INFORMATIONAL

Best Execution

NASD Regulation Reiterates Member Firm Best Execution Obligations And Provides Guidance To Members Concerning Compliance

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representative
- Legal & Compliance
- Senior Management

KEY TOPICS

- Best Execution

Executive Summary

The National Association of Securities Dealers, Inc. (NASD® or Association) is issuing this *Notice* to reiterate the best execution obligations that apply to member firms when they receive, handle, route for execution, or execute customer orders, and to provide guidance to members concerning a broker/dealer's obligation, as articulated on numerous occasions by the Securities and Exchange Commission (SEC), to regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security.[1] This *Notice* also discusses how recently-adopted SEC rules concerning the disclosure of order execution and routing practices will assist members in meeting their regular and rigorous examination obligation. In addition, this *Notice* includes a Question and Answer section that responds to many of the compliance questions that the NASD has received from its members concerning the regular and rigorous component of the duty of best execution.

Questions/Further Information

If members have additional questions regarding these issues, please contact the Legal Section, Market Regulation Department, NASD Regulation, Inc. (NASD Regulation), at (240) 386-5126.

Discussion

Compliance with a member firm's obligation to provide best execution to its customers' orders is an important focus of NASD Regulation's examination, customer complaint, and automated surveillance programs. As a result of these programs, NASD Regulation has brought disciplinary actions that have resulted in censures, fines, and restitution to injured customers. These actions have resulted from findings that customer orders were executed: (1) at prices inferior to the national best bid and offer (NBBO) without justification; (2) in an untimely fashion; or (3) in a manner designed to allow the member firm to profit at the expense of its customer. Additionally, both the SEC and NASD Regulation conducted examinations that discovered that some member firms failed to establish procedures to regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security, or developed procedures that were inadequate.[2]

The NASD previously has addressed best execution issues in numerous *NASD Notices to Members*. Members are urged to review their systems and procedures to ensure that they are designed to incorporate and reflect the principles contained therein.[3] The purpose of this *Notice* is to reiterate some of those principles, address the obligation to provide best execution generally, and to provide guidance on conducting regular and rigorous reviews.

The Duty Of Best Execution

Although not specifically defined, a broker/dealer's duty of best execution derives from common law agency principles and fiduciary obligations. These principles have been incorporated in self-regulatory organization (SRO) rules and, through judicial and SEC decisions, in the enforcement of the antifraud provisions of the federal securities laws. Courts have held that the duty of best execution requires that a broker/dealer seek to obtain for its customers' orders the most favorable terms reason-

ably available under the circumstances.[4] The obligation of best execution also is codified in NASD Rule 2320, which provides that in any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for a security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The factors articulated in NASD Rule 2320(a) to be used when applying the of "reasonable diligence" in this area are:

1. the character of the market for the security, *e.g.*, price, volatility, relative liquidity, and pressure on available communications;
2. the size and type of transaction;
3. the number of primary markets checked; and
4. the location and accessibility to the customer's broker/dealer of primary markets and quotation sources.

As illustrated by the language of NASD Rule 2320, the determination as to whether a member exercised reasonable diligence to ascertain the best inter-dealer market for the security and bought or sold in that market so that the resultant price to the customer was as favorable as possible necessarily involves a "facts and circumstances" analysis. Depending upon the particular set of facts and circumstances surrounding an execution, actions that in one instance may meet a firm's best execution obligation may not satisfy that obligation under another set of circumstances.

The Evolving Nature Of Best Execution

Members should be aware that technological developments and changes to market structure are significant factors that must be considered when assessing reasonable diligence and best execution in general. In this regard, the SEC has stated that "the scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade at more advantageous prices."[5] As these changes in the market occur, broker/dealers must analyze and modify their order execution procedures to consider price opportunities that become "reasonably available."[6] The courts also have recognized a duty on the part of broker/dealers periodically to examine their practices in light of market and technology changes and to modify those practices if necessary to enable their clients to obtain the best reasonably available prices.[7] However, it is clear that the entry or routing of an order to a specific system or market is not a guarantee that a member has obtained best execution for a customer order, nor is the failure to route an order to a specific system or market necessarily a violation of best execution.[8]

Executing Small Orders On An Automated Basis At The National Best Bid Or Offer May Not Satisfy A Member's Duty Of Best Execution

