



TESTIMONY OF

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U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING DAY TRADING

BEFORE THE PERMANENT SUBCOMMITTEE ON
INVESTIGATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS

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Testimony of Arthur Levitt

Chairman

United States Securities and Exchange Commission

Concerning Day Trading

Permanent Subcommittee on Investigations

Committee on Governmental Affairs

United States Senate

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Chairman Collins, Ranking Member Levin, and Members of the Subcommittee:

I appreciate the opportunity to appear before this subcommittee today to discuss the recent developments in day trading and the concerns raised by day trading, and the current initiatives to address these concerns. The Securities and Exchange Commission (“Commission”) has been actively monitoring this novel trading strategy and I commend the Chairman, the Ranking Member, and Members of the Subcommittee for holding these timely hearings.

I. Introduction

Technology developments, in recent years, have had a fundamental impact on securities markets. New systems and the explosive growth of the Internet have provided millions of Americans with unprecedented access to these markets and introduced many new investors to the benefits of investing. Technology and the Internet are valuable tools for investors, who can now monitor, manage, and trade their own portfolios. Investors have access to a wealth of information, which enables them to make their own investment decisions. These developments

have also had a great impact on the securities markets by increasing market liquidity and transparency.

Technological advances have also fostered the development of a new kind of broker-dealer. These firms promote day trading, which discards many established investing principles, such as choosing securities to buy and sell based upon company fundamentals and performance. This new trading phenomenon, while well-publicized, is relatively limited in its reach, with the number of day traders estimated to be less than 7,000. By comparison, there are close to 80 million individuals that own stock and more than 5 million investors using the Internet for brokerage services. The Commission also does not believe that day trading currently presents systemic problems for our markets.

Nevertheless, the Commission is well aware of the potential for individuals to be seduced by promises of easy profits by day trading without fully understanding the risks. Investors should understand that day trading involves significant risk of loss, and that they should not trade with funds they cannot afford to lose. Accordingly, in pursuit of the Commission's mission to ensure fair and orderly markets, and to protect investors, our regulatory, examination, and enforcement staff are looking closely at the activities of firms that promote day-trading activities. The Commission achieves its mission through the application and enforcement of a regulatory scheme based largely on full and fair disclosure. Further, the Commission's investor education efforts reinforce the most important message about day trading – that it is very risky. We are diligently pursuing those firms that do not fully comply with the securities laws. Ultimately, however, if full disclosure is made, the securities laws do not prohibit day trading.

This testimony is designed to inform the Subcommittee about the differences between day trading and other types of electronic, or on-line trading, the Commission's principal

concerns about day-trading activities, and some initiatives taken by the Commission, the self-regulatory organizations (“SROs”) and the industry to address these concerns.

II. What is Day Trading?

The practice of marketing day trading on a retail basis appears to have started about three years ago when advances in computer software allowed individuals to have direct links to the securities markets in a way previously available only to registered professionals. Because the level of individual trading activity varies across a wide spectrum, it is difficult to clearly define “day trading” or “day trader.” On one end of the spectrum lie investors who trade occasionally -- sometimes on-line -- and hold their investments for the longer term. Moving along the spectrum, an increasing number of individuals use their on-line accounts both to invest longer term and to trade short term on momentum or small changes in the price of a stock. On the far end of the spectrum are so-called “day traders,” who exclusively buy and sell stock rapidly throughout the day trying to make money on short-term market moves.

A fundamental distinction between a day trader and a more traditional retail investor who manages investments on-line is the kind of broker-dealer through which he or she trades. The typical broker-dealer the Commission identifies as a day-trading firm advertises the day-trading services it offers along with the benefits of day trading, and solicits individuals to become full-time day traders. Most day-trading firms also teach individuals to engage in strategies based on rapid-fire buying and selling of price-sensitive stocks and then encourage these individuals to use this strategy on an ongoing basis. For a fee, some firms --or their affiliates -- provide training on how to make money trading on small price movements. Day-trading firms also frequently provide their traders with proprietary software and systems that analyze and chart activity in particular stocks. Typically, day-trading firms offer these services at on-site trading facilities,

rather than through Internet web sites. On-line firms, by contrast, merely offer an electronic order entry service to their customers and do not encourage the use of any particular trading strategy.

