

FEDERAL RESERVE BANK  
OF NEW YORK

[Circular No. 8623]  
August 15, 1979]

EXCHANGE SPECIALISTS; CREDIT ON MUTUAL FUND SHARES  
Comment Invited on Proposed Amendments to Regulation T

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

The Federal Reserve Board has proposed amendments to its Regulation T—"Credit by Brokers and Dealers"—that would (a) permit brokers and dealers to lend on mutual fund shares, and (b) permit options specialists to buy and sell short, on a 25% margin basis, the stock underlying the options in which they specialize.

Comment on the proposals should be submitted by October 15 and may be sent to our Consumer Affairs and Bank Regulations Department.

*Mutual fund shares*

The first proposal would permit brokers and dealers to extend and maintain credit on fully paid-for mutual fund shares deposited in a general account. Its purpose is to grant to broker-dealers the same authority that banks and other lenders now have under Regulations U and G.

*Exchange specialists*

The Board announced that its proposal affecting specialists and options market-makers includes the following changes:

1. Specialists and options market-makers would be able to use securities issued by the United States Government or its agencies as collateral in their specialist accounts.
2. Creditors extending credit to a specialist's joint account would no longer be required to participate in the account.
3. Members of a national securities association, such as the National Association of Securities Dealers, would be permitted to receive preferential credit for their market-making transactions if the SEC should determine that they perform the function of specialists and have similar responsibilities.
4. Several other changes, including: restricting "free-riding" on underlying stock positions carried in an options market-makers account; affecting the timing of withdrawal of cash or securities from their accounts by specialists and market-makers; and defining securities that may be carried on preferential credit terms in the accounts of specialists and market-makers.

The purpose of the proposal, the Board said, is "to give a certain amount of flexibility to the operations of brokers or dealers who finance the positions of those persons who have assumed responsibility for maintaining continuous markets in designated securities without permitting unwarranted speculation in the related securities used for 'hedging'."

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Enclosed—for member banks and brokers and dealers—is the full text of the Board's proposals. They will be published in the *Federal Register* and will also be made available upon request. Questions or comments should be directed to our Consumer Affairs and Bank Regulations Department (Tel. No. 212-791-5914).

THOMAS M. TIMLEN,  
First Vice President.

Title 12- Banks and Banking

Chapter II - FEDERAL RESERVE SYSTEM

SUBCHAPTER A - BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. T; Docket No. R-0158]

PART 220 - CREDIT BY BROKERS AND DEALERS

Loan Value for Mutual Fund Shares

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The proposal will permit brokers and dealers to extend credit on fully paid for mutual fund shares deposited in a general account. The present rule permits broker-dealers to extend and maintain credit only on securities registered on a national securities exchange, those included on the Board's List of OTC Margin Stock and on certain non-convertible debt securities which are traded in the over-the-counter market.

The Board intends the proposed rule to reduce significantly the inequity which exists between broker-dealers and banks, who are currently permitted to extend credit on mutual fund shares under Regulation U, and lenders registered with the Board under Regulation G who have the same authority.

DATE: Comments must be received on or before October 15, 1979.

ADDRESS: Secretary, Board of Governors of the Federal Reserve System, Washington, D. C. 20551. All material should be in writing and should include the docket number R-0158.

FOR FURTHER INFORMATION CONTACT: Patsy Abelle, Senior Attorney, or Theodore W. Prush, Senior Securities Regulations Analyst, 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: In response to a request of the Investment Company Institute the Board of Governors proposes to amend Regulation T (12 CFR 220) to permit brokers and dealers to extend

and maintain credit on securities issued by open-end investment companies and unit investment trusts ("mutual fund shares"). The proposal would permit a broker or dealer to extend credit only on fully paid for mutual fund shares deposited in a margin account. Due to the prohibition contained in section 11(d)(1) of the Securities Exchange Act of 1934 credit may not be extended on the initial purchase of such securities, in the absence of an exemption granted by the Securities and Exchange Commission.

