

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 8019]
December 22, 1976

PROPOSED AMENDMENT TO MARGIN REGULATION T

Credit Extended by Brokers and Dealers to Exchange Specialists in Options

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

Following is the text of a statement issued December 16 by the Board of Governors of the Federal Reserve System:

The Board of Governors today published for comment a proposed amendment to its Regulation T (credit by brokers and dealers) to permit registered market makers or specialists in the options market to obtain stock, in certain limited circumstances, on a 25 per cent margin requirement.

The Board requested comment on the proposed amendment through January 17, 1977.

On some exchanges markets in options are made by "registered market makers" while on other exchanges "specialists" perform this function. Under the proposal, such option specialists could purchase and carry stock, as a hedge in their options operations, under specified limitations, at the lower margin rather than the current 50 per cent margin required when stocks are bought or carried on credit.

The purpose of the proposal is to facilitate the making of markets in options—that is, maintenance of continuous and narrow differences between bid and ask prices for options. An option is an agreement, which is itself defined as a security, under which the holder has the right to purchase or sell a particular stock at an agreed price during a specified time period. Option market makers may need at times, to avoid undue risk, to purchase offsetting holdings in the stock involved.

This would not change current provisions permitting specialists to receive good faith loan value on stocks they hold as inventory or as collateral in their options accounts.

The proposal would also permit specialists to use an alternate margin computation from that provided by the Board's uniform margin rule for the writing of options, which is to become effective January 1, 1977.

In a related development, the Board has been advised by the Securities and Exchange Commission that it does not propose to take any action if exchange specialists and market makers do not engage in future transactions in securities underlying exchange-listed options otherwise than in compliance with the amendments the Federal Reserve Board proposed today. In addition, the Commission will require that exchange specialists and market makers reduce any deficiency in their existing margin positions, calculated in accordance with the proposed rule amendment, so that, by February 1, 1977, any such deficiency shall have been reduced to 50 per cent, and, by May 1, 1977, any such deficiency shall have been eliminated completely.

Printed below is the text of the Board's proposal. Comments thereon should be submitted by January 17, 1977, and may be sent to our Bank Regulations Department.

PAUL A. VOLCKER,
President.

[Reg. T]

CREDIT BY BROKERS AND DEALERS

Notice of Proposed Rulemaking

(Docket No. R-0054)

Credit to Exchange Specialists in Options

The Board of Governors of the Federal Reserve System, pursuant to authority contained in sections 7 and 23 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78g and w), proposes for comment an amendment to the provisions in Regulation T which govern credit which a broker or dealer extends to exchange specialists. The purpose of this amendment is to

provide appropriate relief to option specialists who, in furtherance of their obligation to promote an orderly and efficient market, are required to assume certain security positions.

The amendment would permit a specialist in options, in certain limited circumstances, to purchase or

sell short in the specialist's account with a broker or dealer, securities underlying the options in which the specialist is registered. It would also provide a reduced margin requirement for such underlying securities at any time when they serve as a hedge against a short option position which is not offset by a corollary long option position. The proposed amendment would also provide an alternative method of calculating the adjusted debit balance in a specialist's account in order to provide relief for specialists with short security positions comparable to that presently provided to specialists with long security positions. The existing rule for specialist credit was written before the advent of exchange-traded options and, therefore, the concessions which it grants are not specifically structured for the mechanics of the options markets.

The proposed amendment is a response to a request for rulemaking made by the Chicago Board Options Exchange as well as a recognition by the Board of Governors that option specialists might need certain specific relief from the Board's uniform margin rule for the writing of options which is scheduled to go into effect on January 1, 1977. The uniform rule was published in the Federal Register on October 5, 1976 (41 F.R. 43895).

The Board's proposal would allow the purchase and short sale of a security underlying an option in a specialist's account when the account has a short option position which is susceptible to exercise and the account does not hold an offsetting position in a comparable "in-or-at-the-money" option on the same underlying security. While the underlying stock which has been purchased or sold short in the account serves as such a hedge, a margin of 25 per cent (instead of the current margin requirement of 50 per cent) will be required. If the underlying stock or short position is not liquidated when it no longer serves as an allowable hedge, the current margin requirements will be operative. Any account which carries positions in underlying stock which were purchased or sold short under the terms of the proposed rule must be maintained on a daily basis with no excess of the adjusted debit balance over the maximum loan value of the securities in the account.

The amendment is not intended to affect specialists who are not option specialists.