A second distinction between traditional brokerage and day-trading firms is that day-trading firms provide individuals with “real time” links to the major stock markets and the Nasdaq. These linkages give individuals substantial market information not readily available to the average retail investor and provide direct entry to the firms’ order processing systems. This direct access to market-operated order execution systems allows these individuals to send their orders to a particular market or market maker. Through these systems, day traders can receive a trade execution within seconds.

While on-line and traditional retail brokerage firms often provide real-time quotation information, they do not provide the linkages that day-trading firms do to markets and market makers that allow individuals to make their own order routing decisions.¹ Instead, traditional and on-line firms’ systems have pre-set algorithms that determine where a customer’s order is routed for execution.

Although broker-dealers are not required to identify themselves as “day-trading firms,” 62 broker-dealers, with 287 branch offices, were recently characterized as day-trading firms by the North American Securities Administrators Association (“NASAA”).² The Commission

¹ A few on-line firms are beginning to offer their customers services that allow those customers to make their own order routing decisions. However, these services are not promoted as tools for day trading.

² See NASAA, Day Trading Project Group Report, August 9, 1999.

estimates that the number of day-trading firms, in fact, exceeds 100, and believes that there are approximately 5,800-6,800 persons trading full time through day-trading firms.³

III. Organization of Day-Trading Firms

Day-trading firms are typically organized in one of two ways. Most day-trading firms -- like most other broker-dealers -- have customers who open accounts with the firm and use the assets in their own accounts to trade. These day-trading firms are registered with the Commission and are members of the National Association of Securities Dealers ("NASD"). As such, they are subject to all Commission and NASD rules.

Other day-trading firms choose to organize as entities such as limited liability companies ("LLCs"), which sell interests in the firm to individuals wishing to day trade. These firms are registered as broker-dealers, but because individuals who day trade at these firms are part owners of the day-trading firms, they are not considered "customers." Instead, these individuals are "associated persons" of the firm. The day-trading firm allows these individuals to trade using a portion of the firm's capital often an amount tied to the amount of each individual's capital contribution.

There are several implications of day traders being part owners of the firm, rather than customers. First, although the firms are registered as broker-dealers with the Commission, day-trading firms organized as LLCs can avoid becoming NASD members, and are therefore not subject to NASD rules. Rule 15b9-1 under the Securities Exchange Act of 1934 ("Exchange

³ The Electronic Traders Association ("ETA") -- a national association that represents order entry and other related firms -- estimates that there are 4,000 to 5,000 day traders. The ETA's estimate, however, does not include individuals associated with limited liability companies affiliated with the Philadelphia Stock Exchange ("Phlx"). The Phlx

Act”)⁴ exempts a broker-dealer from the requirement of being a NASD member if the broker-dealer does not have customer accounts and is a member of a national securities exchange.

Although this exemption was intended primarily for exchange specialists, a number of day-trading firms are organized as LLCs and are using this exemption as a means to maintain membership only in the Phlx. About 12 to 15 day-trading firms are currently members only of the Phlx. Second, as discussed further below, day traders who trade a firm’s capital can lawfully use leverage significantly beyond the levels permitted by the customer margin requirements promulgated by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and the SROs.

IV. Risks and Concerns Raised by Day Trading

Investing in securities always involves some degree of risk. The critical issue is whether the investor fully understands the level of risk he or she is assuming. While technology provides innumerable benefits to investors by making trading easier and faster, new and relatively inexperienced investors may be using this technology to trade in ways that do not match their goals and risk tolerance. The Commission believes that the riskiness of day-trading strategies must not be hidden. While individuals should be allowed to make their own investing and trading decisions, they need a clear and complete understanding of what the risks are so that they can make an *informed* decision.

The Commission’s mission is to preserve market integrity by promoting fair, orderly, and transparent markets, and to protect investors. An essential component of market integrity is

represents that there are approximately 1,800 day traders associated with Phlx member day-trading firms.