Under the Board's existing rule a broker-dealer is permitted to extend and maintain credit only on securities registered on a national securities exchange, those included on the Board's List of OTC Margin Stock and on certain non-convertible corporate debt securities traded in the over-the-counter market. The Board's proposal would allow a broker-dealer to extend credit on mutual funds shares as well. Presently only banks under the provisions of Regulation U, and lenders registered with the Board under Regulation G are permitted to extend and maintain credit on investment company shares.

Mutual fund shares deposited in a margin account at a broker-dealer would be subject to the same margin requirement as any other margin security. The margin requirement is set forth in section 220.8(a) of Regulation T and is presently 50 per cent of current market value.

To aid in the consideration of this material 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 October 15, 1979. All material submitted should include the docket number R-0158. Such information 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)).

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 proposes to amend 12 CFR part 220 as follows:

#### Section 220.2 - Definitions

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(f) The term "margin security" means any registered security, OTC margin stock, OTC margin bond or any security issued by an open-end investment company or unit investment trust registered pursuant to section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8).

By order of the Board of Governors of the Federal Reserve System, August 8, 1979.

(signed) Theodore E. Allison

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Theodore E. Allison  
Secretary of the Board

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Title 12- Banks and Banking

Chapter II - FEDERAL RESERVE SYSTEM

SUBCHAPTER A - BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. T; Docket No. R-0054]

PART 220 - CREDIT BY BROKERS AND DEALERS

Credit to Exchange Specialists

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: This revision of a proposed amendment to the rule governing credit to exchange specialists, which was published in the Federal Register on May 5, 1977 (42 F.R. 22894), contains changes based upon comments received on that proposal and recommendations of the Securities and Exchange Commission Special Study of the Options Market. As revised, the proposal will permit options specialists to both purchase and sell short the stock underlying the options in which they specialize, with a 25 percent margin requirement. No maintenance requirement is imposed in this revision unless the account, if sold out, would have an unsecured debit balance. The proposed amendment also recognizes new exchange rules approved by the Securities and Exchange Commission which permit traditional stock specialists to trade in puts and calls on their specialty stock and provides comparable relief for such hedging activities. This proposed rule is intended to give a certain amount of flexibility to the operations of brokers or dealers who finance the positions of those persons who have assumed responsibility for maintaining continuous markets in designated securities without permitting unwarranted speculation in the related securities used for "hedging".

DATE: Comments must be received on or before October 15, 1979.

ADDRESS: Secretary, Board of Governors of the Federal Reserve System, Washington, D. C. 20551. All material submitted should be in writing and should include the docket number R-0054.

FOR FURTHER INFORMATION CONTACT: Laura Homer, Chief Attorney, or Theodore W. Prush, Senior Securities Regulations Analyst, 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: The May 5, 1977 proposal was intended to assist option specialists in performing their market-making function by permitting them, in certain circumstances, to purchase or sell short, on preferential

credit terms, the securities underlying the options in which they specialize. A specialist is a person registered on a securities exchange as a specialist in a particular security. In general, a specialist is required to assist in maintaining a fair and orderly market, either alone or in a competitive framework, for that security on the floor of the exchange. Although market makers in the over-the-counter market are not presently within the category, the proposed rule provides for their inclusion if the SEC determines they have parallel responsibilities and functions. The revised proposal would broaden the scope of permitted offset transactions for lower priced options by redefining the definition of an "in or at the money" option "hedging" transaction. The proposal also eliminates the requirement that a creditor participate in all joint account arrangements, and permits a specialist or market-maker to use fully paid for government securities as collateral in his account. In addition, the proposal restricts "free-riding" in a market-maker account, and establishes the conditions under which excess funds or securities may be withdrawn from the account.

To aid in the consideration of this material 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 October 15, 1979. All material submitted should include the docket number R-0054. Such information will be made available for inspection and copying upon request except as provided in section 261.1(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).

Pursuant to sections 7 and 23 of the Securities and Exchange Act of 1934, as amended (15 U.S.C. 78g and w) the Board proposes to amend 12 CFR part 220 as follows:

220.4 - SPECIAL ACCOUNTS

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(g) Specialist's account. (1) In a specialist's account, a creditor may effect, carry or clear for specialists who are members of a national securities exchange or registered securities association such member's designated 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.

