NASD® REGULATION
An NASD Company

Testimony

of

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President
NASD Regulation, Inc.

before the

Permanent Subcommittee on Investigations
Senate Committee on Governmental Affairs

on the

Securities Day Trading Industry

September 16, 1999

I am Mary L. Schapiro, President of NASD Regulation, Inc. NASD Regulation, Inc. and our parent, the National Association of Securities Dealers, Inc. (NASD®), would like to thank the Subcommittee for this opportunity to testify on the securities day-trading industry.

My testimony today will address the issues that you identified in your invitation letter to this hearing. Those issues deal with the general characteristics of day trading, risks involved, our examination findings, our recent rule proposals, and any needed legislation.

By way of summary, NASD Regulation believes that day trading is a legitimate trading strategy, and to the extent it is conducted by individuals capable of understanding and assuming the risks involved with such a strategy, we do not intend to discourage such activities. However, with that said, NASD Regulation sees day trading as a highly risky form of trading that deserves close investigation and study by regulators. We have been addressing the risks that we have seen through a combination of continued dissemination of information to our members and investors, focused examination and enforcement efforts, and the development of new NASD rules and other policy initiatives. Given our current experience, we do not now see a need for new legislative initiatives, but we intend to continue to work together with the SEC and the states on these important issues, and will promise to inform you if we perceive a need for new legislation to protect investors and our markets.

The NASD

Let me briefly outline the role of the NASD in the regulation and operation of our securities markets. Established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934, the NASD is the largest self-regulatory organization for the securities industry in the world. Virtually every broker-dealer in the U.S. that conducts a securities business with the public is required by law to be a member of the NASD. The NASD's membership comprises 5,600 securities firms that operate in excess of 75,000 branch offices and employ more than 600,000 registered securities professionals.

The NASD is the parent company of NASD Regulation, Inc. (NASDR), the Nasdaq Stock Market, Inc. and the American Stock Exchange (AMEX). NASDR and Nasdaq operate under delegated authority from the parent, which retains overall responsibility for ensuring that the organization's statutory and self-regulatory functions and obligations are fulfilled. The NASD is governed by a 27-member Board of Governors, a majority of whom are non-securities industry affiliated. The NASDR subsidiary is governed by a 10 member Board of Directors, balanced between securities industry and non-industry members. Board members are drawn from leaders of industry, academia, and the public. Among many other responsibilities, the boards, through a series of standing and select committees, monitor trends in the industry and promulgate rules, guidelines, and policies to protect investors and ensure market integrity.

NASD Regulation

NASD Regulation is responsible for the registration, education, testing, and examination of member firms and their employees. In addition, we oversee and regulate trading on Nasdaq and the over-the-counter markets.

The 1,600 member staff of NASDR is devoted exclusively to carrying out the NASD's regulatory and enforcement responsibilities. NASDR carries out its mandate from its Washington headquarters and 14 district offices located in major cities throughout the country. Through close cooperation with federal and state authorities and other self-regulators, overlap and duplication is minimized, freeing governmental resources to focus on other areas of securities regulation.

NASDR Enforcement brings cases against members and their associated persons based on information developed internally by periodic examination of member firms, broker terminations for cause, market surveillance, and referrals from our arbitration, corporate financing, and advertising programs. It also uses external sources, including federal and state agencies, customer complaints, news media, and anonymous tips. Enforcement investigations gather information through on-site examinations, document requests, trading activity analysis, and customer and member interviews. If cases are not settled, they go to formal hearings for disposition, and may be appealed to the NASD's National Adjudicatory Council, the Securities and Exchange Commission (SEC), and the US Courts of Appeals. In 1998 alone, NASDR initiated more than a thousand disciplinary cases and suspended or barred more than 650 individuals from the industry.

While our regulatory jurisdiction is limited to our broker-dealer member firms and their associated persons, our examinations, surveillance, and regulatory intelligence alert us to illegal conduct outside of our jurisdiction. We routinely refer such findings to the SEC, the states and criminal prosecutors for their action. In recognition of the resources we were devoting to assisting prosecutors in bringing securities cases, we formed a Criminal Prosecution Assistance Group in April 1998. Since the beginning of this program, we have provided assistance in more than 100 criminal investigations and prosecutions around the country.

NASDR is responsible for developing rules that govern the conduct of the brokerage industry in areas as diverse as sales practices, advertising, trading and underwriting. Rulemaking is a widely participatory process with broad input from industry members, trade associations, other regulators, and the public. By the requirements of the Securities Exchange Act of 1934, NASDR rules do not become final until they are approved by the SEC.

NASDR has examination responsibilities for all of its 5,600 members. In addition to special cause investigations that address customer complaints and terminations of brokers for regulatory reasons or other cause, NASDR has established a comprehensive routine cycle examination program. This program is carried out through a regulatory plan that focuses each District's examination efforts on the firms, individuals, issues and practices that present the greatest regulatory challenges and concerns. Annual on-site inspections are conducted of high priority areas. In addition, NASDR has established an examination frequency cycle for all of its members, which is based upon the type of business conducted by the member, the scope of that business, the extent of customer exposure, method of operation, past regulatory history, and other factors. During 1998, 2,606 main office routine examinations were completed and 5,671 customer complaints and 3,535 terminations for cause were investigated.

NASDR shares responsibility for developing and administering qualifications testing for securities professionals. All sales and supervisory persons associated with NASD member firms must demonstrate a requisite understanding of the products offered by their firms, as well as regulatory requirements. Individuals acting in a management capacity must pass the appropriate principal's examination, while sales personnel must demonstrate specific understanding of the products they intend to sell and the regulations that govern those products. In 1998, NASDR administered 267,000 examinations for 29 different qualification areas.

The Nasdaq Stock Market

The Nasdaq Stock Market, Inc., develops, operates, and regulates a variety of marketplace systems and services. Nasdaq is the largest electronic, screen-based stock market in the world, capable of handling trading volume in excess of one billion shares a day. Today, more than one-half of all equity shares traded in the United States each day are traded on Nasdaq.

The American Stock Exchange

The American Stock Exchange is the nation's second largest floor-based securities exchange and is the only U.S. securities exchange that is both a primary market for listed equity securities as well as a market for equity options, index options, and equity derivatives.

Day Trading and On-Line Trading

A recent outgrowth of technological advances in the securities industry has been the increase in popularity of day trading. The term "day trading" refers to a trading strategy where an individual buys and sells the same security in an attempt to profit from very small movements in the price of a security over a short period of time. Although the term is commonly used to refer to aggressively buying and selling a group of securities in a single day (or selling short and then buying to cover the short position), there are varying degrees of day trading currently being employed. For example, some individuals "day trade" in that they execute purchase and sale (i.e., "round-trip") transactions in a single day; however, they limit such activities to only one or two round-trip transactions in a day, and only on an occasional basis. These individuals typically do not rely on their day-trading activities as their primary source of income and may conduct such activities from computers located at their places of regular employment or their homes. In addition, although as a practical matter, day trading typically requires electronic delivery of orders, day trading can include orders transmitted by non-electronic means, such as by telephone.

However, the term "day trading," as commonly used within the industry, generally refers to the trading activities of the "professional day trader," that is an individual who conducts intra-day trading in a focused and consistent manner, with the primary goal of earning a living through the profits derived from this trading strategy. This form of day trading requires aggressive and frequent securities trading and, as a result, generally requires a significant amount of capital, a sophisticated understanding of securities markets and trading techniques, and high risk tolerance. Day traders typically have a relationship with a brokerage firm that provides them with more direct access to the markets as well as access to real-time trading and related information.

Another outgrowth of technological advances in the securities industry has been on-line trading. Only a few years ago, most individuals had little or no exposure to on-line trading. Individuals with on-line accounts were more likely to work in the financial or securities industries or to have engineering or other technological backgrounds. Recent reports, however, indicate that there are several million on-line trading accounts in the United States. Access to on-line trading resources has enabled investors to be better informed about their own portfolios, as well as specific trends or news in the markets.

While there are differing opinions of what constitutes "on-line trading," the term generally refers to accessing and using securities trading resources via the Internet. On-line trading activities can range from occasionally buying or selling securities on-line, to aggressively day trading on location at a brokerage firm. As requested, my testimony today focuses on issues relating to day trading specifically, rather than on-line trading generally.

Day-Trading Firms

While many factors have contributed to the increase in day trading, one significant factor is recent rapid advances in technology, including the widespread availability of the Internet. The Internet has provided individuals with quick, easy, inexpensive access to the securities markets and information and this, in turn, has encouraged greater participation in the markets by individuals not employed in the securities industry. As a result, individuals have been trading their accounts far more actively than in the past.

Over the past few years, brokerage firms began to consider how best to incorporate technological advances that could impact customer trading activities into their own business model. Certain brokerage firms began to focus primarily, or even exclusively, on promoting day-trading strategies to individuals. These firms generally advertise on the Internet and elsewhere as "day-trading" firms or otherwise promote their execution and other services as desirable for "serious" or "professional" traders. These firms often provide reduced transaction costs through lower commissions and other margin-related costs. In addition, many of these firms offer training on day-trading techniques, as well as provide computer facilities, high speed access lines and software packages specifically designed to support and accommodate day trading. Although day trading can be conducted using the facilities of any brokerage firm, most day trading occurs at these types of firms due, in part, to their programs that offer more direct access to the markets, relatively favorable transaction costs and access to lenders for margin purposes.

The Use of Margin by Day Traders

Day traders often use margin to leverage their trading activity. Day traders typically do not carry securities positions overnight and therefore do not face standard maintenance margin requirements. However, they are subject to special margin requirements under NASD rules that are calculated based on the largest open position held by the day trader during the day. For example, assume that a trader starts the day with $50,000 cash, makes 20 buys and sells, and ends the day flat (neither long or short the stock) with $50,000 cash. During the day, the largest open position at any given time held by the trader was 4,000 shares of a $25 stock, and 1,000 shares of a $50 stock ($150,000). Even though the day trader ends the day flat, he will receive a margin call for 50% of the $150,000, less the equity in his account, or $25,000.

The use of margin by day traders can result in financial losses beyond their initial investment. For example, assume that a day trader begins the day with $50,000 cash in her account. She purchases 5,000 shares of a $20 stock ($100,000) and has therefore received a margin loan of $50,000. The stock price drops to $9 per share. The day trader sells the stock and receives the proceeds from the sale of $45,000. As a result, she has lost her initial $50,000 investment and owes an additional $5,000.

Regulatory Response to Day Trading

The growth in day-trading activities has raised unique investor protection issues and concerns. Day trading is a risky, speculative activity, and even the most experienced day traders may suffer severe and unexpected financial losses, even beyond their initial investment. At a minimum, day trading requires sufficient capital and a sophisticated understanding of the markets and market dynamics. It also requires an expertise in identifying securities to trade and in accurately timing purchases and sales.[1]

Given these risks, the NASD, SEC and state securities regulators have worked together to address the investor protection concerns in this area. Our approach has been three-pronged, relying upon: (1) the dissemination of advisories and other information to NASD member firms reminding them of their obligations under existing rules; (2) focused examinations, investigations and follow-up enforcement actions; and (3) the institution of rulemaking initiatives.

(1) Advisories Concerning Obligations under Existing Rules

[1] In your request letter dated August 25, 1999, in addition to asking about risks, you requested estimates on the percentage of individuals who actually profit from day trading. At this time, we are aware of only one report that has provided any data on the profits derived from day trading, the *Report of the Day Trading Project Group*, dated August 9, 1999, released by the North American Securities Administrators Association, Inc. While limited in scope and based on a small statistical sample, it is a useful first step in gauging the extent to which day trading has been a profitable trading strategy. It is difficult to draw any firm conclusions on this issue pending a more comprehensive review. The NASD has been closely reviewing the issue of day-trading profitability as part of our ongoing examinations and investigations of certain day-trading firms.

In response to the increase in day-trading and other on-line trading activities, the NASD has published the following *Notice to Members* (copies of which are attached, along with any related NASDR press release):

- **Notice to Members 99-33, NASD Regulation Advises Members about Maintenance Margin Requirements for Certain Volatile Stocks and Solicits Comment on Margin Practices (April 1999)**

  This Notice provides members and investors with information about current margin requirements and steps taken by the industry to increase maintenance margin requirements for certain volatile stocks. It also solicits comment on issues relating to the use of margin during volatile market conditions, as well as the use of margin by individuals engaging in day-trading activities. It warns that a sudden change in the market value of a security may result in an unexpected margin call, and a customer's failure to meet the call may cause the firm to liquidate the securities in the account.

  The Notice also discusses issues regarding investor protection and disclosure practices arising as firms become involved in the extension of credit between customers. It notes that in certain instances, customers loan funds to other customers to finance securities trades, or guarantee each other's margin accounts. Member firms sometimes arrange for these loans or guarantees between customers or arrange loans for customers from other sources. The Notice also advises that customers incur additional finance charges when credit is arranged, and they face additional credit risks when extending credit to other customers.

- **NASD Notice to Members 99-12, NASD Regulation Issues Guidance Concerning the Operation of Automated Order Execution Systems during Turbulent Market Conditions (February 1999)**

In light of the recent intra-day volatility and significant surges in trading volume with respect to certain issues, particularly Internet-based issues, this Notice was issued to provide members guidance concerning the operation of their order execution systems and procedures during extreme market conditions. It describes factors that members should consider in evaluating whether modifications to their order execution algorithms or procedures during turbulent market conditions are consistent with their duties of best execution.

- **NASD Notice to Members 99-11, NASD Regulation Issues Guidance Regarding Stock Volatility (February 1999)**

  This Notice recommends that firms provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner. Specifically, it recommends that firms consider disclosing that high volumes of trading at the market opening or intra-day may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was entered. It further notes that firms should consider explaining in detail the difference between market and limit orders and the benefits and risks of each. It also advises that firms consider alerting customers that they may suffer market losses during periods of volatility in the price and volume of a particular stock when systems problems result in the inability to place buy or sell orders. In particular, it notes that customers trading on-line may have difficulty accessing their accounts due to high Internet traffic or because of systems capacity limitations.

The Notice also summarizes current practices that certain on-line firms have implemented in response to the recent market volatility. These practices include: (i) restrictions on on-line trading during initial public offerings; (ii) increased margin requirements for certain volatile stocks; (iii) enhanced investor education on market volatility; and (iv) the use of pop-up or splash screens (i.e., pages that a customer must view when entering a firm's web site) to disseminate important information to customers.

Although the discussion in this Notice relates primarily to on-line trading activities, many of the risks outlined are relevant to day-trading activities, particularly when a day-trading strategy is implemented through an on-line brokerage account.

- **NASD Notice To Members 98-102, Calculating Margin for Day-Trading and Cross-Guaranteed Accounts (December 1998)**

  This Notice discusses margin requirements under Regulation T and NASD Rule 2520[2] for day-trading and cross-guaranteed accounts. The Notice addresses some of the more frequently asked questions regarding the application of Regulation T and Rule 2520 to these types of accounts and provides guidance on common scenarios and questions relating to marginable equity securities.

(2) Examination and Enforcement Activities

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[2] Regulation T of the Board of Governors of the Federal Reserve requires certain minimum margin in connection with the purchase of any security (initial margin). NASD Rule 2520 generally requires initial margin of *at least* the Regulation T amount. Rule 2520 also requires customers to maintain a certain minimum margin – "maintenance margin" – based on the positions in the customer's account.

NASD Regulation is engaged in a cooperative day-trading examination initiative with the SEC. Beginning last Spring, the staffs of NASDR and the SEC launched a broad-based, coordinated examination program of day-trading firms. As part of that effort, NASDR examined 22 day-trading firms that varied significantly in size and makeup. Fifty-five NASDR examiners received special training in the intricacies of day trading. Customized examination modules were developed and used to implement this special program. The two largest firms examined had 1,500 or more day-trading accounts, while at six of the firms, fewer than 20 of its customers were day trading. At about half of the firms examined, day-trading activity accounted for nearly all of the firm's business.

During these specialized examinations, several potential problem areas surfaced, including advertising, Regulation T and margin lending, registration of individuals, short sales, and supervision. We are currently reviewing the results of those examinations and completing the investigations growing out of them. To the extent that these investigations indicate that violations of our rules or the federal securities laws have taken place, formal enforcement actions will be instituted.