In providing guidance to broker/dealers and the investing public concerning the parameters of the duty of best execution, the SEC and the NASD have recognized the practical necessity of automating the handling of small orders. In the context of aggregate order handling decisions, however, the importance of the opportunity for customer orders to be executed at prices that are better than the NBBO is a factor in best execution determinations. The SEC has stated that "routing order flow for automated execution, or internally executing order flow on an automated basis, at the best bid or offer quotation, would not necessarily satisfy a broker-dealer's duty of best execution for small orders in listed and OTC securities."[9] The reasoning behind this view is that prices better than the NBBO may be readily accessible to the member.

In fact, the SEC noted specifically that, "[p]rices superior to the public quote may at times be available in [Electronic Communications Networks (ECN(s)], even after adoption of the ECN [Rule], based, for example, on orders of institutional participants and others not covered by the ECN [Rule]. Superior prices also may be available in systems not classified as ECNs.... [W]here reliable, superior prices are readily accessible in such systems, broker-dealers should consider these prices in making decisions regarding the routing of customer orders."[10] The SEC acknowledged that many of the systems where such superior prices reside are less accessible and involve higher costs for broker/dealers than do the public markets. The SEC further acknowledged that, in many cases, it is not currently feasible to obtain price information efficiently from these systems or to link to these systems on an automated basis. Moreover, the SEC said it was not suggesting that broker/dealers access these systems on a manual basis when handling small orders. The SEC explained, however, that as "technology is rapidly making these systems more accessible, broker/dealers

must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for the purposes of seeking best execution of these customer orders."[11] For instance, if it becomes cost-effective for a broker/dealer to access an ECN or other market for its retail order flow, then such broker/dealer "must take the prices and other relevant costs in that system into account in handling these customer orders."[12] These principles also reinforce the discussion above concerning a broker/dealer's obligation to examine its practices in light of market and technology changes and to modify those practices if necessary to enable its clients to obtain the best reasonably available prices.

Regular And Rigorous Review For Best Execution

As stated above, an important focus of the NASD's examination program concerns the review of a member's procedures to regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security. The requirement to regularly and rigorously examine execution quality flows from the SEC's acknowledgment that it may be impracticable for broker/dealers to provide individualized treatment for certain classes of orders. Instead, the SEC permitted broker/dealers to route those orders to a particular market center for handling and execution, so long as the routing broker/dealer periodically assesses the quality of competing markets and directs its order flow based on this assessment. Although the reach of the regular and rigorous requirement has been articulated by the SEC in a variety of ways throughout the years, it is clear that a broker/dealer may conduct a regular and rigorous review (as opposed to an order-by-order review) for small orders routed or executed pursuant to a predetermined arrangement,[13] including internally executed orders where order-by-order routing is impracticable.[14]

Member firms that route customer orders to other broker/dealers for execution on an automated, non-discretionary basis, as well as firms that internalize customer order flow, must have procedures in place to ensure the firm conducts regular and rigorous reviews of the quality of the executions of its customers' orders. The SEC has articulated certain factors that broker/dealers should consider when meeting its "regular and rigorous" examination obligations:

> Where material price differences exist between the price improvement opportunities offered by markets or market makers, these differences must be taken into account by the broker-dealer. Similarly, in evaluating its procedures for handling limit orders, the broker-dealer must take into account any material differences in execution quality (*e.g.*, the likelihood of execution) among various markets or market centers to which limit orders may be routed. The traditional non-price factors affecting the cost or efficiency of executions should also continue to be considered; however, broker-dealers must not allow an order routing inducement, such as payment for order flow or the opportunity to trade with that order as principal, to interfere with its duty of best execution.[15]

Recently Adopted SEC Rules Concerning The Disclosure Of Order Routing And Execution Practices

The SEC recently adopted two rules concerning the disclosure of order routing and execution practices, Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act.[16] Pursuant to Rule 11Ac1-5 under the Exchange Act, all market centers, defined as "any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association"[17] must make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis. To facilitate comparisons across market centers, the rule adopts basic measures of execution quality (effective spread, rate of price improvement and disimprovement, fill rates and speed of execution) and sets forth specific instructions on how the measures are to be calculated. The statistical information will be categorized by individual security, by five types of orders (*e.g.*, market and inside-the-quote limit) and four order sizes (*e.g.*, 100-499 shares and 500-1999 shares). As a result, users of the market center reports will have great flexibility in determining how to summarize and analyze statistical information relevant to the execution of orders. Users of the data will be able to analyze order executions for a particular security or for any particular group of securities, as well as for any size or type of order across those groups of securities. This rule will be phased in by security commencing May 1, 2001.