(2) A specialist in options is permitted to establish in this account a long or short position in the securities underlying the options in which the specialist 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 transactions are referred to in this paragraph as "permitted offset transactions"):

(i) The account holds short options positions which are "in or at the money" and are not offset by long or short options positions for an equal or greater number of shares of the same underlying securities which are "in or at the money;"

(ii) The account holds long options positions which are "in or at the money" and are not offset by long or short options positions of an equal or greater number of shares of the same underlying securities which are "in or at 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 net long positions in securities other than options in which the specialist makes a market; or,

(vi) The account holds net short positions in securities other than options in which the specialist makes a market.

(3) 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 long positions in securities in which the specialist makes a market;

(ii) No more than 100 per cent of the current market value of any wholly-owned margin securities or exempted securities issued by the U. S. Government or agencies thereof;

(iii) 75 per cent of the current market value of any underlying securities or overlying options that are purchased and held in the account under the terms of paragraph (g)(2) of this section and for five full business days thereafter;

(iv) The maximum loan value prescribed by the Board in §220.8 (the Supplement to Regulation T) when the underlying securities or overlying options no longer serve as permitted offsets.

(4) 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 the securities sold short or the options written where such positions qualify as specialist transactions;

(ii) 125 per cent of the current market value of the securities sold short or the options written and held in the account under the terms of paragraph (g)(2) of this section and for five full business days thereafter;

(iii) The amount prescribed by the Board in §220.8 (the Supplement to Regulation T) when the underlying securities or overlying options no longer serve as permitted offsets plus, for short positions in securities other than options, the current market value of the securities sold short.

(5) 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 allow the specialist a maximum of five full business days to make a deposit sufficient to meet the call.

(6) On any day when the account of an options specialist no longer holds an option position against which the underlying security permitted to be purchased or sold short in the account under the terms of paragraph (g)(2) of this section can be offset, or when the account of a specialist in securities other than options no longer holds security positions against which the overlying options permitted to be purchased or written in the account under the terms of paragraph (g)(2) of this section can be offset, the creditor shall have five full business days to either liquidate the position or obtain a deposit into the account of cash or securities equal to the deposit that would be required to

establish such a position in the general account, reduced by a sum equal to 25 per cent of the current market value of the security. The requirement to liquidate the position or obtain additional margin need not be met if a new offsetting position is established in the interim. To prevent "free-riding" in the account, a creditor who has not obtained the required deposit is prohibited for a 30 day period from extending any further credit to finance in the account transactions in securities in which the specialist is not registered to make a market.

(7) On any day when a specialist requests a withdrawal of cash or securities from the account the creditor shall value non-specialist securities positions in the account in accordance with the provisions of §220.8 (the Supplement to Regulation T) and value specialist positions on a "good faith" loan basis. Withdrawals shall be permitted to the extent that the debit balance in the account does not exceed the value of all of the positions.

(8) 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 collateral which shall be met by noon of the following business day. In the event sufficient collateral is not deposited in the account the creditor shall liquidate existing positions in the account.

(9)(i) The provisions of this paragraph are available to a specialist (or a market-maker designated as a specialist) who is a member of a national securities exchange or registered securities association which submits to the Board of Governors of the Federal Reserve System reports suitable for supplying current information regarding the use of specialist credit;

(ii) The term "joint account" is 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;

(iii) The term "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;

(iv) The term "overlying option" means (1) a put option purchased or a call option written against an existing long position in a specialist's or market-maker's account, or (2) a call option purchased or a put option written against a short position in a specialist's or market-maker's account.



(v) The term "in or at the money" means, with respect to a call option, that the current market price of the underlying security is not more than the greater of 5 per cent or \$2.50 below the exercise price of the option, and, with respect to a put option, the current market price of the underlying security is not more than the greater of 5 per cent or \$2.50 above the exercise price of the option.

By order of the Board of Governors of the Federal Reserve System, August 8, 1979.

(signed) Theodore E. Allison

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Theodore E. Allison  
Secretary of the Board

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