Advertising

NASD Rule 2210 governs "Communications with the Public." The Rule applies to "advertisements" and "sales literature" and prohibits "exaggerated, unwarranted or misleading statements or claims." Generally, electronic advertising such as those found on the Internet, are treated no differently from hard copy advertising and marketing materials.

Nearly 80 percent of the day-trading firms examined had potentially problematic advertisements that have been referred to our Advertising Regulation Department for further review. The problem areas noted in these advertisements range from allegations of immediate execution to statements of profits that can be generated from day trading. One practice under review is the dissemination -- through websites, training materials, and public statements -- of what may be materially misleading and unwarranted information regarding the "success rate" of their customers. The staff is reviewing whether the firms' claims of customer success rates in their marketing and communications with the public can be substantiated as our rules require.

Other materials reviewed from day-trading firms have contained unsubstantiated claims regarding "profit potential," "lowest commissions," "trading for a living," or "industry leader in day trading" without corresponding risk disclosure or qualifying language. In addition, day-trading websites and other communications with the public have indicated that losses can be controlled or minimized through the use of certain strategies or techniques. In short, at least some day-trading firms appear to have failed to provide investors with a sound basis for evaluating the services being offered and contain exaggerated statements rendering the promotion or presentation misleading.

We have already filed one formal disciplinary action against a day-trading firm for violations of our advertising rules. On June 10, 1999, a complaint (attached) was filed against Lakeside Trading, a Metairie, Louisiana day-trading firm, and its president and principal. In addition to alleged margin violations and improper use of customer funds, the complaint alleged that the firm's Internet website contained:

- Misleading statements that implied that individuals accessing the firm's trading systems online had direct access to the markets;

- Statements that exaggerated customers' ability to access the markets;

- Material that failed to disclose that customers' transactions were subject to market fluctuation risks, and that trades may not be executed at all; and

- Material that failed to provide a balanced and complete presentation by omitting disclosure concerning the risks associated with day trading.

Regulation T and Margin Lending

Our day-trading examinations have revealed that at some day-trading firms, principals and employees arrange for credit to be extended from customers who have some equity in their accounts to those who require funds to cover margin calls. Absent these infusions of capital, many of the recipients of the loans would be unable to continue to trade.

Approximately half of the firms examined facilitate the lending of money between customers. At one firm, all the lending was done by one customer. In other instances, the firm works with its clearing firm to identify customers with credit balances who could be lenders. NASDR is investigating potentially violative activity relating to loans made by and between customers that are arranged by the firm or one of its employees for the purpose of meeting initial and maintenance margin requirements. We are reviewing the role of the member in arranging these loans and what, if any, representations are made to the lending customers concerning the risks associated with making the loans.

Registration

NASD rules prohibit equity traders from trading in the Nasdaq and over-the-counter markets without first passing a qualification examination for trading (the Series 55 examination) and registering with NASD Regulation. The Series 55 registration rule, which became effective in April 1998, applies to market makers, agency traders, proprietary traders, and persons who supervise these activities. The rule was developed in response to concerns about rule violations by traders conducting market-making and principal trading functions in both the Nasdaq and over-the-counter markets.

We have found instances where persons engaging in day trading for a firm's proprietary account are not Series 55 registered. One disciplinary action has already been concluded in this area. On July 7, 1999, NASD Regulation censured and fined On-Site Trading, Inc., a Great Neck, NY day-trading firm, $25,000 for failure to properly qualify and register 14 individuals. (AWC and press release are attached.) These individuals effected approximately 3,700 trades in 250 Nasdaq securities on behalf of the firm's proprietary accounts. Without admitting or denying the allegations, On-Site consented to findings that it lacked adequate oversight to ensure proper registration of its traders, and agreed to implement new compliance procedures to prevent future violations. Relatedly, we have also found instances in which individuals entering orders on behalf of customers were not Series 55 registered.

Short Sales

We have found short selling practices at some day-trading firms that appear to violate our rules and the federal securities laws. Specifically, our rules require that firms mark all sales as either "long" or "short" and that the firm determine if it can obtain shares of the security sold short to deliver to the buyer. We have seen practices at some day-trading firms that facilitate short sales by customers when the short sales are not marked as such and when no determination has been made that shares can be delivered to the buyer. We have also seen potential violations of our rules prohibiting customer short sales on what is commonly known as a "downtick." Rule 3350 (the "Short Sale Rule") prohibits member firms from effecting short sales at or below the current inside bid as disseminated by Nasdaq whenever that bid is lower than the previous inside bid.

The staff of the Market Regulation Department of NASDR reviews and investigates short sale activity. Among other activities, the staff utilizes an electronic surveillance program to conduct sweeps of reported short sale activities. These sweeps review trading by all firms that report short sales and objectively identify those trades that appear to violate the Short Sale Rule. Since initiating these sweeps in 1998, more than one-third of these reviews by the staff have involved day-trading firms.[3] Overall, the staff has found a significant number of violations of short sale rules and believes that day-trading firms too frequently lack adequate supervisory procedures to detect and deter such violations. Where appropriate, we intend to initiate

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[3] For the purposes of this statistic, day-trading firms are those that have customers physically present at the firm or at remote locations that buy and sell stocks throughout the day through the use of a Nasdaq terminal and/or internal electronic software systems.

disciplinary action against the member firms and associated persons involved.

We are also reviewing short selling by customers of day-trading firms of hot IPOs in the immediate aftermarket. We are investigating whether some of these activities violate our rule requiring a firm effecting a short sale for a customer to determine if the shares being sold can be located and delivered to the buyer.

Supervision

Adequate supervision and the development and compliance with supervisory procedures are important issues at all broker-dealers, including day-trading firms. NASD Conduct Rule 3010 requires each of our member firms to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations" and NASD Rules.

Day-trading firms have initiated new sales and marketing practices outside the traditional broker-client relationship. They have built a business niche around new technology and new software. These innovations require new supervisory techniques. Yet, at some of the firms we have examined, written supervisory procedures have not adequately addressed many aspects of their core day-trading business. Areas of potentially deficient supervision include procedures in the following areas:

- Loans and lending arrangements between customers;
- Review of advertising, marketing, and training materials;

- Short-selling compliance, such as affirmative determination, selling on "downticks," marking of order tickets long or short; and

- Cancellation of transactions and use of the firm error account.

NASDR is taking the necessary steps through disciplinary action to ensure that these potential deficiencies are addressed.

(3) Rulemaking Initiatives

<u>Disclosure and Appropriateness Determinations</u>

To effectively address the unique investor protection concerns associated with day trading, the NASD determined that rulemaking in this area was necessary to supplement existing rules and regulations. On April 15, 1999, the NASD issued Special Notice to Members 99-32, seeking comment on proposed rules addressing approval procedures for day-trading accounts including appropriateness determinations and disclosure of risks of day-trading activities. The staff received 39 comment letters in response to the Notice, 16 of which were from individuals and 23 from firms or other organizations. The majority of the commenters generally supported the NASD's efforts to address the investor protection concerns raised by individual's engaging in day-trading activities. However, commenters also raised varied suggestions on how best to regulate day-trading activities and presented disparate views on the scope of activities that should be covered by the rules. Based on its review and consideration of the comment letters, the staff made certain revisions to the proposed rules. The proposed rules, as revised, were approved by the Board of Directors of NASDR at its meeting on July 28, 1999.

On August 20, 1999, the NASD filed the proposed rules with the SEC. (Rule filing and press release are attached.) Specifically, the proposed rules would require firms that promote day-trading strategies to (i) determine the appropriateness of day trading for a customer; and (ii) disclose to customers the risks associated with this type of trading. In order for a firm to approve an account for day trading, the firm would be required to have reasonable grounds for believing that a day-trading strategy is appropriate for a customer. In making this determination, the firm would be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her financial situation, tax status, prior investment and trading experience, and investment objectives. The firm also would be required to prepare a record setting forth the basis on which the firm has approved the customer's account. A firm need not make this determination if it obtained from the customer a written representation that the customer did not intend to use the account for day-trading purposes. If a firm later discovered that a customer who provided this written representation was using the account for day trading, the firm would be required to approve the account for day trading within 10 days of the date of discovery.

In addition, the proposed rules would require a firm that is promoting a day-trading strategy to deliver a risk disclosure statement to a customer prior to opening an account for the customer that provides the following:

- **Day trading can be extremely risky.** Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day-trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses.

- **Be cautious of claims of large profits from day trading.** You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead to large and immediate financial losses.
- **Day trading requires knowledge of securities markets.** Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.
- **Day trading requires knowledge of a firm's operations.** You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures.
- **Day trading may result in your paying large commissions.** Day trading may require you to trade your account aggressively, and you may pay commissions on each trade. The total daily commissions that you pay on your trades may add to your losses or significantly reduce your earnings.
- **Day trading on margin or short selling may result in losses beyond your initial investment.** When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day-trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

Firms would be permitted to develop an alternative disclosure statement as long as it is substantially similar to the mandated statement and is approved by NASD Regulation's Advertising Department prior to use.

Margin and Customer Lending

We are continuing to consider whether changes to existing rules regarding margin and lending practices are desirable and have solicited comment on this issue. Concerns identified include:

- what levels of margin are appropriate for these types of activities;
- whether the timing of margin deposit requirements should be changed (current rules permit deposits for margin purposes within seven business days of the trade);
- whether minimum initial and maintenance cash deposits should be required; and
- what limitations should apply to firms that facilitate loans between customers or third parties and customers to cover margin calls.

We are still considering these issues and will determine whether further rulemaking in this area is necessary.

Conclusion

In conclusion, day trading is a highly risky form of trading that we are investigating and studying closely. We intend to continue to work together with the SEC and the states to address the issues in this area. At this time, we do not see a need for any new legislative initiatives, but believe that through a combination of continued dissemination of information to our members and investors, focused examination and enforcement efforts and the development of new NASD rules and other policy initiatives, we can effectively address the investor protection concerns associated with day trading.

LIST OF ATTACHMENTS – DAY-TRADING TESTIMONY

- Press Release: NASD Issues Notice on Margin Issues and Practices (April 20, 1999)
- Notice to Members 99-33, NASD Regulation Advises Members about Maintenance Margin Requirements for Certain Volatile Stocks and Solicits Comment on Margin Practices (April 1999)
- Press Release: NASD Issues Guidance to Brokerage Firms Regarding Sales practices and Order Execution During Turbulent Market Conditions (January 26, 1999)
- NASD Notice to Members 99-12, NASD Regulation Issues Guidance Concerning the Operation of Automated Order Execution Systems during Turbulent Market Conditions (February 1999)
- NASD Notice to Members 99-11, NASD Regulation Issues Guidance Regarding Stock Volatility (February 1999)
- NASD Notice To Members 98-102, Calculating Margin for Day-Trading and Cross-Guaranteed Accounts (December 1998)
- Complaint Filed against Lakeside Trading (May 26, 1999)
- Press Release: NASD Regulation Censures and Fines On-Site Trading, Inc. for Registration Violations (July 7, 1999)
- AWC against On-Site Trading, Inc. (June 25, 1999)
- NASD Rule Filing No. SR-99-41 – Approval Procedures for Day-Trading Accounts (August 20, 1999) Note: Exhibits to Rule Filing are not included
- Press Release: NASD Board Approves Proposed Rule for Opening Day-Trading Accounts (July 29, 1999)

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NASD REGULATION
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Press Release

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NASD Issues Notice on Margin Issues and Practices

Washington, D.C.—NASD Regulation, Inc., recently issued an NASD *Notice to Members* that addresses a range of issues regarding the use of margin accounts and solicits comment on a number of practices relating to margin. The *Notice* was developed in response to a number of questions and concerns raised by industry and investors about current volatile market conditions and the risks posed by margin accounts to both investors and securities firms.

Turbulent markets pose considerable risk to investors who have margin accounts. During times of price volatility, market values of securities can fluctuate dramatically, resulting in sudden margin calls by securities firms. Since a margin call can result in serious consequences to the small investor, it is especially important for firms to clearly explain margin rules and disclose all risk and finance charges associated with the loaning and borrowing of funds to finance securities transactions.

In addition to the discussion of current margin rules, NASD Regulation seeks comment from the public on the following issues:

- variable margin requirements based on the size of a customer's account;
- determining if margin requirements should be linked to volatility;
- determining if customers should have the ability to guarantee each other's accounts;
- requiring customers to make margin deposits during the day in response to intra-day risk exposure;
- determining whether customers receive adequate information on loan terms for the purchase of securities; and
- whether current margin rules are compatible with day trading.

NASD Regulation will accept public comment on the *Notice* through May 31, 1999. To view the *Notice* and/or for further investor information on margin accounts, visit the NASD Regulation Web Site, www.nasdr.com.

NASD Regulation oversees all U.S. stockbrokers and brokerage firms. NASD Regulation and the Nasdaq-Amex Market Group are subsidiaries of the National Association of Securities Dealers, Inc., the largest securities-industry self-regulatory organization in the United States.

For more information on NASD Regulation, visit the Web Site at *www.nasdr.com*.

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Special NASD Notice to Members 99-33

NASD Regulation Advises Members About Maintenance Margin Requirements For Certain Volatile Stocks And Solicits Comment On Margin Practices; **Comment Period Expires May 31, 1999**

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ■ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ■ Internal Audit
- ■ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ■ Operations
- ☐ Options
- ■ Registered Representatives
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ■ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

During the past several months, many stocks, particularly of companies that sell products or services via the Internet (Internet issuers), have experienced sharp increases in both price volatility and trading volume. These extreme market conditions raise concerns regarding the use of margin accounts by individuals to trade volatile stocks. NASD Regulation, Inc. (NASD Regulation®) is issuing this *Special Notice* to provide members, as well as investors, with information about current margin requirements and steps taken by the industry to increase maintenance margin requirements for certain volatile stocks. This *Special Notice* also solicits comment from members and other interested parties on issues relating to the use of margin during volatile market conditions, as well as the use of margin by individuals engaging in day-trading activities.

In a companion *Special Notice to Members* issued today, *Special Notice to Members 99-32*, NASD Regulation solicits comment on two proposed rules that would require a member that has recommended a day-trading strategy to an individual to approve the individual's account for day trading, including determining that the strategy is appropriate for the individual, and to deliver a disclosure statement on the risks of day trading.

Questions concerning this *Special Notice* may be directed to Patrice M. Gliniecki, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8014.

Discussion

In recent months, there has been a sharp increase in the price volatility of many stocks, particularly those of Internet issuers. This volatility in price has been coupled with record trading volumes in many of these stocks. While many factors have contributed to the development of these market conditions, one significant factor is the role played by rapid advances in technology, which have provided customers with easier and less costly access to the securities markets. Customers are now able to trade their accounts far more actively than in the past, and members are often flooded with customer orders for certain individual stocks or groups of stocks (*e.g.*, stocks of Internet issuers).

To address concerns raised by current market conditions, NASD Regulation recently issued *Notice to Members 99-11*, which suggests disclosures that firms can make to educate customers about the risk of price and volume volatility, and discusses steps that have been taken by some firms to respond to this volatility.[1] In a companion *Notice to Members, Notice to Members 99-12*, NASD Regulation provided guidance to firms on the operation of their order execution systems and procedures during extreme market conditions.[2]

As volatile market conditions continue, questions are raised regarding the risks posed to firms and to investors, and the relationship of margin to those risks. A sudden change in the market value of a security may result in an unexpected margin call, and a customer's failure to meet the call may cause the firm to liquidate the securities in the account. The financial consequences of a margin call or an account liquidation may be most severe to customers with small accounts, and small accounts may be more likely to be subject to liquidation. In addition, the forced sale of securities in margin accounts may further contribute to volatility.

Questions regarding investor protection and disclosure practices also arise as firms become involved in the extension of credit between customers. In some instances, customers are making loans to other customers to finance securities trades, and some customers are guaranteeing each other's margin accounts. Member firms sometimes arrange for these loans or guarantees between customers or arrange loans for customers from other sources. Customers incur additional finance charges when credit is arranged, and they face additional credit risks when they extend credit to other customers.