⁴ 17 CFR 240.15b9-1.

investor confidence. Investors lose confidence when misleading information and exaggerated claims are allowed to go unchecked. Accordingly, the Commission supports efforts to ensure that day traders completely understand the risk implications of their trading decisions, and understand that a day-trading strategy carries high costs. Day traders invariably generate hefty commissions and often pay fees for computer and other electronic services. Consequently, they need to make significant profits simply to cover the costs of their trades. If day traders are adequately apprised of the risks of their day-trading strategy, the Commission believes that individual day traders bear responsibility to make sure that they do not trade with funds they cannot afford to lose.

The Commission staff is currently undertaking examinations of more than 40 day-trading firms.⁵ Day-trading firms are registered broker-dealers and, as such, must comply with a panoply of Commission and SRO rules. These firms and their principals can be held liable for violations of the securities laws. Our examinations preliminarily indicate that some day-trading firms are not in compliance with applicable rules and regulations. To date, however, we have not found marked and widespread fraud by these firms. Nonetheless, we have concerns that some day-trading firms may not maintain adequate books and records, or comply with the broker-dealer capital rule, the short sale rule, or margin requirements. These rules are important, and the Commission will vigorously pursue any firms that violate them.

We discuss in greater detail below the Commission's areas of concerns about day-trading firms' operations and the current initiatives to address these concerns.

⁵ The NASD has also inspected over 20 day-trading firms.

1. Disclosure and Advertising Practices

The Commission has concerns about the disclosure and advertising practices of broker-dealers that promote day trading and provide facilities for day traders. We also have concerns about some web sites sponsored by unregistered persons that are catering to day traders by providing them with “hot tips” and “expert advice.”

The Commission’s partnership with the states is a critical part of our efforts in this area. A number of states have been leaders in pursuing false and misleading information disseminated about day trading -- not only as a potential violation of securities laws, but also as a violation of state consumer protection laws.

The Commission’s concerns are more fully discussed below.

a. Promotion of Day Trading by Registered Broker-Dealers

Certain of the disclosure and advertising practices of day-trading firms raise concerns under the federal securities laws. Deceptive advertising can be a violation of the antifraud provisions of the federal securities laws. It can also violate the NASD’s rules prohibiting exaggerated, unwarranted, or misleading statements or claims and requiring members to observe just and equitable principles of trade. Because the Commission believes that firms should not give day traders unrealistic expectations about the potential to profit and should provide day traders with a full explanation of the risks of their trading activities, our ongoing examinations are focused on identifying advertising and other promotions that are inconsistent with the antifraud provisions or NASD rules.

Day-trading firms use various forms of advertising to solicit potential customers. Newspapers, magazines, and web sites are among the most popular advertising mediums. These firms promote to potential day traders such benefits as “maximum leveraged capital of 10 to 1,”

“state-of-the-art trading systems,” “after-hours trade execution capability,” “maximum profit potential,” and “training by experienced professionals.” In some cases, firms claim to offer services that they do not actually provide. The Commission is most concerned with unbalanced advertising and exaggerated claims of profitability, in other words, advertisements that detail the benefits of day trading without disclosing the associated risks and costs. In some cases, representations by day-trading firms that promise profits without disclosing the inherent risks of the day-trading strategy, including available information on probability of profit, may rise to the level of fraud.

The Commission staff recently reviewed the risk and related disclosures on web sites of more than 20 day-trading firms. Many of these sites had little or no risk disclosure, and some contained statements that were not fulsome about, or even downplayed the risks associated with, day trading. Nevertheless, half of the web sites had considerable disclosure about those risks. In our ongoing examinations of these firms, we are evaluating whether other materials that are given to customers include exaggerated or misleading claims as well as the adequacy of risk disclosure.

We are also concerned about the promotion by some day-trading firms of lending between day traders to cover margin deficiencies without fully disclosing all of the risks. This practice is often referred to as journaling. Regulation T, which governs extensions of credit by and to broker-dealers,⁶ provides that a firm may arrange for the extension of credit to or for any customer by any person, provided the broker-dealer does not willfully arrange credit in violation

⁶ Section 7 of the Exchange Act prohibits broker-dealers and other persons from extending credit in contravention of the rules and regulations promulgated by the Federal Reserve. In accordance with its statutory authority, the Federal Reserve promulgated Regulation T “to regulate extensions of credit by broker-dealers.” 12 CFR 220.

