which is defined in paragraph (f)(6), provided it is recorded separately, and confined to its intended purpose, with an adequate record maintained. Paragraph (a)(3) further provides that:

> * * * If a customer has with a creditor both a general account and one or more such special accounts, the creditor shall treat each such special account as if the customer had with the creditor no general account * * *

The agreement between the creditor and the customer should clearly show that two accounts will be maintained and that when transfers of amounts such as dividends, maintenance margin calls, and excess are made, the general account and the SMA are debited or credited as the case may be. Funds cannot be freely transferred back and forth. Generally, while funds can always be transferred from the SMA to the general account, transfers from the general account to the SMA can only be made when certain specific events occur and conditions are met.

8. Q. Customer is long $80,000 convertible debt securities in a special convertible debt security account which has an adjusted debit balance of $50,000. The account is subject to section 8(g). The customer wishes to purchase $60,000 convertible debt securities (which are marginable) and sell $60,000 convertible debt securities on the same day. What is the regulation T margin call if any?

A. $10,000. The margin currently required on the purchase is $30,000 and the margin currently released on the sale is $18,000. However, the customer would not be required to deposit more than is needed to eliminate the so-called regular restriction of $10,000 in the account.

9. Q. Does the 8(g) rule apply to the special bond account?

A. No; in a special bond account, the maximum loan value of collateral held in the account is determined by the creditor in good faith, and the retention requirement which applies to withdrawal of such collateral is equal to the good faith loan value applied by the creditor.

10. Q. Customer has an account subject to 8(g) and wishes to know how much he can buy or sell without incurring a regulation T margin call.

A. (1) Under the current 65 percent margin requirement (in the general account),

(a) To determine how much a customer can buy with the proceeds of a sale in that account, apply this formula:

$$\frac{30\%\ \text{(margin released on sale)}}{65\%\ \text{(margin required on purchase)}} = 46.1\%\ \text{(round off } 46\%\text{)}$$

Thus, a sale of $10,000 would permit a purchase of $4,600.

Proof:

Margin released on sale of $10,000	$3,000
Margin required on purchase of $4,600	2,990

(b) To determine how much a customer would have to sell to meet the margin requirement on a purchase, apply this formula:

$$\frac{65\%\ \text{(margin required on purchase)}}{30\%\ \text{(margin released on sale)}} = 216\tfrac{2}{3}\%\ \text{(round off } 217\%\text{)}$$

Thus, a purchase of $10,000 would require a sale of $21,667.

Proof:

Margin required on purchase of $10,000	$6,500
Margin released on sale of $21,667	6,500

(2) Under the current 50 percent margin requirement (in the special convertible debt security account),

(a) To determine how much a customer can buy with the proceeds of a sale in that account, apply this formula:

$$\frac{30\%\ \text{(margin released on sale)}}{50\%\ \text{(margin required on purchase)}} = 60\%$$

Thus, a sale of $10,000 would permit a purchase of $6,000.

Proof:

Margin released on sale of $10,000	$3,000
Margin required on purchase of $6,000	3,000

(b) To determine how much a customer would have to sell to meet the margin requirement on a purchase, apply this formula:

$$\frac{50\%\ \text{(margin required on purchase)}}{30\%\ \text{(margin released on sale)}} = 166\tfrac{2}{3}\%\ \text{(round off } 167\%\text{)}$$

Thus, a purchase of $10,000 would require a sale of $16,700.

Proof:

Margin required on purchase of $10,000	$5,000
Margin released on sale of $16,700	5,010

11. Q. A regulation T margin call is issued as a result of a same-day substitution occurring in an account that is subject to section 8(g). What computation is required?

A. The amount may be determined by applying this formula:

Less:
 Margin required on commitment
 Margin released on liquidation
Equals: Regulation T margin call

Illustrations

1. In a general account

a. Purchase $10,000 × 65% margin required	$6,500
Sell $9,000 × 30% margin released	2,700
Regulation T margin call	3,800
b. Purchase $8,000 × 65% margin required	5,200
Sell $11,000 × 30% margin released	3,300
Regulation T margin call	1,900

2. In a special convertible debt security account

a. Purchase $6,000 × 50% margin required	3,000
Sell $5,000 × 30% margin released	1,500
Regulation T margin call	1,500
b. Purchase $7,000 × 50% margin required	3,500
Sell $9,000 × 30% margin released	2,700
Regulation T margin call	800

12. Q. Customer's general account which is subject to section 8(g) includes a short position in stock A of 100 shares at 100 (market value $10,000). Customer buys 200 shares of the same stock and maintains his short position, which results in a long position of 200 shares of which 100 shares is considered the long side of the short sale "against the box." Does this transaction result in the issuance of a regulation T margin call and for how much?

A. Yes; the customer would incur a regulation T margin call of $6,500, the margin required on the new net commitment of 100 shares long. Because the customer's account is subject to section 8(g), the retention requirement provision in the regulation (which does not provide for any release on the covering of a short position) would apply.

13. Q. Customer's general account is subject to section 8(g) and he wishes to buy and sell the same stock on the same day (day trade). May he do so without furnishing additional margin under regulation T? (This question assumes that the customer could effect such a day trade in conformance with exchange requirements.)

A. No; regulation T in providing for transactions on a given day in section 220.3(g) does not distinguish between same or different securities. Therefore, the amount of deposit required would be computed on the basis of the margin required on the purchase less the amount released on the sale of the same stock.

14. Q. May the amount deposited to meet a regulation T margin call in an account subject to section 8(g) be credited to the customer's special miscellaneous account?