Discussions with firms about their responses to volatility indicate that many firms have adopted special procedures with respect to margin. For instance, as further detailed below, many firms have increased maintenance margin requirements for selected groups of highly volatile stocks.[3] However, with markets at historically high levels, concerns remain with the amount of funds that customers are borrowing to trade securities, and the manner in which credit is being extended by various sources. Accordingly, this *Special Notice* discusses current margin requirements and certain firm practices when extending credit to customers, and solicits comment on these important issues.[4]

Current Margin Requirements

Federal Reserve Board Regulation T governs the extension of credit to customers by broker/dealers and includes provisions concerning the initial margin requirements for most types of securities transactions. In general, Regulation T requires 50 percent initial margin for long purchases of marginable equity securities. In addition, Regulation T requires 150 percent margin for short sales of equity securities, of which 100 percent can be from sales proceeds.

National Association of Securities Dealers, Inc. (NASD®) Rule 2520 imposes additional margin requirements on customer accounts.[5] Rule 2520 generally requires maintenance margin of 25 percent of the current market value for all long positions in marginable equity securities, meaning that the equity must not fall below 25 percent of the current market value of the securities in the account. For a short securities position where the stock sells at $5 per share or above, Rule 2520 requires maintenance margin of $5 per share or 30 percent of the current market value of the stock, whichever amount is greater. In addition, for a short securities position where the stock sells at less than $5 per share, a customer must maintain margin of $2.50 per share or 100 percent of the current market value, whichever amount is greater. Where the same security is carried long and short by the same customer, Rule 2520 permits maintenance margin of five percent of the current market value of the long security.

Rule 2520 also permits customers to guarantee each other's accounts for maintenance margin purposes.[6] In cross-guaranteed accounts, the amount of maintenance margin excess in one account may be used to offset a maintenance margin deficit in the other cross-guaranteed account. In addition, if the cross-guaranteed accounts are long and short the same securities, including the same number of shares, the maintenance margin requirement on the combined positions is five percent. Day trading is also recognized by Rule 2520 through the definitions of "day-trading," "day-trader," and certain specified margin requirements.[7] Under these provisions, a day trader may need to deposit additional equity in his or her account to satisfy a day-trade margin call.

Members also may establish their own margin requirements (referred to as "house" requirements), provided that they are at least as stringent as the requirements under Regulation T and Rule 2520. Members also may temporarily raise their margin requirements in response to market conditions.

Increased Maintenance Margin

In light of current market conditions, some members have elected to increase their maintenance margin requirements for certain volatile stocks to help ensure that the equity in each customer account is sufficient to cover the large swings in the price of the stocks. In general, the firms have increased the amount of equity that must be maintained in margin accounts for long positions in these stocks to between 40 percent and 100 percent. In addition, the firms often have raised their maintenance margin requirements on short positions to an even greater degree than on long positions.

Identifying Stocks For Increased Maintenance Margin

Firms have considered a variety of parameters in identifying the stocks that will be subject to increased maintenance margin requirements. A particularly useful approach is to calculate the volatility of the stock and impose more stringent requirements on stocks that are highly volatile. In this context, one appropriate way to measure volatility is to calculate the standard deviation of the relative daily return of a given stock over a specified time period, such as three months (which would capture an entire quarterly earnings cycle).[8]

Firms also may identify stocks for more stringent maintenance margin requirements by reviewing customer accounts to assess trading activity in a particular stock, as well as the firm's aggregate risk exposure to the stock. This type of analysis should be performed in conjunction with calculating the volatility of the stock. Other factors firms may consider in reviewing their margin requirements during extraordinary market conditions include price fluctuations (such as a recent sharp rise or decline in price), the degree to which trading in a stock is concentrated in a small number of Market Makers, or an issuer's market capitalization or industrial code classification. Firms also have indicated that they regularly review and, where appropriate, revise the lists of stocks that are subject to increased maintenance margin requirements.

NASD Regulation believes that increasing the maintenance margin requirements to be applied to certain stocks is an appropriate response to extreme volatility in those stocks. Discussions with firms have indicated that customers generally have not been transferring their accounts to other firms in response to increased margin requirements for volatile stocks. In this regard, NASD Regulation believes that a firm's decision to adopt such measures should not be influenced by the possible short-term competitive effects. Moreover, NASD Regulation will continue to monitor actions taken by members to adjust maintenance margin requirements in response to market volatility, and the effects of those actions, to determine whether changes to NASD rules may be warranted.

Disclosure Of Credit Terms To Customers

In reviewing margin procedures, firms also should confirm that they are providing appropriate disclosure of credit terms to customers with margin accounts. Under the federal securities laws, brokers that extend credit to customers to finance securities transactions are required to furnish, in writing, specified information regarding the terms of the loan.[9]

These disclosures must be made on both an initial and periodic basis. For instance, at the time a customer opens a margin account, a broker must provide the customer with a written statement disclosing, among other things, the annual rate of interest, the method of computing interest, and what other credit charges may be imposed. These initial disclosures help to ensure that the customer understands the terms and conditions of the margin loan and allow the customer to compare available credit terms.[10] A firm also is required to provide periodic (at least quarterly) written statements to the customer, which disclose such information as opening and closing balances, total interest charges, and other charges resulting from the extension of credit.

Request For Comment

NASD Regulation encourages members and other interested parties to comment on the issues discussed in this *Special Notice*, including whether adjusting NASD margin requirements for certain stocks is an appropriate means of addressing volatility in the securities markets. In addition, we seek comment on the following issues:

1. Should margin requirements applicable to a securities transaction or account differ based on the size of a customer's account? In particular, should margin requirements be more stringent for small accounts, given that the financial consequences of a margin call to the holder of a small account may be more severe? If so, should there be any exemptions to such a heightened margin requirement for small accounts? What would be an appropriate definition of "small account"?

2. Should margin requirements be linked to volatility? If so, how should this approach work?

3. Should the ability of customers to guarantee each other's accounts for maintenance margin purposes be eliminated or restricted? For instance, should rules require that cross-guaranteed accounts be owned or controlled by the same customer in order to receive special maintenance margin treatment? What would be the effect of any such revisions? Should the five percent maintenance margin treatment for perfectly offsetting long and short positions between cross-guaranteed accounts be eliminated or revised?

4. How important is margin to day-trading activities? Are the current margin requirements applicable to day-trading accounts appropriate? If not, how should the current requirements be revised?

5. Should customers be required to make margin deposits during the day in order to account for intra-day risk exposure? If so, what should those margin requirements be, and should margin deposits be made prior to additional trading taking place?

6. Are customers receiving adequate disclosure of the credit terms of margin transactions? When a firm arranges loans for customers from other sources, are customers receiving adequate disclosure of the credit terms of the loans? Are the persons or entities making the loans receiving adequate disclosure of the risks and terms of the loans?

Comments should be mailed to:

Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com

Important Note: The only comments that will be considered are those submitted in writing or via e-mail.

Comments must be received no later than **May 31, 1999**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission.

Endnotes

[1] *NASD Notice to Members 99-11*, NASD Regulation Issues Guidance Regarding Stock Volatility (Feb. 1999).

[2] *NASD Notice to Members 99-12*, NASD Regulation Issues Guidance Concerning The Operation Of Automated Order Execution Systems During Turbulent Market Conditions (Feb. 1999).

[3] *See NASD Notice to Members 99-11* (Feb. 1999) for additional discussion of margin requirements for volatile stocks.

[4] NASD Regulation also recently issued investor guidance on the use of margin accounts and the risks involved with trading securities on margin. *See* NASD Regulation's Web Site at *www.nasdr.com.*

[5] While often thought of as a "maintenance" margin rule, Rule 2520 also contains initial margin requirements. Initial margin is the greater of the amount specified in Regulation T or the maintenance margin specified in Rule 2520.

[6] *See NASD Notice to Members 98-102*, Calculating Margin For Day-Trading And Cross-Guaranteed Accounts (Dec. 1998), for further discussion of margin requirements for cross-guaranteed accounts. When calculating Regulation T margin, cross guarantees have no effect.

[7] *See id.* for further discussion of margin requirements for day-trading accounts.

[8] The relative daily return of a stock can be derived from the closing price (or the bid-ask mid-point) of an issue each day during the specified time period. Using the closing price, the daily relative return would be the percent price change between the most recent closing price and the previous day's closing price. For example, a stock that closes at $10 on Monday and at $11 on Tuesday has a relative daily return for Tuesday of 10 percent. Once this daily relative return has been calculated for each of the trading days during the specified time period, a firm can calculate the standard deviation (or dispersion) of these returns to determine the volatility of the issue.

[9] *See* Rule 10b-16 under the Securities Exchange Act of 1934. Brokers also are subject to the general anti-fraud provisions of the federal securities laws.

[10] *See* Securities Exchange Act Release No. 8773 (Dec. 8, 1969) (adopting Rule 10b-16).

Special Notices to Members are published on an accelerated basis and distributed independently of monthly *Notices to Members* newsletters. Numerical sequencing may thus appear to contain gaps during a given monthly publication cycle. Such temporary gaps reflect a priority in the production process and will disappear at the conclusion of monthly electronic posting and print distribution.

NASD Notices to Members is published monthly by NASD Corporate Communications, Kim Dineen, Editor, NASD Editorial Services Department, 1735 K Street, NW, Washington, DC 20006-1500, (202) 728-8370.

NOTE: As of January 1999, there has been a change in *Notices to Members* distribution. Members no longer receive complimentary copies of *Notices to Members*. Each Executive Representative is entitled to one annual subscription at cost ($15 per year). Additional annual subscriptions are available for $225; single issues cost $25. Send a check or money order (payable to the National Association of Securities Dealers, Inc.) to NASD MediaSource, P.O. Box 9403, Gaithersburg, MD 20898-9403, or to phone in an order using American Express, MasterCard, or Visa charge, call (301) 590-6142, Monday to Friday, 9 a.m. to 5 p.m., Eastern Time. Back issues may be ordered by calling MediaSource at (301) 590-6142.

NASD Notices to Members (December 1996 to current) are also available on the Internet at *www.nasdr.com*.

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NASD REGULATION
An NASD Company

Press Release

NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

For Release: Tuesday, January 26, 1999
Media Contact: Nancy A. Condon
(202) 728-8379

NASD Issues Guidance to Brokerage Firms Regarding Sales Practices and Order Execution During Turbulent Market Conditions

Washington, D.C.—NASD Regulation, Inc., today issued two *Notices to Members* of the National Association of Securities Dealers, Inc. (NASD®) addressing the recent turbulent market conditions. Recent increased volatility and volume present new issues for investors, regardless of the method of trading. In *Notice to Members 99-11*, NASD Regulation suggests disclosures that brokerage firms should make to investors to educate them about the risks of price and volume volatility. *Notice to Members 99-12* provides firms with guidance on the operation of their order execution systems and procedures during extreme market conditions. A companion bulletin for investors is available on the NASD Regulation Web site *www.nasdr.com.*

Notice to Members 99-11 encourages firms to ensure that investors are knowledgeable about firm procedures for handling securities transactions during volatile market conditions. NASD Regulation has suggested disclosures that firms should consider making to educate investors:

- **Delays.** Firms should consider disclosing that high volumes of trading at market opening and at various points during the day may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was entered. This disclosure is particularly important to investors who have come to expect quick executions at or near the quotes displayed on their computer screens and may not understand that Market Makers may execute orders manually or reduce their size guarantees during periods of volatility, possibly resulting in delays in order execution and losses.

- **Types of Orders.** Firms should consider explaining, in detail, the differences between market and limit orders and the benefits and risks of each. It is important for investors to understand that firms are required to execute a market order fully and promptly without regard to price. That execution may be at a price significantly different from the current price quoted for the security. Limit orders are executed only at a specified price or better and while the investor receives price protection, there is the possibility that the order may not be executed.

  Firms should consider additional disclosure for customers who place market orders for initial public offerings (IPOs) – particularly those trading at a price significantly higher than their offering price or in 'hot stocks', those that have recently traded under 'fast market' conditions in which the price changes so quickly that quotes for the stock cannot keep pace with its trading price.

- **Access.** Firms should consider alerting investors that there may be periods of time when they may be unable to access their accounts due to high volume. Customers trading through on-line accounts may have difficulty accessing their accounts due to high Internet traffic or because of systems capacity limitations. Customers trading through brokers at full-service or discount firms or through representatives of on-line firms when on-line trading has been disabled or is not available may have difficulty reaching account representatives on the telephone during periods of high volume. Firms should make investors aware that they may suffer losses during periods of volatility due to delays in effecting buy and sell orders. They should also explain their procedures for responding to these access problems.

- **Communications with the Public.** When on-line trading firms use advertisements or sales literature to make claims about the speed and reliability of their services, they may not exaggerate the firm's capabilities or omit material information about the risks associated with on-line trading and the possibilities of delayed executions. These broker/dealers should have the systems capacity to support any claims they make about their trading services.

The *Notice* also describes a number of steps broker/dealers have taken to respond to volatility. These procedures, when clearly disclosed to customers, may be appropriate responses to price and volume volatility.

Notice to Members 99-12 provides broker/dealers guidance concerning the operation of their order execution systems and procedures for handling customer orders and obtaining best execution for them in light of the recent dramatic intraday volatility and surges in trading volume. 'Best execution' is the obligation of broker/dealers, Market Makers, and others to execute customer orders at the best prevailing market price.

Recent market conditions have raised questions about the proper handling of customer orders and resulted in requests for guidance on best execution under these market conditions. Under non-turbulent market conditions, order execution systems should be designed to process and execute a reasonably anticipated order volume in an efficient, fair, and consistent manner. During extreme market conditions, when large order imbalances and price volatility may result, many firms implement procedures that are designed to preserve uninterrupted execution of customers' orders while lessening the firms' exposure to extraordinary market risk.

NASD Regulation has indicated that firms should consider the following when evaluating whether order execution procedures are appropriate during turbulent market conditions:

- Procedures for handling of customer orders must be fair, consistent, and reasonable.

- Disclosure to customers (and order entry firms) should be made when the firm's order execution procedures differ during turbulent market conditions. Disclosing alternative order procedures, however, does not insulate the broker/dealer from potential best execution violations – the alternative procedures must also be fair.

- Modified order execution procedures should be implemented only when warranted by market conditions. Firms are required to document the basis for activating alternative procedures.

- The SEC has stated that firms must take steps to prevent their systems from being overwhelmed during periodic spikes in systems 'message traffic' due to high volume so that they are equipped to handle exceptional loads. Best execution concerns may be raised if a firm frequently activates alternative order execution procedures to compensate for inadequate systems.

- To the extent that broker/dealers execute orders manually during extreme market conditions, firms are reminded that NASD rules provide that failure to adequately staff an order execution department is not justification for "executing away from the best available market".

Both *Notices to Member, 99-11* and *99-12*, can be viewed in full via the NASD Regulation Web site, *www.nasdr.com*.

NASD Regulation oversees all U.S. stockbrokers and brokerage firms. NASD Regulation, along with The Nasdaq-Amex Market Group, are subsidiaries of the National Association of Securities Dealers, Inc. (NASD®), the largest securities-industry self-regulatory organization in the United States.

NASD Notice to Members 99-12

NASD Regulation Issues Guidance Concerning The Operation Of Automated Order Execution Systems During Turbulent Market Conditions

Suggested Routing

- ■ Senior Management
- □ Advertising
- □ Continuing Education
- □ Corporate Finance
- ■ Executive Representatives
- □ Government Securities
- ■ Institutional
- □ Insurance
- ■ Internal Audit
- ■ Legal & Compliance
- □ Municipal
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Executive Summary

In light of the recent dramatic intraday volatility and significant surges in trading volume with respect to certain issues traded on The Nasdaq Stock Market, Inc. (Nasdaq®), particularly Internet-based issues, NASD Regulation, Inc. (NASD Regulation℠) is issuing this *Notice to Members* to provide members guidance concerning the operation of their order execution systems and procedures during extreme market conditions. In sum, while National Association of Securities Dealers, Inc. (NASD®) and Securities and Exchange Commission (SEC) rules and regulations do not specify or mandate a particular order execution algorithm or procedure for the execution of customer orders (aside from requirements imposed by the NASD's limit order protection interpretation), NASD Regulation believes that members' best execution obligations require that such algorithms and procedures treat customer orders in a fair, consistent, and reasonable manner. In addition, to the extent that members (particularly wholesale firms) deviate from or alter their execution algorithms or procedures during turbulent market conditions, NASD Regulation believes that firms should consider disclosing such altered procedures and the basis for activating such altered procedures to their customers and firms sending them order flow.[1]

Questions or comments concerning this *Notice* may be directed to the Legal Section of NASD Regulation's Market Regulation Department, at (301) 590-6410.