of Regulations U or X.⁷ Traditionally, journaling has been used in rare instances when one individual -- often a relative -- agrees to cover the margin deficiencies of another individual. Typically, these loans are made on an overnight basis to traders who would otherwise face a margin call. The borrowers are typically charged interest of one-tenth of 1 percent daily, which amounts to 36.5 percent on an annual basis. The increasing use of journaling raises significant concerns, particularly if day-trading firms are actively promoting such lending between customers without fully disclosing all of the risks to both lenders and borrowers. It also raises the concern that some day traders may not fully understand that they are trading beyond their own means.

b. Advertising by Unregulated Web Sites

The Commission is also concerned about web sites that, although not operated by day-trading firms, are trying to capitalize on the day-trading phenomenon. These sites offer, for a fee, so-called “expert investment advice.” Often the sites will provide stock recommendations on a daily basis to day traders. Many of these sites feature prominent advertising that trumpets the potential rewards of day trading by use of their recommendations. These sites rarely make sufficient risk disclosure. Whether these sites are operating as unregistered investment advisers, however, depends on the facts and circumstances of a particular case.⁸ Some of these web sites may provide the type of individualized investment advice that could be covered by the Investment Advisers Act of 1940.

⁷ 12 CFR 220.13. Regulation U applies to margin stock credit extended by banks and persons other than broker-dealers. Regulation X requires that credit obtained within or outside the U.S. comply with Regulations T and U.

⁸ In *Lowe v. SEC*, the U.S. Supreme Court held that a publisher of a securities newsletter which provides impersonal investment advice and commentary to subscribers was not

2. Leverage

Leverage is a common element in day-trading firms' and their customers' trading. In general, both the broker-dealer net capital rule and customer margin requirements limit leverage. The relative importance of these rules to day traders is directly related to the structure of the firm through which they trade.

When a firm has customers who are day traders, those customers may only day trade in margin accounts. In addition, the firm may only lend to these customers in compliance with both the initial margin requirements of Regulation T and the maintenance margin requirements under SRO rules. Regulation T allows broker-dealers to lend to their customers up to 50 percent of the initial purchase price of stock ("initial margin"). After the initial purchase, the SROs' margin rules require customers to maintain equity in their accounts equal to at least 25 percent of the value of the stock held in the account ("maintenance margin").

Margin requirements are calculated at the end of each day. Accordingly, to comply with Regulation T, a customer must have on deposit in his or her margin account equity (consisting of cash or fully paid securities) equal to 50 percent or more of the purchase price of any stock purchased that day and still held in the account at the end of the day. To comply with SRO maintenance margin requirements, a customer must leave on deposit in his or her margin account equity equal to at least 25 percent of the value of stock held in that account at the end of the trading day.

Because margin requirements are only calculated at the end of each day, a day trader⁹ who has no positions in his or her account at the end of the day would have neither an initial margin nor a maintenance margin requirement, assuming no losses in the account. Nonetheless the day trader and, to the extent credit is extended, the firm are at risk during the day.

To address this risk, the SROs established separate margin rules for day traders, which require day traders to demonstrate that they have the ability to meet the initial margin requirements for at least their largest open position during the day. More specifically, these rules require a customer to deposit in his or her account at the end of the day, the margin that would have been required under Regulation T (*i.e.*, the 50 percent initial margin requirement) if the customer had not liquidated the positions during the trading day.¹⁰

If a customer's account is below the initial or maintenance margin minimums, the broker-dealer must ask the customer to deposit additional cash or securities to satisfy the margin deficiency. This request is known as a margin call. Customers typically have 15 days to meet a margin call. Customers who are day traders, however, only have 7 days to meet a call for additional cash or securities.

One purpose for establishing margin requirements was to prevent broker-dealers from lending too much money against collateral whose value had the potential to fall quickly (*i.e.*, stock). While margin requirements are designed to protect the financial integrity of broker-dealers that provide credit, they also protect customers from taking on too much leverage. Accordingly, the Commission has concerns when firms fail to comply with margin requirements

⁹ Under SRO rules, a day trader is a person who buys and sells the same security on the same day at least three times in a calendar year.