The proposed amended paragraph is set forth below:

SECTION 220.4—SPECIAL ACCOUNTS

* * *

(g) **Specialist's account.** (1) In a special account designated as a specialist's account, a creditor may effect and finance, for any member of a national securities exchange who is registered and acts as a specialist in securities on the exchange, such member's transactions as a specialist in such securities, or effect and finance, for any joint venture in which the creditor participates, any transactions in any securities of an issue with respect to which all participants, or all participants other than the creditor, are registered and act on a national securities exchange as specialists.

(2) Such specialist's account shall be subject to the same conditions to which it would be subject if it were a general account unless the specialist's exchange is a national securities exchange which requires and submits to the Board of Governors of the Federal Reserve Sys-

tem reports suitable for supplying current information regarding specialist's use of credit pursuant to this paragraph (g), in which case, the following modifications of and exceptions to the general rule will apply:

(i) The required calculations of §220.3(b)(1)(ii) to determine if an account is an "account subject to § 220.8(g)" and the requirements of § 220.6(b) regarding joint ventures shall not apply.

(ii) The maximum loan value of registered securities in such account shall be:

(a) Such maximum loan value as the Board shall prescribe from time to time in § 220.8 (the Supplement to Regulation T) where (1) the security is identified as held for investment pursuant to a rule of the Commissioner of Internal Revenue (Regs. section 1-1236-1(d)), or (2) the security is an underlying security acquired in the account as permitted under paragraph (g)(3) of this section and held in the account on any day when it is not eligible to be held pursuant to paragraph (g)(3)(i) of this section.

(b) 75 per cent of the current market value of an underlying security that is purchased in the account under the terms of paragraph (g)(3) of this section and held in the account on any day when it is eligible to be held pursuant to paragraph (g)(3)(i) of this section.

(c) The maximum loan value as determined by the creditor in good faith for any other registered security.

(iii) The amount to be included in the adjusted debit balance of the account shall be:

(a) The margin required for the writing of options may be either the amount required by § 220.3(i) and § 220.8 (the Supplement to Regulation T) or 130 per cent of the current market value of each option held in a short position in the account which is not offset by one of the positions which may be used in lieu of margin under § 220.3(i)(1).

(b) The margin required in connection with the sale of a security sold short in conformity with this paragraph shall be the current market value of the security sold short plus either 25 per cent of such current market value on any day when the position is eligible to be held pursuant to the conditions provided in paragraph (g)(3)(ii) of this section or such margin as the Board shall prescribe for short sales in § 220.8 (the Supplement to Regulation T) for positions not so held.

(iv) At any time when a position in an underlying security which was purchased or sold short in the account under the terms of paragraph (g)(3) of this section is held in the account, the account shall be maintained on a daily basis with no excess of the adjusted debit balance over the maximum loan value of the securities in the account.

(3) In this account, a specialist in options on a national securities exchange is permitted to purchase or sell short the securities underlying the options in which such member is registered and acts as a specialist only under one or more of the following conditions:

(i) The account holds short positions in call options in which the member is registered and acts as a specialist which are "in or at the money" but only to the extent the positions are not offset in the account by long

positions in call options for an equal or greater number of shares of the same underlying securities which are "in or at the money" and do not expire before the short positions in call options;

(ii) the account holds short positions in put options in which the member is registered and acts as a specialist which are "in or at the money" but only to the extent the positions are not offset in the account by long positions in put options for an equal or greater number of shares of the same underlying securities which are "in or at the money" and do not expire before the short positions in put options;

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

(iv) the account held a long position in an option which was exercised.

(4) For the purpose of this paragraph:

(i) The term "underlying security" means the security which will be delivered upon exercise of the option.

(ii) The term "joint venture" does not include any account which, by written agreement with a creditor,

permits the commingling of the security positions of a specialist or a specialist unit with those of other specialists or specialist units unless such agreement provides for a sharing of profits and losses from the account on some predetermined ratio.

(iii) The term "in or at the money" means, with respect to a call, that the current market price of the underlying security is not more than 5 per cent below the exercise price of the option, and, with respect to a put, the current market price of the underlying security is not more than 5 per cent above the exercise price of the option.

To aid in the consideration of this matter by the Board interested persons are invited to submit relevant data, views, comments, or arguments. Any such material should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, to be received not later than January 17, 1977. All material should include the docket number R-0054. Such material will be made available for inspection and copying upon request, except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).