Discussion

The recent extraordinary volatility and volume in particular stocks, particularly Internet-based stocks, has led to questions as to whether customer orders in these stocks are handled properly, and requests for guidance on best execution under these circumstances. In a companion *Notice to Members* issued today, *Notice to Members 99-11*, NASD Regulation is providing guidance to firms that deal directly with customers with respect to disclosure firms should consider making to inform investors of the increased risks associated with trading during turbulent market conditions. *Notice to Members 99-11* also lists some of the steps on-line firms have taken to respond to volatility. With this *Notice*, NASD Regulation is providing guidance as to the factors Market Makers should consider in evaluating whether modifications to their order execution algorithms or procedures during turbulent market conditions are consistent with the best execution of customer orders.

Given the high trade volume and share volume of the Nasdaq market, as well as competitive pressures to provide swift executions, wholesale firms (*i.e.*, those firms that principally execute orders routed to them from other firms) and integrated firms (*i.e.*, firms with a large retail business that also engage in market making and other activities) have developed their own automated order execution systems for smaller customer orders, generally 3,000 shares or less. During non-turbulent market conditions, these systems, which are by no means uniform, typically execute orders on a first-in-first-out basis and afford priced orders priority on a price/time basis, in addition to complying with applicable SEC and NASD rules, such as the SEC's limit order display rule and the NASD's limit order protection rule. As a general matter, these systems should be designed to process and execute orders during non-turbulent market conditions in a fair, consistent, and reasonable manner and have a capacity that is adequate to handle reasonably anticipated trading volume in an efficient manner.

During extreme market conditions, where there are large order imbalances and/or significant price volatility, however, many firms implement procedures that are designed to preserve the continuous execution of customers' orders while also lessening the exposure of the firm to extraordinary market risk. For example, some firms switch from an automated order execution mode to a manual execution mode in which orders are generally routed through SelectNet℠ to execute against another Market Maker, passing on those prices to the customer. Other firms provide partial executions up to a certain size and, if applicable, place the remainder of the order in a queue that is then processed on a first-in-first-out basis.[2] These are but two examples of the procedures firms have adopted during extreme market conditions and are not intended to reflect preferred procedures.

Some firms have asked NASD Regulation whether their procedures during extreme market conditions are consistent with the best execution of customer orders. Accordingly, NASD Regulation is issuing this *Notice* to provide guidance in this area. Specifically, NASD Regulation believes firms should consider the following guidelines when evaluating whether their order execution algorithms or procedures are appropriate during turbulent market conditions. Nothing in the following guidelines is intended to suggest that firms are restricted from revising their execution algorithms for business reasons unrelated to market turbulence.

1. The treatment of customer orders under any order execution algorithm or procedure must remain fair, consistent, and reasonable.

2. To the extent that a firm's order execution algorithm or procedures are different during turbulent market conditions, the firm should disclose to its order entry firms (and customers if applicable) the differences in the procedures from normal market conditions and the circumstances in which the firm may generally activate these procedures. In this connection, however, NASD Regulation notes that the disclosure of alternative order handling procedures that are unfair or otherwise inconsistent with the firm's best execution obligations would neither correct the deficiencies with such procedures nor absolve the firm of potential best execution violations.

3. Modifications to order execution algorithms or procedures designed to respond to turbulent market conditions may be implemented only when warranted by market conditions. Excessive activation of modified procedures on the grounds of turbulent market conditions could raise best execution concerns. Accordingly, firms should document the basis for activation of their modified procedures.

4. As noted above, and as the SEC has stated, "[b]roker-dealers therefore need to take steps to prevent their operational systems from being overwhelmed by periodic spikes in systems message traffic due to high volume. In particular, broker-dealers should not merely have sufficient systems capacity to handle average-to-heavy loads."[3] Frequent activation of modified order execution algorithms or procedures because a firm has failed to maintain adequate system capacity to handle exceptional loads may raise best execution concerns.

5. To the extent firms execute orders manually during extreme market conditions, NASD Regulation reminds firms that NASD Rule 2320(d) provides that "[f]ailure to maintain or adequately staff an over-the-counter order room or other department assigned to execute customers' orders cannot be considered justification for executing away from the best available market . . . ."

Ultimately, it necessarily involves a facts and circumstances analysis to determine whether actions taken by a firm during turbulent market conditions are consistent with the duty of best execution. Accordingly, NASD Regulation cannot provide specific guidance that a particular order execution algorithm or order handling procedure during turbulent market conditions is always consistent with best execution. Nevertheless, NASD Regulation believes the guidelines set forth above provide useful direction for firms.

Endnotes

[1] Firms that direct order flow likewise have a best execution obligation to conduct regular and rigorous review of the quality of executions of orders sent to correspondent Market Makers.

[2] Firms also have reduced their size guarantee on individual stocks or groups of stocks (*i.e.*, Internet stocks) on a going-forward basis, irrespective of market conditions at any given time.

[3] See SEC Staff Legal Bulletin No. 8 (September 9, 1998).

NASD Notice to Members 98-102

Calculating Margin For Day-Trading And Cross-Guaranteed Accounts

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☐ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
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- ☐ Mutual Fund
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Executive Summary

Federal Reserve Board Regulation T governs the extension of credit to customers by broker/dealers. Among the provisions of Regulation T are requirements governing the initial margin requirements for certain securities transactions. In addition, National Association of Securities Dealers, Inc. (NASD®) Rule 2520 requires NASD members to impose additional margin requirements on customer accounts.[1] The purpose of this *Notice* is to communicate the opinion of the NASD on the margin requirements under Regulation T and Rule 2520 for day-trading and cross-guaranteed accounts with the expectation that members will calculate margin for such accounts in a manner that is consistent with Regulation T and Rule 2520.

The NASD believes that some members are calculating margin for day-traders and cross-guaranteed accounts in a manner that is not consistent with the requirements of Regulation T and Rule 2520. Accordingly, members are advised to review their margin calculation practices to ensure that they conform to the requirements of these rules. Adherence to the margin requirements is in the best interest of the investing public and serves to protect the financial security of members that extend credit.

Finally, the NASD believes that some members may be failing to take certain account-related charges when computing their net capital pursuant to Securities and Exchange Commission (SEC) Rule 15c3-1. These charges include those specified in Rule 2520(f)(4) for certain guaranteed accounts. Members should review the requirements of SEC Rule 15c3-1 and Rule 2520 to determine whether they are in compliance with these rules.

Members should be aware that the NASD believes compliance with the margin and net capital requirements is of paramount importance and intends to examine member firms for compliance with these rules.

Questions concerning this *Notice* may be directed to Samuel Luque, Associate Director, Member Regulation, NASD Regulation, Inc. (NASD Regulation℠), at (202) 728-8472, or Susan DeMando, Regional Compliance Supervisor, Member Regulation, NASD Regulation, at (202) 728-8411.

Discussion

This *Notice* addresses some of the most frequently asked questions regarding the application of Regulation T and Rule 2520 to day-trading and cross-guaranteed accounts. In addition, this *Notice* addresses only common scenarios and questions relating to marginable equity securities and is not meant to be a complete discussion of the application of Regulation T and Rule 2520 to all possible trading strategies utilized by day-trading and/or cross-guaranteed accounts.

In order to clarify member understanding of the requirements relating to day-trading and cross-guaranteed accounts, highlighted below in plain English are some of the fundamental requirements and provisions of these rules.

General

- Members must perform two separate margin calculations for each account each day; one for Regulation T and one for Rule 2520. The calculations should be performed at the end of each trade date; intra-day calculations are not permitted. Members must comply with the requirements of both rules at all times.

- "Day-trading" means buying and selling the same security on the same day. A "day-trader" is any customer whose trading shows a pattern of day-trading (see Rule 2520(f)(8)(B)). (See also the Securities Industry Association's *Credit Division Manual's* definition of "day-trading" as "selling first and then repurchasing" the same security on the same day.)

• Day-trades should occur only in margin accounts. Day-trading in a cash account may amount to free riding (*i.e.*, purchasing a security and then selling it without having paid for the purchase).

• Regulation T requires initial margin of 50 percent for new purchases and 150 percent for short sales (of which 100 percent can come from the proceeds of the short sale, with the customer depositing the remaining 50 percent). (See Regulation T, Sections 220.12(a) and (c)(1).)

• Rule 2520 requires maintenance margin of 25 percent of the current market value for all long positions, and $5 per share or 30 percent of the current market value, whichever amount is greater, of each stock "short" in the account selling at $5 per share or above (see Rule 2520(c)(1) and (c)(3)). *If a customer's account is both "long" and "short" the same security, Rule 2520(e)(1) requires five percent maintenance margin of the current market value of the long security. The short position must be marked to the market.*

• If two accounts are cross-guaranteed and one is long the same security that the other is short the same number of securities, the maintenance margin requirement on the combined positions is five percent. This five percent maintenance margin requirement in no way eliminates the requirement to comply with the initial margin requirements of Regulation T on the original purchase and short sale.

• When calculating Regulation T margin, cross guarantees have *no* effect (see Regulation T, Section 3(d)). Therefore, members must apply Regulation T to each account separately, notwithstanding the fact that Rule 2520 permits certain special maintenance margin treatment for transactions in cross-guaranteed accounts.

• Rule 2520(f)(4) permits cross guarantees for maintenance margin purposes so that the amount of maintenance margin excess in one account may be used to offset a maintenance margin deficit in the other cross-guaranteed account. In any given situation, the account with the maintenance margin excess is considered the guaranteeing account and the account with the maintenance margin deficit is considered the guaranteed account.

• The fact that Regulation T margin is calculated at the end of the business day only does not mean that broker/dealers can disregard intraday risk. Reliance on the proceeds of anticipated sales to pay for purchases exposes the broker/dealer to risk.

Regulation T

• Margin is required for each long or short securities position unless an exception or special provision is available (see Regulation T, Section 4(b)). The required margin is set forth in Section 12 (the Supplement).

• Regulation T margin is calculated at the end of the business day. All transactions on the same day are combined to determine the Regulation T requirement. Therefore, Regulation T does not distinguish between day-trading and other forms of trading (see Regulation T, Section 4(c)(1)).

• A Regulation T margin requirement may be satisfied by a transfer from the Special Memorandum Account (SMA), or by a deposit of cash, margin securities, or exempted securities, in any combination (see Regulation T, Section 4(c)(2)).

• Regulation T treats a short sale "against the box" as a long sale (see Regulation T, Section 4(b)(2)). As a result, there is no Regulation T requirement on the transaction; however, Rule 2520(e)(1) imposes a five percent margin requirement on the market value of the long position and requires the short position to be marked to the market.

• A sale cannot be treated as a short sale "against the box," nor can it be treated as a long sale, if the account making the sale is not long the same number of shares of the same security, even if another cross-guaranteeing account is long the security. Because cross guarantees have no effect under Regulation T, the fact that another cross-guaranteeing account is long the security is meaningless for Regulation T purposes and the sale must be regarded as a short sale subject to a margin requirement of 150 percent (see Regulation T, Section 12(c)(1)).

• Regulation T has no margin requirements for day-trading *per se*. Regulation T margin is calculated on the position in the account at the end of the day. Therefore, if a day-trader engages in numerous day-trades throughout the day, but ends the day with no securities position, Regulation T requires margin equal to the net loss in the account at the end of the day. A Regulation T call must be issued for the entire amount of the loss. The call may be met by a deposit of cash or securities (margin or exempted), a transfer from SMA, or any combination (see Regulation T, Section 4(c)(2)).

Rule 2520

• While often thought of as a "maintenance" margin rule, Rule 2520 also contains initial margin requirements (see paragraph (b)). Initial margin is always the greater of the amount specified in Regulation T or the maintenance margin specified in paragraph (c). This requirement applies to both non day-traders (see paragraph (B)) and day-traders (see paragraph (f)(8)(B)).

• Rule 2520 was created to work in tandem with Regulation T. Therefore, because Regulation T calculations are made only at the end of the day, Rule 2520 maintenance margin calculations must be made only at the end of the day.

Although firms may calculate margin intra-day for risk assessment and risk avoidance purposes, and may impose margin calls based on such intra-day calculations, members may not grant additional buying power[2] to a customer on the basis of such intra-day calculations. Buying power may only be based on the preceding day's end-of-the-day margin calculations.

• A maintenance margin call may be satisfied by a deposit of cash, margin securities, or exempted securities, in any combination. A maintenance margin call *may not* be satisfied by a transfer from the SMA.

• Rule 2520(f)(4) permits special margin treatment for transactions in cross-guaranteed accounts if certain conditions are met. Since Regulation T does not recognize cross guarantees, nothing in Rule 2520 is intended to grant guaranteed accounts any benefit that would circumvent the provisions of Regulation T.

• Day-trading is recognized by Rule 2520 through the definitions of "day-trading," "day-trader" and the margin requirements specified in Rule 2520 (f)(8)(B). The paragraph states:

> Whenever day-trading occurs in a customer's margin account the margin to be maintained shall be the margin on the "long" or "short" transaction, whichever occurred first, as required pursuant to the other provisions of this Rule. When day-trading occurs in the account of a "day-trader" the margin to be maintained shall be the margin on the "long" or "short" transaction, whichever occurred first, as required by Regulation T of the Board of Governors of the Federal Reserve System or as required pursuant to the other provisions of this Rule, whichever amount is greater.

Questions And Answers Relating To The Calculation Of Initial And Maintenance Margin On Day-Trading And Cross-Guaranteed Accounts

For the purpose of the illustrations contained in this *Notice*, the examples assume: 1) that the securities discussed are marginable equity securities; 2) that unless otherwise noted the maintenance margin requirement on short transactions is 30 percent of the current market value of the security; 3) the customer intends to meet his/her requirement with a deposit of cash; and 4) that each of the customers has a history of day-trading, whether or not the trades in a specific example are day-trades.

1.

*Q. Customer A and Customer B cross guarantee each other's accounts. Customer A buys $1,000,000 of securities on Day 1 and is long the securities at the end of the day. Customer B sells short $1,000,000 of **different** securities on Day 1 and is short the securities at the end of the day. What are the Regulation T and maintenance margin requirements for each customer?*

A. Since Regulation T does not acknowledge the existence of the cross guarantee, Regulation T would require Customer A to put up margin of 50 percent or $500,000 in payment for the securities purchased in Customer A's account (see Regulation T, Section 220.12(a)). Regulation T would require Customer B to put up margin of 150 percent or $1,500,000 in payment for the securities sold short in Customer B's account, of which $1,000,000 could come from the proceeds of the short sale (see Regulation T, Section 220.12(c)(1)).

Rule 2520 requires maintenance margin for Customer A of $250,000 (25 percent of the market value long) and maintenance margin for Customer B of $300,000 (30 percent of the market value short). (See Rule 2520, paragraphs (c)(1) and (c)(3) respectively.)

2.

Q. Considering the facts in Question 1 again, would the answer be different if the securities bought by Customer A and sold short by Customer B were the same *securities,* i.e., *because of the cross guarantee the accounts were fully hedged?*

A. Again, since Regulation T does not acknowledge the existence of the cross guarantee, Regulation T would require Customer A to put up margin of 50 percent or $500,000 in payment for the securities purchased in Customer A's account (see Regulation T, Section 220.12(a)). Regulation T would require Customer B to put up margin of 150 percent or $1,500,000 in payment for the securities sold short in Customer B's account, of which $1,000,000 could come from the proceeds of the short sale (see Regulation T, Section 220.12(c)(1)).

Rule 2520 (e)(1) permits maintenance margin of five percent of the current market value of the long securities for "Offsetting 'Long' and 'Short' Positions" where the same security is carried long and short *for the same customer.* Given the existence of the cross guarantee, Rule 2520(f)(4) allows any account guaranteed by another account to be consolidated with the other account, and the margin to be maintained may be determined on the net positions on both accounts. In this case, since Customer A and Customer B are long and short the same securities, and since they cross guarantee each other's accounts, they may utilize the five percent maintenance margin requirement outlined in paragraph (e)(1) on the offsetting positions. Therefore, the required maintenance margin for the combined position would be $50,000.

3.

