

REGULATORY CIRCULAR RG98-30

Date: March 25, 1998

To:

- Members
- Member Firm Options Departments
- Member Firm Margin and Compliance Departments
- Member Firm Stock Loan Departments
- Member Firms Engaged Only in the Business of Financing and Carrying Market-Maker Accounts

From: Department of Financial and Sales Practice Compliance

Subject: Amendments to Regulations T and U

The Board of Governors of the Federal Reserve System (the "FRB") has announced further amendments to Regulation T and U which become effective on **April 1, 1998**.¹ These amendments address many issues raised by the Exchange that had not been addressed through amendments implemented by the FRB in June 1996 in connection with a general review of Regulation T that was initiated in 1992. In addition, further amendments were necessary after the National Securities Markets Improvement Act was signed into law in October 1996. Amendments most relevant to option positions are highlighted below.

REGULATION T

Elimination of the initial margin requirement on short securities when offset by a long call. The FRB is allowing a long call to serve as margin for short sales of the underlying security. The FRB is requiring that the long call be 1) American style; 2) issued by a registered clearing corporation and traded on a national securities exchange; and 3) in or at-the-money with respect to the price at which the security was sold short.

The FRB has not acted on the Exchange's requests to eliminate or relax the initial margin requirement on a long security if it is paired with a long put. However, the FRB does not preclude the Exchange from developing rules that

¹ See FRB Release published January 16, 1998, Docket Nos. R-0905, R-0923 and R-0944. (63 F.R. 2805).

would provide a more favorable margin treatment through a portfolio margining system.

Portfolio Margining. The FRB is adding a provision to Reg. T which will allow portfolio margining to be developed by the industry and approved by the Securities and Exchange Commission as an alternative to compliance with Reg. T. This action opens the way for risk-based margin rules for stock / option offsets.

Elimination of collateral requirements for lending securities. The FRB has eliminated collateral requirements for the borrowing and lending of securities. The collateral required has been cash or cash equivalents equal to the current market value of the security loaned. Now, lenders will be able to accept a fully paid call option along with cash equal to the call's aggregate exercise amount as collateral, which is a capability the Exchange has long sought.

REGULATION U

Enhanced financing capability for market-maker clearing firms. In the same announcement, the FRB also detailed amendments to Regulation U (Credit by Banks and Persons Other Than Broker-Dealers For the Purpose of Purchasing or Carrying Margin Stocks). With respect to broker-dealers whose non-proprietary activity is limited solely to the business of financing and carrying the accounts of registered market-makers, the Exchange was successful in persuading the FRB to allow an exception that will enable such firms to finance proprietary trading, including joint back office activity, on a good faith basis with banks, insurance companies and other institutions with the exception of broker-dealers.² The FRB is providing this capability through an amendment in Regulation U. Except for broker-dealer loans, this gives such clearing firms equal footing with clearing firms that conduct a substantial business with persons other than broker-dealers and are thus exempt from FRB margin regulations under the Markets Improvement Act.³

Non broker-dealer lenders able to lend up to 50% on listed options. In respect of options, Reg. U has also been amended to allow lenders other than broker-dealers (e.g., banks) to extend 50% loan value against listed options. The Exchange, based on the input of member firms, and in uniformity with the other option self-regulatory organizations ("SROs"), has filed a rule change with the SEC seeking a 25% loan value for listed options and only for options with an expiration exceeding 9 months (see SR-CBOE-97-67). This amendment to Reg.

² A "joint back office" or "JBO" arrangement involves the purchase of an ownership interest in the clearing firm by a broker-dealer customer of the firm, thereby permitting the customer to receive good faith financing as an "owner" of the firm.

³ It is the FRB's position that Section 7(c) of the Securities Exchange Act of 1934 does not give it authority to exempt borrowing by a broker-dealer. It is easier for the FRB to provide an exception through an amendment to Reg. U. Therefore, the FRB gave lenders other than broker-dealers the capability to loan on a good faith basis to broker-dealers engaged solely in the business of financing and carrying the accounts of registered market-makers.

U should provide further support for the extension of loan value to long options under SRO rules.

The FRB's announcement contains numerous other amendments, most being technical in nature or not directly related to options. Questions regarding amendments to the FRB's regulations should be directed to Jim Adams (786-7718) or Rich Lewandowski (786-7183) in the Department of Financial and Sales Practice Compliance.