¹⁰ See, *e.g.*, New York Stock Exchange Rule 431 (f)(8)(B).

or fail to adequately disclose the risks and costs associated with borrowing money. The Commission's staff has found isolated instances where day-trading firms appear to have failed to comply with margin requirements or properly disclose terms and conditions of loans in contravention of SEC rules.¹¹ We continue to scrutinize these issues.

As mentioned above, when day-trading firms are organized as LLCs and individual day traders contribute to the firm's capital, the day traders are permitted to trade using the firm's capital. These LLC firms typically participate in joint back office ("JBO") arrangements, which allow them to enhance their borrowing power.¹² JBO arrangements have become popular because they allow day-trading firms to receive preferential margin treatment from their clearing firms. Specifically, a day-trading firm that participates in a JBO arrangement can receive credit from its JBO clearing firm on "good faith" terms. As a result, the customer margin requirements found in Regulation T and SRO rules do not limit the extension of credit to a JBO participant. Rather, credit can be extended for up to 100 percent of the purchase price of the securities. As discussed below, the SROs have proposed revisions to their rules that would make these JBO arrangements more difficult to use.

Because of the borrowing power permitted by JBO arrangements, the leverage of day-trading firms organized as LLCs is limited only by the net capital rule. This essentially allows firms to leverage their position 6 to 1, rather than the 2 to 1 leverage allowed day traders under SROs' rules.

¹¹ See Exchange Act Rule 10b-16, 17 CFR 240.10b-16.

¹² Section 220.7(c) of Regulation T authorizes the creation of JBO arrangements. These JBO arrangements permit "a creditor [to] effect or finance transactions of any of its owners if the creditor is a clearing and servicing broker or dealer owned jointly or individually by other creditors." 12 CFR 220.7(c).

3. Unregistered Broker-Dealer and Investment Adviser Activities

Some day-trading firms are reportedly encouraging individual day traders to take on “partners” or other third parties from whom the day traders would obtain additional funds for trading. Depending on the facts, these activities could be characterized as unregistered broker-dealer or investment adviser activities. The definitions of broker and dealer under the Exchange Act are very broad and could potentially encompass these day traders’ third party activities. Specifically, an individual who “is engaged in the business of effecting transactions in securities for the account of others” (*i.e.* a broker),¹³ or an individual who is “engaged in the business of buying and selling securities for his own account” (*i.e.*, a dealer),¹⁴ would be required to register as a broker or dealer under Section 15(b)¹⁵ of the Exchange Act. To the extent that individuals are handling funds and securities for others, receiving transaction-based compensation or purchasing securities for third parties, they may be acting as “brokers” or “dealers.”

In addition, while investment advisers with less than \$25 million of assets under management do not have to register with the Commission, they may have to register in one or more states. Some states have found that individuals at some day-trading firms were operating as unregistered investment advisers.¹⁶

4. Short Sale Rule Violations

Selling short is a trading strategy that enables an investor, who believes that the price of a security will decline, to profit from the security’s decline by selling the security without actually

¹³ Exchange Act § 3(a)(4), 15 U.S.C. 78c(a)(4).

¹⁴ Exchange Act § 3(a)(5), 15 U.S.C. 78c(a)(5).

¹⁵ Exchange Act § 15(b), 15 U.S.C. 78o(b).

¹⁶ See *In Re Day Trade, Inc., et al.*, (Tex. SSB Ref. 98-020) (April 6, 1998).

owning it. If the security's price does decline, the investor can purchase the security at the lower price to deliver to the initial purchaser (*i.e.*, "cover" the short position). If, however, the security's price rises, the investor will have to pay the higher price to cover his short sale and thus incur a loss on the transaction.

The short sale rule prohibits investors from selling an exchange-listed stock short unless the stock's last trade was at the same price or higher than the previous trade -- the uptick rule. In addition, firms that sell a stock short or allow their customers to sell short must first make sure that the shares can be borrowed or that delivery of the securities can be made to the purchaser by the settlement date.¹⁷ Although the Commission's short sale rule does not prohibit short selling of Nasdaq stocks, the NASD's rules do.¹⁸

There have been reports of day traders executing short sales in violation of the short sale rule. Examinations preliminarily indicate that some firms may be deliberately circumventing the short sale rule by falsely designating trades as "long" sales when they are actually short sales. This is an area of focus in the Commission's inspections of day-trading firms.