Q. *On Day 1, Customer C purchases $400,000 of securities. The Regulation T margin required is $200,000. The customer deposits $250,000 cash in the account and, as a result, has received a margin loan of $150,000 from the broker/dealer to complete the transaction. What is the customer's Regulation T buying power for Day 2? What is the customer's day-trading buying power for Day 2?*

A. Going into Day 2, Customer C has Regulation T buying power of $100,000 because the previous day's Regulation T excess of $50,000 would provide $100,000 in buying power. Thus, if Customer C purchases securities on Day 2 that he does not sell on Day 2, he can make such purchases up to $100,000 without incurring a Regulation T call. Buying power is calculated as follows: ($250,000 - ($400,000 x 50%)) x 2 = $100,000.

Going into Day 2, the customer has day-trading buying power of $300,000 because the maintenance margin excess of $150,000 provides day-trading buying power of $300,000. If Customer C purchases securities on Day 2 which he subsequently sells on Day 2, *i.e.*, he engages in day-trading, he can make such purchases up to $300,000 without incurring a day-trading call. This is calculated as follows: ($250,000 - ($400,000 x 25%)) x 2 = $300,000.

The above answer presumes Customer C did not incur a loss on the day-trades (*i.e.*, made a profit or broke even). If Customer C were to buy $300,000 of securities and sell them the same day for $280,000, he would have a Regulation T call for $20,000, or 100 percent of the loss. Regulation T requires additional margin when a transaction creates or increases a margin deficiency in an amount equal to the deficiency created or increased (see Regulation T, Section 220.4(c)(1)).

4.

Q. *Customer D makes one purchase for $2,000,000 in the morning of Day 1 and then sells the securities at a profit in the afternoon of Day 1 for the same account ending the day with no securities position. What is the customer's margin requirement?*

A. Regulation T margin is calculated on the end of the day position. Because the customer has no securities position at the end of the day, and did not incur a loss, there is no Regulation T requirement. However, there is a required day-trading maintenance margin requirement of $1,000,000. The margin call would be classified as a Rule 2520 Call (not a Regulation T call) since it is Rule 2520 (b) that sets the margin for the trade.

5.

Q. *On Day 1, Customer E buys 100 ABCD at $88 in an existing margin account that has no SMA, and deposits $4,400, which is the Regulation T requirement, into the account. She carries the position over into Day 2. On Day 2, she sells 100 ABCD at $89 at 11 a.m. What is impact of the sale on the customer's Regulation T buying power or day-trading buying power for the remainder of Day 2?*

A. Going into Day 2, the customer has zero Regulation T buying power since she deposited the exact amount of the Regulation T requirement into her account on Day 1, *i.e.*, $8,800 x 50% = $4,400. Per Regulation T, Section 220.4(c)(1), buying power for Day 2 is based on the status of the account at the end of Day 1. Intra-day sales on Day 2 cannot be used to increase Regulation T buying power for Day 2. Therefore, Customer E's Regulation T buying power for Day 2 remains at zero, irrespective of the sale on Day 2.

Going into Day 2, the customer has day-trading buying power of $4,400. If Customer E chooses to purchases securities on Day 2 that she subsequently sells on Day 2, *i.e.*, she engages in day-trading, she can make such purchases up to $4,400 without incurring a day-trading call. This is calculated as follows: ($4,400 - ($8,800 x 25%)) x 2 = $4,400. The customer's day-trading buying power is set at $4,400 for Day 2. It can not be adjusted by intra-day activity.

6.

Q. *On Day 1, Customer F has an account containing equity securities with a market value of $100,000, a* *debit balance of $70,000, equity of $30,000, and maintenance margin excess of $5,000. On Day 2, the customer purchases $100,000 in equity securities and later in the same day sells them for $105,000. What is the Regulation T requirement for Day 2?*

A. Regulation T margin is calculated on the end of the day position. Since the customer has no securities position at the end of Day 2 resulting from Day 2 transactions and earned a profit on the sale, there is no Regulation T requirement for Day 2.

However, there is a Rule 2520 requirement. Going into Day 2, the customer may use the maintenance margin excess carried over from Day 1 to day-trade additional securities. Customer F has a maintenance margin excess of $5,000 ($30,000 - ($100,000 x 25%)). She could use this excess to day-trade $10,000 ($5,000 x 2) in equity securities on Day 2 without having to deposit any additional margin as long as she incurs no loss (*i.e.*, she makes a profit or breaks even) on the Day 2 day-trades. Taking the above into account, the customer should receive a Rule 2520 day-trading margin call of $45,000 representing half of the purchase price not covered by the day-trading buying power.

Endnotes

[1]Several years ago, the NASD amended Rule 2520 to make it substantially the same as New York Stock Exchange (NYSE) Rule 431, including paragraph numbering. Thus, for example, paragraph 2520(f)(4) is the same as NYSE Rule 431(f)(4). The NASD has also customized Rule 2520 in a few places in recognition of certain differences between the NASD and NYSE in rules, jurisdiction, and market structure. Members should be familiar with the requirements of either NASD Rule 2520 or NYSE Rule 431, depending upon which one applies to them.

[2]Buying power - either Regulation T or day-trading - represents the dollar value of securities that can be purchased with a given amount of Regulation T or maintenance margin excess respectively (usually twice the amount of the excess).

NASD Notice to Members 99-11

NASD Regulation Issues Guidance Regarding Stock Volatility

Suggested Routing

- ■ Senior Management
- ■ Advertising
- ■ Continuing Education
- □ Corporate Finance
- ■ Executive Representatives
- □ Government Securities
- □ Institutional
- □ Insurance
- □ Internal Audit
- ■ Legal & Compliance
- □ Municipal
- ■ Mutual Fund
- □ Operations
- □ Options
- ■ Registered Representatives
- □ Registration
- □ Research
- □ Syndicate
- ■ Systems
- ■ Trading
- ■ Training
- □ Variable Contracts

Executive Summary

In recent months, there has been a sharp increase in price volatility and volume in many stocks, particularly of companies that sell products or services via the Internet (Internet issuers). NASD Regulation, Inc. (NASD Regulation℠) is issuing this *Notice to Members* to suggest disclosures that firms can make to retail customers to educate them about the risks of price and volume volatility. This *Notice* also describes steps taken by some on-line brokers to respond to volatility. A companion *Notice to Members* issued today, *Notice to Members 99-12*, provides members with guidance concerning the operation of their order execution systems and procedures during extreme market conditions.

Questions or comments concerning this *Notice* may be directed to Mary Revell, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8203.

Discussion

Recently, there has been a marked increase in the price volatility of many stocks, particularly those of Internet issuers. This volatility has been coupled with record trading volume in many of these stocks. Customers eager to trade Internet stocks have flooded their brokers with large numbers of orders, leading to large order imbalances, systems queues, and backlogs. During these extreme market conditions, many firms implemented procedures that are designed to preserve the continuous execution of customers' orders while also lessening the exposure of the firm to extraordinary market risk. For example, some Market Maker firms temporarily discontinued normal automatic order executions and handled orders manually. Firms also reduced their size guarantees on individual stocks or groups of stocks (*i.e.*, stocks of Internet issuers) on a going-forward basis. Delays in order executions and executions at prices significantly away from the market price quoted at the time the order was entered then occurred, which in turn led to market losses caused by executions at prices higher or lower than customers expected, especially with respect to orders placed over the Internet.

First and foremost, NASD Regulation reminds member firms of their obligations under Securities and Exchange Commission (SEC) Staff Legal Bulletin No. 8 to ensure that they have adequate systems capacity to handle high volume or high volatility trading days.[1] In this connection, we note that the SEC staff's position relates to all firms handling orders and is premised on a legal obligation to treat customers fairly.[2] Second, firms should provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner. This *Notice* describes the types of disclosure we deem appropriate.

We also have spoken to several order entry firms that provide on-line trading services about the steps they are taking to respond to volatility. This *Notice* provides members with information about these steps.[3]

Disclosure

Recent events show that the way some stocks are traded is changing dramatically, and the change in trading methods may affect price volatility and cause increased trading volume. This price volatility and increased volume present new hazards to investors, regardless of whether trading occurs on-line or otherwise. Firms are reminded that their procedures for handling customer orders must be fair, consistent, and reasonable during volatile market conditions and otherwise. To ensure that customers are knowledgeable about these procedures, we suggest that all firms, both order entry firms (*i.e.*, firms with a retail business that route orders to other firms for execution) and integrated firms (*i.e.*, firms with a large retail business that also engage in market making and other activities), whether they offer on-line trading services or not, consider making the following types of disclosures to educate retail customers about their procedures for handling the execution of a securities transaction, particularly during volatile market conditions, along with any additional disclosures they deem appropriate. NASD Regulation notes, however, that disclosure of procedures that are unfair, inconsistent, or unreasonable would not correct deficiencies with these procedures.

Delays

Firms should consider disclosing that high volumes of trading at the market opening or intra-day may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was entered. Firms should consider explaining to customers how order executions are handled by Market Makers, and explain that Market Makers may execute orders manually or reduce their size guarantees during periods of volatility, resulting in possible delays in order execution and losses. This disclosure is particularly important with respect to on-line investors, who have come to expect quick executions at prices at or near the quotes displayed on their computer screens.

Types Of Orders

Firms should consider explaining in detail the difference between market and limit orders and the benefits and risks of each. In particular, firms should consider disclosing that they are required to execute a market order fully and promptly without regard to price and that, while a customer may receive a prompt execution of a market order, the execution may be at a price significantly different from the current quoted price of that security. Firms should tell customers that limit orders will be executed only at a specified price or better and that, while the customer receives price protection, there is the possibility that the order will not be executed.

As a related matter, firms should consider additional disclosure for customers who place market orders for initial public offering (IPO) securities trading in the secondary market, particularly those that trade at a much higher price than their offering price, or in "hot stocks" (those that have recently traded for a period of time under what is known as "fast market conditions," in which the price of the security changes so quickly that quotes for a stock do not keep pace with the trading price of the stock). Firms may disclose that in such cases customers' risk of receiving an execution substantially away from the market price at the time they place the order may be significantly reduced if they also include a cap (or floor) with the order above (or below) which the order is not to be executed, by placing a limit order.

Access

Firms should consider alerting customers that they may suffer market losses during periods of volatility in the price and volume of a particular stock when systems problems result in inability to place buy or sell orders. Customers trading on-line may have difficulty accessing their accounts due to high Internet traffic or because of systems capacity limitations. Customers trading through brokers at full-service or discount brokerage firms or through representatives of on-line firms when on-line trading has been disabled or is not available because of systems limitations may have difficulty reaching account representatives on the telephone during periods of high volume. Firms should explain their procedures for responding to these access problems.

Communications With The Public

Firms may use advertisements or sales literature to make claims about the speed and reliability of their trading services. These communications with the public must not exaggerate the members' capabilities or omit material information about the risks of trading and the possibilities of delayed executions. Moreover, members should have the systems capacity to support any claims they make about their trading services. Misrepresentations or omissions of material facts in public communications violate National Association of Securities Dealers, Inc. (NASD®) Rule 2210 as well as Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade.

Current Practices

As stated above, on-line firms have described to us steps they have taken to respond to volatility. These procedures are detailed below. While NASD Regulation believes that these actions, when clearly disclosed to customers, may be appropriate responses to trading in securities experiencing extraordinary volatility, they may not be sufficient or appropriate responses in all circumstances. Each action provides protection to the firm and obviously also impacts a firm's customers wishing to trade those securities.

Hot IPOs And Hot Stocks

There recently has been significant volatility during the period of time when certain IPOs have opened for secondary market trading, particularly the IPOs of Internet issuers. When some of these IPOs started trading on an exchange or on The Nasdaq Stock Market, Inc., after going public, they initially have traded at a much higher price than their IPO offering price. The prices of some of these "hot" IPOs have doubled or more in initial trading (one increased more than tenfold in price), only to fall sharply in subsequent trading. This price volatility has been accompanied by significant trading volume. Certain non-IPO stocks of Internet issuers also recently have traded for a period of time under fast market conditions.

The extraordinary volume of orders and cancellations entered on-line and otherwise during those periods caused queues and backlogs for many order entry and Market Maker firms. As a result of the level of market volatility and volume of orders, a number of Market Makers discontinued their normal automatic execution of orders and began handling orders manually. Firms also reduced their size guarantees on individual stocks or groups of stocks. This in turn led to delays in order executions, executions at prices significantly away from the market quoted at the time the order was entered, and delays in execution confirmations and cancellation reports.

Order entry firms responded to this price volatility and to changes in Market Maker order handling procedures in several ways. One firm has halted on-line trading of hot IPOs and stocks, requiring customers to purchase these securities through a registered representative, either in person or via the telephone. When contacted, representatives can explain, for example, the difference between market and limit orders and the benefits and risks of each, and encourage customers whose primary goal is to achieve a target price and protect against sudden price moves, and who understand that there is a possibility that the order will not be executed, to enter limit orders. When used, this halt has been implemented only for a short period of time, typically one day.

Other firms do not accept market orders for hot IPOs, requiring customers who wish to buy these stocks to enter a limit order specifying the highest price they would pay for these issues. Still other firms do not accept any orders for certain IPOs that are forecast to be hot until the IPO begins trading in the secondary market. Finally, some firms call clients back who have placed orders on IPOs that look to be volatile. The firms alert customers to restrictions they impose by placing a notice on their Web sites.

Margin

All firms, whether on-line or otherwise, may raise margin requirements for volatile stocks. Some firms that permit on-line trading have raised the amount of equity that must be maintained in margin accounts (maintenance margin) for long positions in certain volatile stocks to between 40 percent and 100 percent.[4] The rationale for raising maintenance margin is to help ensure that the equity in a customer's margin account is sufficient to cover large changes in the price of a stock. Increasing maintenance margin requirements protects both the firm and customers by ensuring that investors have more equity in their margin accounts as protection in case of a large change in the value of a stock, which reduces the likelihood that the firm will have to liquidate assets in the customer's account to meet a margin call. Firms evaluate stocks for more stringent maintenance margin requirements by examining price fluctuations, market capitalization, and volatility.

On-line firms also have responded to recent volatility by prohibiting the use of margin to purchase certain securities. Some securities have been designated as "not marginable," requiring customers to purchase the securities with 100 percent initial margin, allowing payment to be made within three days of settlement. Firms also have designated certain securities as "cash on hand," requiring customers to have 100 percent of the purchase price of the security in the account before the transaction can be executed.

Investor Education

Many firms provide some kind of investor education on issues related to market volatility on their Web sites. This education may be found in a part of the Web site devoted generally to investor education and in firm newsletters. It may include definitions of market and limit orders, an explanation of the difference between the two types of orders, and the risks and benefits of each. Some firms encourage customers to use limit orders when they are more concerned about achieving a desired target price for a trade than an immediate execution. Investor education also can be found in some firms' account-opening documents and cash- and margin-account opening documents. Finally, many firms have customer help desks and support agents, both of which provide answers to customer questions.

Pop-up Or Splash Screens

Certain firms have added a page that a customer must view when entering the customer account pages of their Web sites indicating, for example, that maintenance margin has been raised for certain listed securities; trade reports may be delayed; only limit orders will be accepted for certain securities; and the latest "real-time" quotes viewed on the site may not be reflective of the current trading price of a stock.

Some firms use these pages to discuss what happens when customers attempt to cancel market orders and enter replacement orders. Because of delays in receiving trade reports on volatile trading days, some customers, fearing that their orders have not been executed, have attempted to cancel their initial market orders and enter new orders. Because market orders must be executed as promptly as possible, firms explain that it may not be feasible to cancel a market order, since it may already have been executed, even if a customer has not yet received a trade report confirming the execution. Customers are told that entering a cancel order and a separate replacement order may result in the customer being responsible for the execution of duplicate orders, if the cancellation order cannot be processed in a timely fashion. Firms advise customers instead to place limit orders to reduce the risk of placing a duplicate order and ensure that the price received is within acceptable limits. One firm has created another category of order called "cancel and replace": the firm will execute the second or "replace order" only if it can confirm that the initial order was in fact canceled.

Member firms are exploring the feasibility of creating more of these screens on a stock-specific or trade-specific basis. This could include, for example, a "pop-up" screen explaining that a particular stock is trading in a fast market condition when a customer seeks to place an order in the stock.