A. No; any regulation T margin call must be credited directly to the account with respect to which the call was issued and may not be transferred to the customer's special miscellaneous account.

15. Q. Customer's general account is subject to section 8(g). He effects a same-day substitution by liquidating securities worth $21,334, thereby releasing 30 percent ($6,400), and purchasing margin securities worth

$10,000, thereby requiring margin of 65 percent ($6,500). Must the customer deposit the $100 difference?

A. No; the creditor may waive a regulation T margin call of $100 or less.

16. Q. Customer's special convertible debt security account is subject to section 8(g). His general account is in a so-called restricted status but not subject to section 8(g). May he effect a same-day substitution of securities in like amounts in his general account without incurring a regulation T margin call?

A. Yes. Each account is computed separately, either one of which may or may not be subject to section 8(g).

17. Q. Customer's general account is subject to section 8(g) and he has a $200 balance in his special miscellaneous account. May he withdraw the $200?

A. Yes; regulation T would not prevent such a withdrawal. However, exchange and creditor requirements should be considered.

18. Q. A customer's general account is priced as of the previous night's close of business and is subject to section 8(g) by $300. On the current day, may the customer deposit $300 directly into his general account and subsequently effect a same-day substitution of margin securities without incurring a regulation T margin call?

A. No; when an account is subject to section 8(g), a deposit on the current day of the amount by which the account is subject to section 8(g) would not eliminate the section 8(g) restriction. Accordingly, a regulation T margin call should be issued in the appropriate amount if there is effected in the account a same-day substitution of margin securities.

19. Q. Customer is long a profitable call option on 100 shares of margin stock A at 50 in his general account which is subject to section 8(g). He wishes to exercise the option and hold the stock which is currently at 55. What is the regulation T margin call if any?

A. $3,250, the margin required on the purchase of $5,000. In pricing the account subsequent to the purchase, loan value would be applied to the stock's current market value of $5,500.

20. Q. Customer is long a profitable call option on 100 shares of margin stock B at 50 in his general account which is subject to section 8(g). He wishes to exercise the option by buying stock B at 50 and selling stock B at 55 on the same day What is the regulation T margin call if any?

A. $1,600, the margin required on the purchase ($3,250) minus the margin released on the sale ($1,650).

21. Q. Is it possible under regulation T for a customer who is long a profitable option in his general account which is subject to section 8(g) to terminate his position in the option and have immediate access to the funds representing the profit?

A. Yes; he may give instructions to his broker to transfer the option from his general account to his special cash account where he could sell the option itself either back to the broker or to others.

22. Q. A customer's general account is subject to section 8(g). May he transfer a profitable call option from his general account to his special cash account where he would exercise it?

A. Yes; provided that full cash payment for the purchased stock is available in the special cash account or is deposited promptly. Such payment must be deposited in the special cash account prior to the release of the proceeds of the resale of the security, if 'the customer wishes to liquidate the position in the security acquired upon exercise.

23. Q. Customer is short an uncovered call option on 100 shares of stock C with a striking price of 50 in his general account which is subject to section 8(g). His net debit balance was reduced by $1,500 (30 percent margin requirement) when the short option position was taken (made up by receipt of $500 premium and additional deposit of $1,000, both credited to the general account). Presently, the market value of stock C is up to 60 and customer's adjusted debit balance now includes $2,800 ($6,000×30 percent = $1,800 plus the mark to the market loss of $1,000). The call is exercised against him at 60 and customer purchases the stock and delivers it the same day. What is the regulation T margin call, if any?

A. $2,400, the margin required on the purchase of stock C ($3,900) minus the margin released on the sale of stock C ($1,500). When an account is subject to section 8(g), the retention requirement provisions in the regulation do not provide for any release of any portion of the amount included in the adjusted debit balance computation in connection with the option prior to its exercise. The account, of course, may subsequently be refigured for any regulation T excess.

24. Q. Customer's account is the same as in question 23. However, when the call is exercised against him at 60, customer borrows the stock for delivery (without buying in), thereby establishing a short position in stock C. What is the regulation T margin call if any?

A. $3,250, the margin required on the newly established short position in stock C. Here, too, because the account is subject to section 8(g), the regulation would not permit the broker to offset the regulation T margin call by any portion of the amount previously included in the adjusted debit balance computation in connection with the outstanding option prior to its exercise. It should be further noted that subsequent to the exercise and during the time the customer maintains the short position in stock C, the adjusted debit balance computation for the short position would be based on the current market value of the security.

25. Q. Customer's account is the same as in question 23. However, when the call is exercised, the customer assumes a short position of 100 shares in stock C. Later in the day the customer covers his short position by purchasing on the open market 100 shares of stock C at 60. What is the regulation T margin call, if any?

A. $2,400, the margin required on the purchase of stock C ($3,900) minus the margin released on the sale of stock C ($1,500).

26. Q. Customer is short an uncovered call option on 100 shares of stock D with a striking price of 50 in his general account which is subject to section 8(g). His net debit balance was reduced by $1,500 (30 percent margin requirement) when the short option position was taken. Presently, the market value of stock D is down to 40 and customer's adjusted debit balance now includes $200 ($4,000×30 percent=$1,200 minus the mark to the market gain of $1,000). The holder of the option allows it to expire. May the customer who is short the option withdraw any portion of the amount included as margin in the adjusted debit balance computation in connection with the option or use the amount against another transaction?

A. No. When an account is subject to section 8(g), the retention requirement provisions in the Regulation do not provide for any release of any portion of the amount included as margin in the adjusted debit balance computation in connection with the option.

By order of the Board of Governors, June 15, 1973.

[SEAL] CHESTER B. FELDBERG,
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