In addition, under the Exchange Act registered broker-dealers have a duty to supervise their associated persons with a view to preventing violations of the federal securities laws. In the case of firms that are formed as LLCs, day traders are associated persons. Therefore, these LLCs have a responsibility to ensure that their traders fully comply with the securities laws.

Accordingly, if a day trader who is trading an LLC firm's capital is found to violate any

¹⁷ See Exchange Act § 10(a), 15 U.S.C. 78j(a) and Exchange Act Rule 10a-1, 17 CFR 240.10a-1; and Exchange Act Rule 10a-2, 17 CFR 240.10a-2. See also New York Stock Exchange Rule 440B.

¹⁸ See NASD Rule 3350. The NASD's short sale rule applies only to National Market System securities and prohibits short sales of such securities at or below the current best (inside) bid when the current best (inside) bid as displayed on Nasdaq is below the

provision of the federal securities laws, the firm itself could potentially be held responsible and sanctioned by the Commission. Our examinations have found that day-trading firms do not have strong supervisory structures in place, and in particular, may lack the surveillance systems needed to prevent and detect short sale violations by day traders.¹⁹

When day traders are trading using the firm's capital, and the firm's aggregate position in a stock is "short," the firm must ensure that no trader at the firm executes any trade that violates the short sale rule. In other words, a firm must have procedures designed to prevent a trader from selling on a down tick when the firm's aggregate position in the stock is short. The Commission found that traders at some LLC firms do not have access to the firm's aggregate position, and would therefore be unable to determine whether they were complying with the short sale rule.

Overall, the Commission has concerns that many day-trading firms may not be complying with the short sale rule and, further, some may have no mechanism for ensuring compliance with this rule.

V. Commission, SRO and Industry Initiatives

1. Revising Exchange Act Rule 15b9-1²⁰

Broker-dealers that are members of a national securities exchange currently do not have to become members of the NASD if they do not have customer accounts. A number of day-trading firms have taken advantage of this exemption and are members only of the Phlx. The

preceding best (inside) bid.

¹⁹ In the case of day-trading firms that are not organized as LLC, day traders are customers rather than associated persons. Therefore, these firms do not have a duty to supervise their day-trading customers.

²⁰ 17 CFR 240.15b9-1.

Commission staff is considering revisions to this exemption, found in Rule 15b9-1, to require day-trading firms conducting off-floor activities to become members of the NASD and comply with NASD rules. We are considering this revision because we do not think the existing rule structure of the regional exchanges is well-suited for the day-trading business. By amending Exchange Act Rule 15b9-1, all day-trading firms would be subject to NASD rules.

Rule 15b9-1 was intended to exempt exchange specialists from the requirement under Exchange Act Section 15(b)(8)²¹ that a broker-dealer be a member of a national securities association. Of course, in adopting any change to the exemption in Rule 15b9-1, we will be careful not to interfere unduly with the valuable market making functions firms, such as specialists, provide to exchanges.

2. Leverage Issues

The Commission and the SROs are reviewing the broker-dealer financial responsibility rules and margin rules to determine whether these rules should be modified or enhanced to better address the increase in day trading. The Commission is also studying credit risk practices at day-trading firms to determine whether the firms are applying prudent credit risk procedures when setting trading limits for customers.

- Loans Between Customers

The Commission is reviewing the use of customer-to-customer unsecured loans (*i.e.*, journaling). While lawful, we are concerned about this practice, particularly where broker-dealers are actively facilitating these loans. The Commission is evaluating the adequacy of the

²¹ 15 U.S.C. 78o(b)(8).

disclosure made to lenders and borrowers to ensure that it adequately discloses the risks to both parties.

In addition to the disclosure issues, we are looking at these customer-to-customer loans that are used to satisfy day traders' margin requirements. Rather than serving as a guarantee between accounts, these customer-to-customer loans often take the form of a letter of authorization, where the lender agrees that it will make funds available to the borrower for the purpose of meeting margin calls. Generally, these unsecured loans between customers do not violate margin regulations. The Commission and the SROs, however, do not believe that relying on these letters of authorization is a prudent credit practice. Instead, lenders should be required to commit to transfer funds if, for example, there is a loss in the borrower's account.