Endnotes

[1]Staff Legal Bulletin No. 8 (MR), published on September 8, 1998, states the views of the SEC's Division of Market Regulation about the need for broker/dealers to maintain enough internal systems capacity to operate properly when trading volume is high. This Bulletin is available on the SEC's Web site at: *http://www.sec.gov/rules/othern/slbmr8.htm*

[2]The Legal Bulletin cites an SEC Release in support of its position. *See* note 8, citing Securities Exchange Act Release No. 8363 (July 29, 1968), 33 FR 11150 (August 7, 1968).

[3]This *Notice* addresses possible responses to recent stock price volatility, particularly in stocks traded through on-line brokerage firms. While it does not address firms' suitability obligations in connection with recommended transactions or their know-your-customer obligations, firms are reminded that the existence of these obligations does not depend upon whether a trade is executed on-line or otherwise.

[4]This increase is from the 25 percent maintenance margin required by NASD and stock exchange rules or the 30 percent to 35 percent maintenance margin required by many firms.

COMPLAINT:

NASDR Department of Enforcement

v.

Lakeside Trading and Thomas G. Russell.

Note: The issuance of a disciplinary complaint represents the initiation of a formal proceeding by the Association in which findings as to the allegations in the complaint have not been made and does not represent a decision as to any of the allegations contained in the complaint. Because this complaint is unadjudicated, you may wish to contact the respondent before drawing any conclusions regarding the allegations in the complaint.

NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

Department of Enforcement, Complainant, v. Lakeside Trading, Respondent [CRD No. 39418] and Thomas G. Russell, Registered General Securities Principal and Registered Financial and Operations Principal [CRD No. 2669033] Respondents.	Disciplinary Proceeding No. C05990018 Hearing Officer ___________ **COMPLAINT**

Upon information and belief, Complainant alleges as follows:

1. Respondent Member Lakeside Trading ("Lakeside Trading") became a member of the Association in 1996. Lakeside Trading, during all periods mentioned herein, was a registered broker/dealer with the Securities and Exchange Commission and a member of the Association, which registration and membership remain currently in effect.

2. Individual Respondent Thomas G. Russell ("Respondent Russell") entered the securities industry in December 1995 as a General Securities Representative of Lakeside Trading, a member of this Association. Respondent Russell, during all periods mentioned herein, was associated with member firm Lakeside Trading, and was registered with the Association under Article V of the By-Laws as a General Securities Principal, and as a Financial and Operations Principal, which registrations remain currently in effect.

FIRST CAUSE OF COMPLAINT

NASD Conduct Rules 2110, 2330(a), and 2510(b): Misuse of Customer Funds
Against Lakeside Trading and Thomas G. Russell

3. During the period from on or about October 12, 1998, through on or about December 1, 1998, Lakeside Trading, acting through Thomas G. Russell, its president and sole principal, improperly used customer funds, in that Respondent Russell executed approximately 788 transactions in the account of a public customer IV, account no. 62823861, then directed the trading profits from the customer's account to the firm by placing excessive commissions on certain trades equaling approximately 95% of the total trading profits earned in the account during that period.

4. During this period, Respondent Russell effected 788 discretionary trades in the account of public customer IV, and failed to obtain written discretionary authority from the affected public customer.

5. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 2110, 2330(a), and 2510(b) by Lakeside Trading and Thomas G. Russell, each separately.

SECOND CAUSE OF COMPLAINT

NASD Conduct Rules 2110 and 2330(e): Guaranteed Customer Against Loss
Against Thomas G. Russell

6. In September 1998, Thomas G. Russell guaranteed public customer IV against losses in a securities account maintained by IV at Lakeside Trading, account no. 62823861, by telling IV that only profitable transactions would be placed in his account.

7. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 2110 and 2330(e) by Thomas G. Russell.

THIRD CAUSE OF COMPLAINT

Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Conduct Rules 2110 and 2520(f)(7): Regulation T Violations; Effecting Transactions Beyond Financial Means, Against Thomas G. Russell

8. On or about November 30, 1998, Thomas G. Russell, by the use of means or instrumentality of interstate commerce, or of the mails, or of a facility of a national securities exchange, caused the execution of transactions in his personal account, account no. 62711000, which he maintained at Lakeside Trading's clearing firm JB Oxford & Company, for which transactions he knowingly did not have the financial resources to settle, nor the ability to meet the initial margin requirements of Federal Reserve Board Regulation T. Specifically, on trade date November 30, 1998, Respondent Russell purchased shares in

FIRST CAUSE OF COMPLAINT

NASD Conduct Rules 2110, 2330(a), and 2510(b): Misuse of Customer Funds
Against Lakeside Trading and Thomas G. Russell

3. During the period from on or about October 12, 1998, through on or about December 1, 1998, Lakeside Trading, acting through Thomas G. Russell, its president and sole principal, improperly used customer funds, in that Respondent Russell executed approximately 788 transactions in the account of a public customer IV, account no. 62823861, then directed the trading profits from the customer's account to the firm by placing excessive commissions on certain trades equaling approximately 95% of the total trading profits earned in the account during that period.

4. During this period, Respondent Russell effected 788 discretionary trades in the account of public customer IV, and failed to obtain written discretionary authority from the affected public customer.

5. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 2110, 2330(a), and 2510(b) by Lakeside Trading and Thomas G. Russell, each separately.

the stock of Books-a-Million and OnSale Inc., costing $1,739,986.84 in his personal account, while maintaining no more than a $25,000.00 cash balance in the account. Respondent Russell failed to disclose to JB Oxford & Company his inability to pay for these transactions. These activities resulted in eventual realized losses to JB Oxford & Company of approximately $218,797.00.

9. In addition, on or about December 1, 1998, Thomas G. Russell effected unauthorized transactions in the stock of Books-a-Million and OnSale Inc., totaling approximately $275,225.00 in the account of public customer IV, with the intention of transferring gains in that account to his own account. These transactions resulted in eventual realized losses in the account of public customer IV of approximately $97,430.00.

10. Such acts, practices, and conduct constitute separate and distinct violations of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2520(f)(7) by Thomas G. Russell.

FOURTH CAUSE OF COMPLAINT

NASD Conduct Rule 2110: Misrepresentations
Against Thomas G. Russell

11. In connection with the activities detailed in the Third Cause of Complaint, on or about December 1, 1998, Thomas G. Russell willfully misled representatives of his clearing firm, JB Oxford & Company, by misrepresenting in a telephone conversation that he had sold

over $1.7 million in unsecured positions in the stock of Books-a-Million and OnSale Inc. in his personal account. By so doing, Respondent Russell prevented JB Oxford & Company from taking action to limit losses in the account, so that he could continue to maintain the positions in anticipation that the values would increase.

12. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rule 2110 by Thomas G. Russell.

FIFTH CAUSE OF COMPLAINT

SEC Rules 17a-5(a)(2)(iii) and 17a-5(d), and NASD Conduct Rule 2110: Failure to File FOCUS Report and Audited Financial Statements Against Lakeside Trading and Thomas G. Russell

13. For the month-ending period of December 31, 1998, Lakeside Trading, acting through Thomas G. Russell, in contravention of SEC Rule 17a-5(a)(2)(iii), failed to file its FOCUS Part IIA and Schedule I with the Association within 17 business days, as required by said Rule.

14. In addition, for the year-ending period of December 31, 1998, Lakeside Trading, acting through Thomas G. Russell, in contravention of SEC Rule 17a-5(d), failed to file audited financial statements.

15. Such acts, practices, and conduct constitute separate and distinct violations of SEC Rules 17a-5(a)(2)(iii) and 17a-5(d), and NASD Conduct Rule 2110, by Lakeside Trading and Thomas G. Russell, each separately.

SIXTH CAUSE OF COMPLAINT

NASD Conduct Rules 2110 and 2210(c)(3)(A):
Failure to Obtain Prior Approval of Initial Advertisement and the Revisions thereto on Website
Against Lakeside Trading and Thomas G. Russell

16. On or about June 1, 1998, Lakeside Trading, acting through Thomas G. Russell, employed its initial advertisement, in the form of an internet web-site, without having previously filed such material with the Association ten days prior to use, as required by NASD Conduct Rule 2210(c)(3)(A). Lakeside Trading, acting through Thomas G. Russell, failed to file its initial advertisement until July 23, 1998.

17. In addition, during the period from on or about July 24, 1998, through on or about November 30, 1998, the firm, acting through Respondent Russell, continuously revised such advertisements without filing ten days prior to use, as required by the Association.

18. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 2110 and 2210(c)(3)(A), by Lakeside Trading and Thomas G. Russell, each separately.

SEVENTH CAUSE OF COMPLAINT

NASD Conduct Rules 2110, 2210(d)(1)(A) and 2210(d)(1)(B): Misleading Advertising
Against Lakeside Trading and Thomas G. Russell

19. During the period from on or about June 1, 1998, through on or about November 30, 1998, Lakeside Trading, acting through Thomas G. Russell, employed advertising, in the form of

an internet web-site, that failed to provide a sound basis for evaluating the services provided by the firm and included exaggerated and unwarranted statements that were potentially misleading. Specifically, the firm, acting through Russell, included on the internet web-site:

a. misleading statements that implied that individuals accessing the firm's trading systems on-line had direct access to the markets;

b. material that failed to clarify that investors must place trades for the purchase and sale of securities through Lakeside Trading as intermediary;

c. statements that exaggerated customers' ability to access the markets;

d. material that failed to disclose that customers' transactions were subject to market fluctuation risks, and that trades may not be executed at all; and

e. material that failed to provide a balanced and complete presentation by omitting disclosure concerning the risks associated with day trading.

20. Such acts, practices and conduct constitute separate and distinct violations of NASD Conduct Rules 2110, 2210(d)(1)(A), and 2210(d)(1)(B) by Lakeside Trading and Thomas G. Russell, each separately.

EIGHTH CAUSE OF COMPLAINT

NASD Conduct Rule 2110 and Procedural Rule 8210: Failure to Respond
Against Thomas G. Russell

21. By letters dated March 9, 1999, April 26, 1999, April 28, 1999 and May 12, 1999, the District staff requested that Respondent Thomas G. Russell provide certain information to the staff. These requests for information were sent pursuant to, and in accordance with, the provisions of Procedural Rule 8210, all as more fully detailed on Exhibit "A," attached hereto.

22. Respondent Thomas G. Russell failed to respond to the above requests.

23. Such acts, practices and conduct constitute separate and distinct violations of NASD Conduct Rule 2110 and Procedural Rule 8210 by Thomas G. Russell.

PRAYER FOR RELIEF

WHEREFORE, Complainant respectfully requests:

A. Findings of fact and conclusions of law that Respondents committed the violations charged and alleged herein;

B. An order imposing sanctions upon the Respondents in accordance with NASD Rule 8310;

C. An order requiring Respondents to disgorge fully any and all ill-gotten gains and/or make full and complete restitution, together with interest;

D. An order imposing such costs of any proceeding as are deemed fair and appropriate under the circumstances in accordance with NASD Rule 8330; and

E. An order imposing any other fitting sanction.

Warren A. Butler, Jr.
Vice President and District Director
NASD Regulation, Inc., District No. 5
1100 Poydras Street, Suite 850
New Orleans, Louisiana 70163-0802
(504) 522-6527

Andrew A. Favret, Chief Counsel
NASD Regulation, Inc., District No. 5
1100 Poydras Street, Suite 850
New Orleans, Louisiana 70163-0802
Phone: 504/522-6527
FAX: 504/522-4077

Rory C. Flynn, Of Counsel
Department of Enforcement
NASD Regulation, Inc.
1801 K Street, N.W., Suite 800
Washington, D.C. 20006
Phone: 202/974-2874
FAX: 202/974-2805

NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

Department of Enforcement, Complainant v. Lakeside Trading, Respondent CRD No. 39418 and Thomas G. Russell, Respondent Registered General Securities Principal and Registered Financial and Operations Principal CRD No. 2669033 Respondents	Disciplinary Proceeding No. C05990018 Hearing Officer ________________ **CERTIFICATE OF SERVICE** Date: May 26, 1999

I hereby certify that on this 26th day of May, 1999, I caused a copy of the foregoing Complaint and Notice of Complaint to be sent by first class certified mail to Thomas G. Russell, 218 West Livingston Place, Metairie, Louisiana 70005 (Receipt No. Z 431 858 010); and to Thomas G. Russell, c/o Lakeside Trading, 3850 North Causeway Boulevard, Metairie, Louisiana 70002 (Receipt No. Z 431 858 011).

Andrew A. Favret, Chief Counsel
NASD Regulation, Inc., District No. 5
1100 Poydras Street, Suite 850
New Orleans, Louisiana 70163-0802
Phone: 504/522-6527
FAX: 504/522-4077

Exhibit "A"
Formal Complaint
Lakeside Trading, et al.
Case No. C05990018
Exam. No.: E05990101

CHRONOLOGY OF THE ASSOCIATION'S REQUESTS FOR INFORMATION
SENT TO THOMAS G. RUSSELL, UNDER THE PROVISIONS OF NASD PROCEDURAL RULE 8210.
LAKESIDE TRADING: E05990101

DATE	ADDRESS	METHOD	INFORMATION REQUESTED	DUE DATE	DATE RECEIVED BY RUSSELL	DATE RESPONSE RECEIVED	REGULAR MAIL RETURNED
09-Mar-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	via facsimile (504) 834-9729	Financial stmts. for January 31, 1999 (previously due in District Office by February 24, 1999).	upon receipt	Facsimile confirmation 10:59am, 3/9/99	none	n/a
26-Apr-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	Regular and Certified Mail receipt No.: P 119 330 123	All items previously requested during on-site exam dated 4/19/99. Also documents requested previously in 3/9/99 letter above.	upon receipt	Signed for by Thomas Russell on 4/30/1999	none	no
28-Apr-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	Regular and Certified Mail receipt No.: Z 431 858 020	Written statement detailing trading activity engaged in.	upon receipt	Signed for by Thomas Russell on 4/30/1999	none	no
12-May-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	Regular, facsimile (504) 834-9729 and Certified Mail receipt No.: P 119 330 124	All documents requested previously in 3/9/99, 4/26/99, and 4/28/99 letters above.	upon receipt	Facsimile confirmation 9:51am, 5/12/99	none	no

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NASD REGULATION
An NASD Company

NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Press Release

For Release: Wednesday, July 7, 1999
Media Contact: Nancy A. Condon
(202) 728-8379
Other Contact: Barry Goldsmith
202-974-2850

NASD Regulation Censures and Fines On-Site Trading, Inc. For Registration Violations

Washington, D.C.—NASD Regulation Inc., announced today that it censured and fined On-Site Trading, Inc., of Great Neck, NY, $25,000 for failure to properly qualify and register 14 individuals.

In addition to proprietary traders employed by the firm at its main trading floor in Great Neck, On-Site provides services to day-trading customers who effect trades from 10 On-Site branch offices and other remote locations around the country.

The censure and fine mark the first disciplinary action by NASD Regulation for violations of the NASD's Series 55 registration rule. The rule prohibits equity traders from trading in the Nasdaq® and over-the-counter markets without first passing a qualification examination for trading and market making and registering with NASD Regulation.

Without admitting or denying the charges, On-Site consented to the entry of findings that 14 employees who acted as equity traders between May 1, 1998 and January 31, 1999 failed to comply with the Series 55 registration rule. During that period, those 14 traders effected approximately 3700 trades in 250 Nasdaq securities.

On-Site also consented to findings that it lacked adequate oversight to ensure proper registration of its traders. As part of the settlement, On-Site agreed to implement new compliance procedures to prevent future violations.

The Series 55 registration rule became effective in April 1998. It applies to market makers, agency traders, proprietary traders, and persons who supervise these activities. The rule was developed in response to concerns about rule violations by traders conducting market-making and principal trading functions in both the Nasdaq and over-the-counter markets.

In addition to the specialized Series 55 examination, equity traders must also have passed either the General Securities Registered Representative Examination (Series 7) or the Corporate Securities Limited Representative Examination (Series 62). The Series 55 examination includes questions regarding the Nasdaq market and market-maker activities, automated execution and trading systems, trade reporting, and other industry regulations.

This matter resulted from an investigation conducted by NASD Regulation's New York

District Office.

NASD Regulation oversees all U.S. stockbrokers and brokerage firms with public customers. NASD Regulation and The Nasdaq-Amex Market Group, Inc., are subsidiaries of the National Association of Securities Dealers, Inc., the largest securities-industry self-regulatory organization in the United States.

For more information on NASD Regulation, visit its Web Site, *www.nasdr.com*.