Some market participants are also concerned about this practice. It was recently reported that Spear, Leeds & Kellogg, a broker-dealer that clears trades for some day-trading firms, is no longer willing to engage in the practice of journaling for its correspondent firms.

- SRO Actions on Margin and Capital

As part of the Commission's and SROs' overall review of day-trading firms, the New York Stock Exchange ("NYSE") recently issued an Information Memorandum reminding broker-dealers that they are required to maintain sufficient net capital at all times, not just at the end of the day.²² This means that day-trading firms organized as LLCs must be able to demonstrate that they have sufficient net capital for intra-day positions, even if the intention of the firm is to liquidate or cover the positions before the end of the same day. Accordingly, a firm must develop procedures for closely monitoring the day-trading activities of its day-trader

²² NYSE Interpretation Memorandum No. 99-8 (August 1999).

members to ensure that the firm is not leveraged beyond what is permitted under the Commission's net capital rule.

Generally, the net capital rule requires broker-dealers to take a capital charge if a customer fails to meet a margin call. With respect to outstanding margin calls in customer day-trading accounts, the Commission is working with the NYSE on an Information Memorandum that will remind broker-dealers that they must take a capital charge for outstanding special maintenance margin calls associated with day-trading accounts. The Memorandum will clearly state that a capital charge applies to day-trading margin calls as well as other types of margin calls. The Notice also will remind firms that they should be taking this capital charge even for margin calls on day-trading positions that were liquidated at the end of the day.

In addition, the NASD, in December of 1998, released a Notice to Members clarifying member understanding of margin calculations, under Regulation T and NASD Rule 2520, for day-trading and cross-guaranteed accounts.²³ Further, the Notice to Members clarified that members must be in compliance with the Commission's net capital requirements under Exchange Act Rule 15c3-1.²⁴

Specifically, the NASD stated that customers may day trade only in margin accounts because day trading in a cash account could amount to free riding (*i.e.*, purchasing a security and then selling it without having paid for the purchase). Thus, day-trading firms must be in compliance with both Regulation T and NASD margin rules at all times. This requires day-trading firms to perform two separate calculations for each customer, one for Regulation T and

²³ NASD Notice to Members 98-102 (December 1998).

²⁴ 17 CFR 240.15c3-1.

one for the NASD rule, at the end of each day. Moreover, the NASD reiterated that just because broker-dealers must calculate customer margin at the end of each day does not mean that they can disregard intra-day risk and that they may impose margin calls based on intra-day calculations. However, broker-dealers may not grant additional buying power to customers on the basis of intra-day calculations.

- Capital Contributions

In response to day-trading firms organized as LLCs, the Commission staff is preparing a letter to the SROs to restate the Commission's position that an investor must make a long term investment in the broker-dealer before that investment may be included in the firm's net capital. Under current net capital rules, day traders who invest in an LLC cannot withdraw their investment a short time later if they simply decide to stop day trading. In fact, the investor may not be able to withdraw his investment at all if the withdrawal would jeopardize the firm's net capital position. We are examining firms to ensure that they have treated funds contributed by these investors appropriately, including whether investors in day-trading firms received adequate disclosures regarding the restrictions on their ability to withdraw their investment in the firm. Preliminarily, however, we have not found problems with these agreements.

- Joint Back Office Arrangements

Margin and other credit issues are further being addressed through a series of SRO rule filings that propose capital and equity requirements for members participating in JBO arrangements. As discussed earlier, JBO arrangements allow day-trading firms to borrow from their clearing firm on "good faith terms." In other words, the margin requirement is any amount mutually agreed upon by the parties. JBO arrangements are attractive to day-trading firms because they enable these firms to borrow at lower interest rates and for up to 100

percent of the purchase price of securities. The SRO proposals would limit day-trading firms' ability to use JBO arrangements by establishing significant capital and equity requirements. These new requirements would ensure that clearing firms extend good faith credit to day-trading firms under JBO arrangements in a prudent manner.

3. NASD Sales Practice Proposal

The NASD submitted to the Commission, on August 20, 1999, proposed rule changes designed to address the sales practices of day-trading firms.²⁵ The first initiative would require firms that promote day-trading activities to disclose to customers, prior to opening accounts, the risks associated with that type of trading. The disclosure would include several points for customers to consider before engaging in day-trading activities, including that the customer should be prepared to lose all of the funds used for day trading and that day trading on margin may result in losses beyond the initial investment.

The second initiative would require day-trading firms to make a threshold determination that day trading is appropriate for a particular customer. Specifically, a day-trading firm, in approving an account for day trading, would need reasonable grounds for believing that a day-trading strategy is appropriate for a customer by gathering essential facts about the customer. This determination would not be required if the customer signs an agreement stating that he or she does not intend to use the account for day-trading activities. If the firm later discovers that the account is used for day-trading activities, the firm would be required to approve the account for day trading within 10 days of discovery.

²⁵ The NASD, as part of its recent sales practice and disclosure rule proposal, proposed the following definition of day-trading strategy: "An overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities." See SR-NASD-99-41 (August 20,

The Commission published these proposed rules for comment on September 14, 1999.²⁶ The comment period will end twenty-one days after the notice has been published in the Federal Register.

4. Investor Education

The Commission believes that investor protection -- at its most basic and effective level - starts with the investor. In this day and age, there is no substitute for investor awareness and caution. Four months ago, the Commission unveiled its new investor education web site, www.sec.gov/invkhome.htm. The site offers investors the best information and advice we have about investing -- including on-line trading and day trading.

Day trading is risky, and it is therefore critical for day traders to understand three things. First, investors should make sure the firm is registered with the Commission and the state in which it does business. Second, investors should check with their state regulator to see whether the firm has a disciplinary record or history of complaints. Finally, investors should understand that day trading may result in severe financial losses, with little expectation of ever making a profit.

5. Series 7 Exam

Because some day-trading firms have been able to maintain membership solely in the Phlx, the Commission recently approved a proposed rule change by the Phlx to require persons who are associated with member firms and who trade off the floor of the Phlx to successfully complete the Series 7 Exam.²⁷ The Series 7 Exam is the basic examination used to qualify

1999).

²⁶ Exchange Act Release No. 41875.

²⁷ Securities Exchange Act Release No. 41776 (August 20, 1999) 64 FR 47214 (August 30, 1999).

persons for registration as general securities representatives. The new rule primarily affects about 1800 day traders at 12 to 15 Phlx member firms, which are organized as LLCs or similar structures.

The rule will help to ensure that these day traders have a basic knowledge of the securities markets and laws, as well as investment products and risks. It will also bring the Phlx qualification requirements in line with those of the NYSE, the American Stock Exchange, and the Chicago Stock Exchange, which require securities traders who do not solicit public business to pass the Series 7 Exam. The Pacific Exchange has filed a similar proposal, which the Commission is currently considering.

6. Enforcement Efforts

The Commission's Division of Enforcement is pursuing several active investigations concerning day-trading operations.²⁸ The bulk of the investigations stem from referrals based upon examinations by the Commission's Office of Compliance Inspections and Examinations; others have arisen from customer complaints. The investigations cover a wide array of potential violations described above, including: margin violations, short sale violations, net capital deficiencies, and misleading advertising.

The Division of Enforcement is also investigating several web sites that, while not day-trading operations themselves, are trying to capitalize on the day-trading phenomenon. These web sites provide self-proclaimed expert stock recommendations on a daily basis to day traders in exchange for a fee. The staff is investigating certain web sites that feature advertising

²⁸ Commission rules and privacy considerations prohibit identification of any firm or individual involved in any of these investigations until such time as the Commission may bring an enforcement proceeding. See *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d

trumpeting the potential rewards of day trading by use of their stock recommendations, while making little or no risk disclosure. In addition to potential misleading advertising, these investigations are also focusing on whether anyone associated with these web sites receives compensation to tout any security without making proper disclosure, or whether anyone is illegally trading ahead of the recommendations.

VI. Conclusion

The Commission is concerned that all day traders fully understand the costs and risks of engaging in this strategy, and that they only trade with funds they can afford to lose. As discussed above, the Commission is concerned with some day-trading firms' advertising and disclosure practices, the use of leverage, unregistered broker-dealer and investment adviser activities, and short sale rule violations. The Commission, together with the states and the SROs, will continue to vigorously enforce existing laws to protect investors and the integrity of our markets.