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NASD REGULATION, INC.
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. CAF990009

TO: Department of Enforcement
NASD Regulation, Inc.

RE: On-Site Trading, Inc. - MEMBER
CRD No. 30271

Pursuant to Rule 9216 of the National Association of Securities Dealers, Inc. ("NASD") Code of Procedure, we submit this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD Regulation, Inc. will not bring any future actions against us alleging violations based on the same factual findings.

We understand that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by both the Office of Disciplinary Affairs and the National Adjudicatory Council ("NAC") of NASD Regulation, Inc.;

2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against us; and

3. If accepted:

   a. this AWC will become part of our permanent disciplinary record and may be considered in any future actions brought by NASD against us;

   b. this AWC will be made available through NASD Regulation, Inc.'s public disclosure program in response to public inquiries about our disciplinary record;

   c. NASD Regulation, Inc. may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and

   d. We may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any allegation in this AWC or create the impression that the AWC is without factual basis. Nothing in this provision affects our testimonial obligations or right to take legal positions in litigation in which the NASD is not a party.

We also understand that our experience in the securities industry and disciplinary history may be factors which will be considered in deciding whether to accept this AWC. That experience and history are as follows:

On-Site Trading, Inc., during all periods mentioned herein, was a registered broker/dealer with the Securities and Exchange Commission and a member of the Association, which registration and membership remain currently in effect. On-Site Trading, Inc. has not been subject to any formal disciplinary action by the Association.

I.

WAIVER OF PROCEDURAL RIGHTS

We specifically and voluntarily waive the following rights granted under the NASD's Code of Procedure:

A. To have a Formal Complaint issued specifying the allegations against us;

B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and

D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, we specifically and voluntarily waive any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

We further specifically and voluntarily waive any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

II.

ACCEPTANCE AND CONSENT

A. We hereby accept and consent, without admitting or denying the alleged violations, to the entry of the following findings by NASD Regulation, Inc.:

> At various times during the period of May 1, 1998 to January 31, 1999, On-Site Trading, Inc. failed to ensure that 14 persons who were actively engaged in the trading of securities in the Nasdaq and OTC markets were properly registered as equity traders in accordance with the Association's Series 55 rule requirements.

During the aforementioned time period, those 14 equity traders effected approximately 3700 trades involving approximately 250 Nasdaq securities.

Additionally, On-Site Trading, Inc. failed to establish, maintain, and enforce written supervisory procedures that would ensure the proper registration of persons who traded securities in the Nasdaq or OTC markets.

Such acts, practices and conduct constitute separate and distinct violations of NASD Membership and Registration Rules 1032 and NASD Conduct Rules 2110 and 3010 by On-Site Trading, Inc..

B. We also consent to the imposition, at a maximum, of the following sanctions:

1. A censure;

2. A monetary fine in the amount of $25,000.00;

3. An undertaking requiring On-Site Trading, Inc. within 90 days of the date of acceptance of this Letter of Acceptance, Waiver, and Consent to conduct a review, in a manner acceptable to the Association, of its supervisory procedures regarding registration of personnel engaged in the activity of equity trading. Thereafter, upon completion of the review, On-Site Trading, Inc. will implement such changes to its supervisory procedures necessary to ensure that all persons in the firm engaged in equity trading are properly registered with the Association. On-Site Trading, Inc. will be required to prepare and submit to the District No. 10 staff a written report detailing its review procedures and revised supervisory procedures no later than 90 days from the date of acceptance of this Letter of Acceptance, Waiver, and Consent.

The sanctions imposed herein shall be effective on a date set by the Association staff.

III.

OTHER MATTERS

A. We understand that we may attach a Corrective Action Statement to this AWC which is a statement by us of demonstrable corrective steps taken to prevent future misconduct. We may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD Regulation, Inc. nor does it reflect the views of NASD Regulation, Inc. or its staff.

B. We agree to pay any monetary sanctions imposed on us upon notice that this AWC has been accepted and that such payments are due and payable, and have attached the election of payment form showing the method by which we propose to pay any fine imposed.

We certify that we have read and understand all of the provisions of this AWC and have been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce us to submit it.

On-Site Trading, Inc.

6/17/99
Date

A duly authorized officer of the firm

Reviewed by:

Counsel for On-Site Trading, Inc.

Accepted by NASD Regulation, Inc.:

July 2, 1999
Date accepted by NAC

Roger B. Sherman
Vice-President

Attachments:
Standard Election of Payment Form

Attachment

ELECTION OF PAYMENT FORM

We intend to pay the fine proposed in Section II of the Letter of Acceptance, Waiver and Consent by the following method (check one):

- [x] A personal check or bank check for the full amount;
- [ ] Credit card authorization for the full amount;[1]
- [ ] The installment payment plan (only if approved by NASDR staff and the National Adjudicatory Council).[2]

Respectfully submitted,

6/21/99
Date

On-Site Trading, Inc.

A duly authorized officer of the firm

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[1] Only Mastercard and Visa are accepted for payment by credit card. If this option is chosen, the appropriate forms will be mailed to you, with an invoice, by the NASD Regulation's Finance Department. **Do not include your credit card number on this form.**

[2] The installment payment plan is only available for fines of $5,000 or more. Certain interest payments, minimum initial and monthly payments, and other requirements apply. You must discuss these terms with the NASD staff prior to requesting this method of payment.

NASD Regulation *In the Matter of On-Site Trading, Inc. (ENF0328)*	Submission of Proposed Letter of Acceptance, Waiver and Consent **CORRECTIVE ACTION STATEMENT** June 21, 1999

On-Site Trading, Inc. ("OST") submits this Corrective Action Statement in support of the proposed Letter of Acceptance, Waiver and Consent ("AWC"). It does not constitute factual or legal findings by NASD Regulation, Inc., nor does it reflect the views of NASD Regulation, Inc., or its staff:

Background

In February 1998 the NASD published Notice to Members 98-17 ("NTM 98-17"), which announced that effective April 1, 1998, the Limited Representative Equity Trader Exam ("Series 55") would be required for certain traders. NTM 98-17 explained the operation of a two-year grace period for current traders pursuant to the filing of a formal application by May 1, 1998.

In July 1998 the NASD published Notice to Members 98-60 ("NTM 98-60"), which acknowledged that the earlier NTM 98-17 May 1 application date had previously been extended to May 15, and further stated in relevant part:

To be eligible for this extended qualification period, equity traders had to submit applications to NASD Regulation before May 1, 1998. The NASD now has amended its Registration Rules to extend the filing period to August 31, 1998, for persons who were functioning as equity traders before May 1, 1998, and who missed that cut-off date for filing their applications for the Series 55 Examination.

Consequently, in implementing the new Series 55 rule, NASD provided for three different filing dates.

Explanation

During the period of time the NTMs were published, OST was engaged in several ongoing regulatory matters requiring significant allocation of its staff resources and time. Further, OST's staff was required to attend to the daily demands of its business. As a result, OST staff charged with implementing the new rule change apparently failed to fully understand key aspects of the Series 55. In specific, OST staff misinterpreted the rule and believed that the extensions granted to *functioning* equity traders included *new* traders. Compounding this inadvertent error, OST staff mistakenly believed that there was a 90 grace period attached to the taking of the qualifying examination. As a result of the above referenced confusion, 14 equity traders effected trades without having been registered in a Series 55 capacity.

Corrective Action Taken

When the deficiency was brought to OST's attention it promptly reacted and prohibited further trading until such time as the exam requirement was met. All individuals requiring Series 55 examinations have either passed the test or are prohibited from functioning in that registered capacity.

Additionally, OST recently expanded its compliance staff and back-office, and has implemented a revised "SECTION IV - REGISTRATION" in its written supervisory procedures ("WSP"). (See attachment A). Section 4.1 "Registration Requirement" of the revised WSP succinctly explains the new Series 55 requirements and details the procedure required to ensure compliance for those traders functioning under the two-year grace period.

OST also prepared a written outline entitled "PROCEDURES FOR SETTING UP NEW FIRM TRADER" which was disseminated to the firm's registration staff. (See Attachment B) This document sets out in 12 steps the process required at the firm to open a new trader's trading account and to issue an ID to that new trader. Paragraph 2 states in pertinent part that "No person can be assigned an account number or user id unless they are fully registered with a Series 7 or 62, Series 63, and a Series 55."

As to the element of human error that largely caused this problem, OST is satisfied that the steps it has taken to memorialize the rule change and the guidelines now in place to verify registration status, will limit further errors. However, the compliance and registration departments of the firm will attempt to further coordinate their efforts and will seek to more closely review future rule changes involving similar issues.

Dated: June 21, 1999

On-Site Trading, Inc.

A duly authorized officer of the firm

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NASD®
Parent of The Nasdaq-Amex Market Group

Press Release

National Association of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1500

For Release: Thursday, July 29, 1999
Contact: Nancy A. Condon
(202) 728-8379

NASD Board Approves Proposed Rule for Opening Day-Trading Accounts

Washington, D.C.—The National Association of Securities Dealers, Inc. (NASD®) Board of Governors today approved a rule that would require firms that promote day-trading strategies to disclose to customers, prior to opening accounts, the risks associated with that type of trading. In addition, those firms would have to make a threshold determination that day trading is appropriate for the customer. The rule will not become effective until approved by the Securities and Exchange Commission, after public comment.

As Internet trading has become more popular, more brokerage firms have begun to promote day-trading activities for individual investors. The growth of day-trading activities raises unique investor protection issues and concerns. Day trading requires not only sufficient capital, but also a sophisticated understanding of the markets and market dynamics, and sophistication in identifying securities to trade and in accurately timing buys and sells.

In response to these issues and concerns, the Board agreed that firms promoting day-trading strategies must:

- Disclose Risk – A firm promoting day trading will be required to deliver a disclosure statement to the customer discussing the unique risks posed by day trading. The disclosure will include several points for customers to consider before engaging in day trading, including that they should be prepared to lose all of the funds used for day trading and that day trading on margin may result in losses beyond their initial investment. Firms will be permitted to develop an alternative disclosure statement as long as it is substantially similar to the mandated statement and is approved by NASD Regulation's Advertising Department prior to use.

- Approve the Account for Day Trading – To approve an account for day trading, the firm must have reasonable grounds for believing that a day-trading strategy is appropriate for a customer by gathering the essential facts relative to the customer. A firm need not make this determination if it obtains from the customer a written agreement that the customer does not intend to use the account for day-trading purposes. If a firm later discovers that a customer who provided this written agreement is using the account for day trading, the firm will be required to approve the account for day trading within 10 days of the date of discovery.

"It is important for a firm that is actively promoting a day-trading strategy to be responsible for assessing whether the strategy is appropriate for an individual who opens a day-trading account at the firm. Today's action by the Board of Governors will go a long way to better protect investors in an increasingly more sophisticated technological environment," said Mary L. Schapiro, President of NASD Regulation, Inc.

Individuals seeking to establish day-trading accounts at these types of firms would be covered by the proposed rule, regardless of whether they engage in day-trading activities in their own names or under partnership or corporate names. The rule would apply only to accounts that are opened after the effective date of the rule.

The National Association of Securities Dealers, Inc. (NASD®), is the largest securities-industry, self-regulatory organization in the United States. It is the parent organization of The Nasdaq-Amex Market Group, Inc., and NASD Regulation, Inc. Through its regulatory subsidiary, the NASD develops rules and regulations, provides a dispute resolution forum, and conducts regulatory reviews of member activities for the protection and benefit of investors. The NASD oversees the nation's 5,600 brokerage firms and more than 600,000 registered brokers.

For more information about the NASD and its subsidiaries, please visit the following Web Sites: *www.nasd.com*; *www.nasdaq-amex.com*; *www.nasdr.com*; or the Nasdaq-Amex Newsroom℠ at *www.nasdaq-amexnews.com*.

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NASD
REGULATION
An NASD Company

NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500
202 728 8000

August 20, 1999

Richard C. Strasser, Esq.
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

Re: **File No. SR-NASD-99-41**
Approval Procedures for Day-Trading Accounts

Dear Mr. Strasser:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Patrice Gliniecki, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8014; e-mail Patrice.Gliniecki@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Alden S Adkins

Alden S. Adkins
Sr. Vice President
and General Counsel

Enclosure

File No. SR-NASD-99-41
Consists of 195 Pages
August 20, 1999

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend the Rule 2300 Series of the NASD Rules to include new Rules 2360 and 2361. The proposed rule change would require a member firm that is promoting a day-trading strategy to furnish a risk disclosure statement to a non-institutional customer prior to opening an account for the customer and either to (1) approve the customer's account for a day-trading strategy or (2) obtain from the customer a written agreement that the customer does not intend to use the account for day-trading purposes. As part of the account approval process, the firm would be required to make a threshold determination that day trading is appropriate for the customer. Below is the text of the proposed rule change. Proposed new language is underlined.

Rule 2360. Approval Procedures for Day-Trading Accounts

<u>(a) No member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer, unless, prior to opening the account, the member has furnished to the customer the risk disclosure statement set forth in Rule 2361 and has:</u>

<u>(1) approved the customer's account for a day-trading strategy in accordance with the procedures set forth in paragraph (b) and prepared a record setting forth the basis on which the member has approved the customer's account; or</u>

(2) received from the customer a written agreement that the customer does not intend to use the account for the purpose of engaging in a day-trading strategy, except that the member may not rely on such agreement if the member knows that the customer intends to use the account for the purpose of engaging in a day-trading strategy.

(b) In order to approve a customer's account for a day-trading strategy, a member shall have reasonable grounds for believing that the day-trading strategy is appropriate for the customer. In making this determination, the member shall exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her financial situation, tax status, prior investment and trading experience, and investment objectives.

(c) If a member that is promoting a day-trading strategy opens an account for a non-institutional customer in reliance on a written agreement from the customer pursuant to paragraph (a)(2) and, following the opening of the account, knows that the customer is using the account for a day-trading strategy, then the member shall be required to approve the customer's account for a day-trading strategy in accordance with paragraph (a)(1) as soon as practicable, but in no event later than 10 days following the date that such member knows that the customer is using the account for such a strategy.

(d) Any record or written statement prepared or obtained by a member pursuant to this rule shall be preserved in accordance with Rule 3110(a).

(e) For purposes of this rule, the term "day-trading strategy" means 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.

(f) For purposes of this rule, the term "non-institutional customer" means a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

Rule 2361. Day-Trading Risk Disclosure Statement

(a) Except as provided in paragraph (b), no member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer unless, prior to opening the account, the member has furnished to the customer, in writing or electronically, the following disclosure statement:

You should consider the following points before engaging in a day-trading strategy. For purposes of this notice, a "day-trading strategy" means a 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.

- **Day trading can be extremely risky.** Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day-trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses.
- **Be cautious of claims of large profits from day trading.** You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead to large and immediate financial losses.

- **Day trading requires knowledge of securities markets.** Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.
- **Day trading requires knowledge of a firm's operations.** You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures.
- **Day trading may result in your paying large commissions.** Day trading may require you to trade your account aggressively, and you may pay commissions on each trade. The total daily commissions that you pay on your trades may add to your losses or significantly reduce your earnings.
- **Day trading on margin or short selling may result in losses beyond your initial investment.** When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day-trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

(b) In lieu of providing the disclosure statement specified in paragraph (a), a member that is promoting a day-trading strategy may provide to the customer, in writing or electronically, prior to opening the account, an alternative disclosure statement, provided that:

(1) The alternative disclosure statement shall be substantially similar to the disclosure statement specified in paragraph (a); and

(2) The alternative disclosure statement shall be filed with the Association's Advertising Department (Department) for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changes are recommended by the Association, shall be withheld from use until any changes specified by the Association have been made or, if expressly disapproved, until the alternative disclosure statement has been refiled for, and has received, Association approval. The member must provide with each filing the anticipated date of first use.

(c) For purposes of this rule, the term "day-trading strategy" shall have the meaning provided in Rule 2360(e).

(d) For purposes of this rule, the term "non-institutional customer" means a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on July 28, 1999, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors reviewed the proposed rule change at its meeting on July 29, 1999. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt new NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Patrice M. Gliniecki, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8014.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Introduction

Certain brokerage firms focus primarily, or even exclusively, on promoting day-trading strategies to individuals. These firms generally advertise on the Internet and elsewhere as "day-trading" firms or otherwise promote their execution and other services as desirable for "serious" or "professional" traders. In addition, many of these firms offer training on day-trading techniques, as well as provide computer facilities and software packages specifically designed to support and accommodate day trading.

Day trading, however, raises unique investor protection concerns. In general, day traders seek to profit from very small movements in the price of a security. Such a strategy often requires aggressive trading of a brokerage account. As a result, day trading generally requires a significant amount of capital, a sophisticated understanding of securities markets and trading techniques, and high risk tolerance. Even experienced day traders with in-depth knowledge of the securities markets may suffer severe and unexpected financial losses.

The Proposal in Special Notice to Members 99-32

To address investor protection concerns arising from day-trading activities, on April 15, 1999, NASD Regulation issued Special Notice to Members 99-32 soliciting comment on proposed rules regarding approval procedures for day-trading accounts. The proposal set forth in the Notice required a firm that had <u>recommended</u> an intra-day trading strategy to an individual to approve the individual's account for day trading. The proposal also required the firm, as part of the account approval process, to determine that the strategy was appropriate for the customer and to provide a disclosure statement to the customer discussing the risks associated with day-trading activities. As further discussed below, NASD Regulation received 39 comment letters in response to Notice to Members 99-32.

The Revised Proposed Rule Change

Based on the comments received in response to the Notice and input provided by the various NASD standing-committees, NASD Regulation has revised the proposed rule change concerning the opening of day-trading accounts. The proposed rule change, similar to its predecessor in Notice to Members 99-32, focuses on disclosing the basic risks of engaging in a day-trading strategy and assessing the appropriateness of day-trading strategies for individuals.

In particular, the proposed rule change would require a firm that is promoting a day-trading strategy, directly or indirectly, to deliver a specified risk disclosure statement to a non-institutional customer prior to opening an account for the customer. In addition, the firm would be required to (1) approve the customer's account for day trading or (2) obtain a written agreement from the customer stating that the customer does not intend to use the account for day-trading activities. A firm would not be permitted to rely on the written agreement from the customer if the firm knows that the customer intends to use the account for day trading. In addition, if a customer who provides such an agreement later engages in a day-trading strategy, the firm would be required to approve the account for day-trading.

As part of the account approval process, a firm would be required to have reasonable grounds for believing that the day-trading strategy is appropriate for the customer. In making this determination, the firm would be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her financial situation, tax status, prior investment and trading experience, and investment objectives. The firm also would be required to prepare a record setting forth the basis on which the firm has approved the customer's account. Any record or written statement prepared or obtained by the firm pursuant to the proposed rule change would have to be preserved in accordance with NASD Rule 3110(a).

Requirement to Approve the Account for Day Trading

Elimination of the Term "Recommend"

As noted above, the proposal articulated in Notice to Members 99-32 applied to firms that had recommended an intra-day trading strategy to individual investors. Many commenters raised serious concerns with the proposal's use of the term "recommend." While the proposed rules did not define "recommendation" in the context of day trading, Notice to Members 99-32 provided general guidance on the types of activities that would constitute a recommendation in this context. The Notice stated that in general, a member would be recommending a day-trading strategy for purposes of the proposed rules if it affirmatively promoted day trading through advertising, training seminars, or direct outreach programs, and an individual engaged in day trading in response to those solicitations.

Many commenters voiced concerns that the Notice adopted an overly broad view of "recommendation," and feared that this broader view would be applied in other contexts. In particular, these commenters were concerned that advertisements or other promotions alone would be deemed to trigger a firm's duty to customers under the NASD's general suitability rule, Rule 2310. In this regard, one commenter stated its belief that the historical understanding that a recommendation is a specific communication from a broker to a customer at a specific time must be maintained. A second commenter suggested that the rules include a clear statement that "recommendation" for purposes of the rules shall mean "recommendation" as that term is commonly used throughout NASD rules, other Notices to Members, and NASD interpretative letters. This same commenter believed the rules should explicitly state that advertising does not constitute a recommendation for purposes of the proposed rules.

Several commenters suggested specific interpretations of the term "recommendation" in the day-trading context. For instance, one commenter expressed the view that the types of conduct that constituted "recommending" involved actively reaching out to the investing public with the goal of reaping financial benefits from the recommendation being made. The commenter also believed that the definition of recommendation should expressly exclude conduct such as solely operating a Web site that provided general financial information and news. A second commenter suggested exempting from the proposed rules those Internet-based firms that do not provide individualized instructions or guidance with respect to day trading, and that do not promote or endorse particular investment strategies to customers on an individual basis. Many commenters, after addressing issues raised by the proposal's use of the term "recommendation," suggested that the proposal be limited to a risk disclosure requirement.

In contrast, several commenters believed that the proposed rules should apply to a broader scope of firms and firm activities, such as to any firm that permits or accepts intra-day trading transactions. In this regard, one commenter opined that all firms promoting, advertising, recommending, or providing their customers with the opportunity to day trade should be required to comply with the rules. Another commenter suggested that the proposed rules should apply to all firms that promote or advertise day-trading activities or that have more than a certain percentage of day-trading accounts.

After considering the comments, NASD Regulation has revised the proposed rule change to apply to those firms that are "promoting a day-trading strategy." This revision should address commenters' concerns that the interpretation of the term "recommendation" in the day-trading context could obfuscate use of the term in the general suitability area. By using the concept of "promoting a day-trading strategy," the proposed rule change also would more clearly apply to those situations where a member firm either solicits a person on an individual basis or advertises to the general public.

NASD Regulation has determined not to define "promoting a day-trading strategy" for purposes of the proposed rule change. However, NASD Regulation believes that the promotion by a member of efficient execution services or lower execution costs based on multiple trades alone would <u>not</u> trigger the requirements under the proposed rule change. In addition, merely providing general investment research or advertising the high quality or prompt availability of such general research would <u>not</u> constitute the promotion of day trading under the proposal. Similarly, merely having a Web site that provides general financial information or news or that allows the multiple entry of intra-day purchases and sales of the same securities would <u>not</u> constitute the promotion of day trading.

However, a member would be subject to the proposed rule change if it affirmatively promotes or touts day-trading activities or strategies through advertising, training seminars, or direct outreach programs. For instance, a firm generally would be subject to the proposed rule change if its advertisements address the benefits of day trading, rapid-fire trading, or momentum trading, or encourage persons to trade or profit like a professional trader. A firm also would be subject to the proposed rule change if it promotes its day-trading services through a third party. Moreover, the fact that many of a firm's customers are engaging in a day-trading strategy would be relevant in determining whether a firm has promoted itself in this way.

Notably, while the proposed rule change does not define the term "promoting a day-trading strategy," firms could submit their advertisements to NASD Regulation's Advertising Department for review and guidance on whether the content of the advertisement constitutes such activity for purposes of the rule change. As a result, the proposed rule change, as revised, should both limit concerns about any effect of the proposal on the NASD's general suitability rule and allow firms to better determine whether a particular advertisement would trigger the rule prior to publication or distribution of the advertisement.

Persons Covered by the Proposed Rules

Comments also were varied regarding whether any proposed day-trading rules should reach a broader range of customers. One commenter stated that the application of the rules should not be limited to natural persons, but should include "non-institutional customers" as defined by NASD Rules. This commenter noted that many day traders have opened accounts under partnership or corporate names and that these customers typically are no more sophisticated than customers who open accounts in their own names. Several commenters also believed that all existing customers should be covered by day-trading rules or, at a minimum, receive a risk disclosure statement. One individual suggested that any proposed day-trading rules should apply to all new day-trading accounts, rather than to new customers.

In response to commenters' concerns, NASD Regulation has determined to revise the proposal to apply to all non-institutional customers. For purposes of the proposed rule change, the term "non-institutional customer" would mean a customer that does not qualify as an "institutional account" under NASD Rule 3110(c)(4). Rule 3110(c)(4) defines "institutional account" to mean the account of (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million. Applying the proposed rule change to non-institutional customers would ensure that most individuals would be covered by the proposed rule change, regardless of whether they engage in day-trading activities in their own name or in the name of a corporation or partnership. As revised, the proposed rule change would not apply to an existing customer unless the customer opens a new account at a firm that is promoting a day-trading strategy.

Accounts Used For Purposes Other Than Day-Trading Activities

As an alternative to approving an account for a day-trading strategy, the proposed rule change would permit a firm that is promoting a day-trading strategy to obtain from the customer a written agreement that the customer does not intend to use the account for the purposes of day trading ("other-use agreement"). In addition, the firm would be required to provide a risk disclosure statement to the customer even if the firm obtains an other-use agreement. A firm would not be permitted to rely on an other-use agreement if it knows that the customer intends to use the account for day trading. Moreover, if a firm opens an account for a customer in reliance on an other-use agreement, but later knows that the customer is using the account for day-trading activities, then the firm would be required to approve the customer's account for day trading in accordance with the rule as soon as practicable, but in no event later than ten days from the date of discovery.

Elements to Consider in Making Appropriateness Determinations

Commenters also suggested additional elements that a firm should consider in order to assess the appropriateness of a day-trading strategy for an individual. For example, several commenters believed that firms should be required to determine the source of funds that an individual intends to use for day-trading activities. Other commenters, however, voiced concerns that any such requirement would be an invasion of privacy or questioned why this requirement would not apply to all types of brokerage accounts. One individual believed that all persons should be required to meet a minimum net worth standard in order to engage in day trading.

After considering the comments, NASD Regulation has revised the proposed rule change to require a firm that is promoting a day-trading strategy to have reasonable grounds for believing that the strategy is appropriate for the customer and to exercise reasonable diligence to ascertain the essential facts relative to the customer. The proposed rule change continues to require a firm to review the customer's financial situation, prior investment and trading experience, and investment objectives. A firm also would be expressly required to review the customer's tax status. The proposed rule change, however, would not require firms to determine the source of funds, primarily because of concerns with defining the scope of any such obligation and the risks of imposing disproportionate burdens on firms.

Definition of an Intra-Day Trading Strategy

The proposal set forth in Notice to Members 99-32 defined "intra-day trading strategy" to mean "an overall trading strategy characterized by the regular transmission by a customer of multiple intra-day electronic orders to effect both purchase and sale transactions in the same security or securities." Several commenters suggested a broader definition of the term. For example, one commenter stated that the term should include a person who regularly makes only one buy and one sale of a particular security or group of securities on a daily basis. A second commenter believed that the term should include short-term trading strategies that could occur over, for example, a two-day period. Another commenter suggested that the definition include any offer and sale of the same security if the offer and sale are accomplished prior to settlement.

In contrast, one commenter emphasized its belief that the long-standing historical definition of a day trader requires a pattern of day trades, noting that there are legitimate reasons to buy and sell a single security in a single day that are not premised on a day-trading strategy. This commenter suggested that the proposal apply only when a clearly defined and easily identified pattern of activity exists over a considerable period of time. Another commenter expressed a general view that the definition of day trading lacked sufficient clarity, and raised a series of questions regarding the scope of the term, including whether it should include the transmission of orders in a non-electronic environment.

In light of the comments, NASD Regulation has revised the proposed definition of "day-trading strategy" to mean "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." NASD Regulation believes that the revised definition would include those instances where an individual regularly transmits one or more purchase and sale (i.e., "round-trip") transactions in a single day. In addition, although as a practical matter, day trading typically requires electronic delivery of orders, the proposed definition of "day-trading strategy" has been revised to include orders transmitted by non-electronic means, such as by telephone.

Requirement to Provide Day-Trading Risk Disclosure Statement

As discussed above, the proposed rule change would require a firm that is promoting a day-trading strategy to deliver a disclosure statement to the customer discussing the unique risks posed by day trading. The disclosure statement would include several factors that a customer should consider before engaging in day trading, including that the customer should be prepared to lose all of the funds that he or she uses for day trading and that day trading on margin may result in losses beyond the initial investment. The firm would be permitted to develop an alternative risk disclosure statement, provided that the alternative statement was substantially similar to the mandated statement and was filed with, and approved by, NASD Regulation's Advertising Department.

Many commenters agreed that customers should receive additional information on the risks of day-trading or other on-line trading activities. One commenter suggested that firms be required to provide a risk disclosure statement to all new individual customers, rather than limit dissemination to individuals to whom firms have recommended a day-trading strategy. In contrast, another commenter believed that it was more effective for the NASD to provide risk disclosures to potential customers in an educational atmosphere, such as the NASD's

Web site. Some commenters suggested specific revisions to the proposed risk disclosure statement. In this regard, one commenter proposed that the statement include the language from the text of the Notice that day trading generally would not be appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. Another commenter expressed concern that the suggestion in the disclosure statement that persons inquire as to a firm's capacity to permit customers to engage in day trading might place an unrealistic obligation on the customer.

Comments generally were divided as to whether customers should be required to acknowledge receipt of the disclosure statement. One commenter believed that a firm should be able to provide a copy of the statement on its Web site or in an initial mailing to the customer at the time of account opening. The commenter stated that the document was a disclosure of risks and not an agreement between the parties. Another commenter asserted that firms should have flexibility in deciding whether to require a customer to sign the statement. In contrast, one commenter emphasized that requiring customers to acknowledge receipt of the statement would protect both the customer and the firm. In addition, one individual suggested that the proposed rules require customers to sign the statement and to wait three days prior to trading to allow for additional reflection and consideration.

After considering the comments, NASD Regulation has modified the proposed rule change to require firms promoting a day-trading strategy to deliver the risk disclosure statement to all non-institutional customers prior to opening an account for such customers. NASD Regulation is not recommending that all firms be required to disseminate the disclosure statement to all new customers because the benefits of such a requirement are unclear. However, NASD Regulation will continue to monitor the growth of day-trading activities to determine whether, in the future, such a requirement might be justified. In addition, NASD Regulation encourages all firms, particularly firms that provide on-line trading capability, to provide the mandated risk disclosure statement or a substantially similar disclosure statement to their customers.

The disclosure statement also has been revised to include the additional key point that day trading generally is not appropriate for persons of limited resources and limited investment or trading experience and low risk tolerance. The provision in the proposed statement that an individual should confirm that a firm has adequate capacity to support day-trading activities has been deleted, in light of concerns that the provision might place undue burdens on the customer.

Comments Suggesting No or Minimal Regulatory Response

Those commenters that opposed any action in the area of day trading generally questioned why day-trading activities merited special regulation. For example, two commenters emphasized that many investments were risky and generally believed that the proposed rules inappropriately targeted day-trading firms. Some commenters also suggested that the proposed rules were paternalistic. Another commenter raised concerns that the proposal unfairly suggested to investors that on-line trading is somehow less scrupulous and more risky than trading through a traditional broker/dealer. This commenter also believed that the existing regulatory framework provides ample means to combat abuses associated with day trading. In addition, one commenter generally stated that it was premature to attempt regulation of day-trading practices. Several individual commenters, in opposing regulation of day trading, emphasized the benefits of electronic trading and their ability to protect themselves.

As noted above, however, NASD Regulation believes that the proposed rule change focuses on the promotion of trading strategies that present very high risk to individuals and, as revised, should be easier for firms to apply to their activities. Firms that are actively promoting a day-trading strategy should be responsible for assessing whether the strategy is appropriate for an individual who opens a day-trading account at that firm. These firms also should be required to disclose the risks of engaging in a day-trading strategy to an individual prior to opening an account for that individual.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD believes that the proposed rule change codifying the obligation of firms promoting day-trading strategies to disclose the risks of these strategies to non-institutional customers and to determine whether the strategy is appropriate for a customer will help to protect investors and the public interest in an increasingly more sophisticated trading environment.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Special Notice to Members 99-32 (April 15, 1999). The comment period expired on May 31, 1999. Thirty-nine comment letters were received in response to the Notice. A copy of Notice to Members 99-32 is attached as Exhibit 2. A summary of the comment letters received in response to the Notice is attached as Exhibit 3. Copies of the comment letters are attached as Exhibit 4. Of the 39 comment letters received, approximately 13 were in favor of the proposed rule change, 8 supported risk disclosure only, 12 were opposed to the proposed rule change, and 6 expressed no opinion or addressed broader issues.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. NASD Special Notice to Members 99-32 (April 15, 1999).
3. Summary of Comment Letters received in response to Special Notice to Members 99-32.
4. Comment Letters received in response to Special Notice to Members 99-32.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: Alden S Adkins

Alden S. Adkins, Sr. Vice President and General Counsel

Date: August 20, 1999