Under Rule 11Ac1-6 under the Exchange Act, all broker/dealers (including introducing firms) that

route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. Broker/dealers will be required to comply with this rule for all covered securities on July 2, 2001. In addition, broker/dealers will be required to disclose to customers, on request, the venues to which their individual orders were routed for orders routed on July 2, 2001 and thereafter.

Questions And Answers

1. Why must a firm conduct a regular and rigorous review of execution quality?

The regular and rigorous examination requirement substitutes for having to analyze certain order routing decisions on an order-by-order basis, when such analysis is impracticable. The SEC previously has recognized the impracticality of such a requirement and instead required that broker/dealers, to satisfy their best execution obligations for routed orders, "periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders."[18]

2. What is a regular and rigorous review of execution quality?

The focus of the analysis is to determine whether any "material" differences in execution quality exist and, if so, to modify the firm's routing arrangements or justify why it is not modifying its routing arrangements. This analysis must compare the quality of the executions the firm is obtaining via current order routing and execution arrangements (including the internalization of order flow) to the quality of the executions that the firm could obtain from competing markets and market centers. Accordingly, a broker/dealer must evaluate whether opportunities exist for obtaining improved executions of customer orders.

3. Which member firms must perform this review? Must introducing firms conduct this type of review?

The review should be performed by any member that routes customer order flow to another broker/dealer for execution on an automated, non-discretionary basis, as well as firms that internalize customer order flow.

NASD Regulation realizes that many member firms do not execute customer orders on a principal or agency basis,[19] but rather route all customer order flow that they receive to an executing broker/dealer. This executing broker/dealer is, in many instances, the introducing broker/dealer's clearing firm and handles the introducing broker/dealer's customers' securities accounts on a fully disclosed basis. The executing broker/dealer, depending on the particular transaction, may act as principal, riskless principal, or agent with respect to customer orders that it receives from its introducing broker. In other instances, an introducing broker/dealer may route customer order flow to another broker/dealer who pays the introducing broker/dealer for customer order flow.

Despite the fact that an introducing broker/dealer may never execute customer orders, it nonetheless has an obligation to ensure that its customer orders are executed in a manner consistent with the duty of best execution. No NASD member can transfer to another entity its obligation to provide best execution to its customers' orders. Therefore, an introducing firm has an obligation to conduct an independent review for execution quality. NASD Regulation understands, however, that executing broker/dealers usually are better positioned than introducing broker/dealers to evaluate the quality of executions that an introducing broker/dealer's customers receive, especially where such customer order flow is routed on a routine or automated basis to the executing broker/dealer. Therefore, NASD Regulation believes that an introducing broker/dealer must take reasonable steps to ensure that the introducing broker/dealer and its executing broker/dealer are complying with the duty of best execution. An introducing firm that routes its order flow to its clearing firm or other executing broker/dealer can rely on the clearing or executing firm's regular and rigorous review as long as the statistical results and rationale of the review are fully disclosed to the introducing firm and the introducing firm periodically reviews how the clearing or executing firm is conducting that review, as well as the results of that review. In cases where the introducing broker/dealer is relying on the review conducted by its clearing firm or other executing broker/dealer, the introducing firm must ensure that such analysis is thorough, considers the execution quality of a broad range of market centers, measures the execution quality provided by the clearing or executing firm for the introducing firm's own orders, and considers market centers to which the clearing or executing firm currently routes its order flow as well as market centers other than those to which the clearing or executing firm currently routes its order flow. Subsequent to its review of this information, the introducing firm should exercise its independent judgment

and decide whether to retain its current order routing algorithm or modify it in some manner.

4. What factors should the member consider in reviewing and comparing the execution quality of its current order routing and execution arrangements to the execution quality of other markets and market centers?

A. Material differences in execution quality, including price improvement opportunities. The SEC has defined price improvement as the difference between the execution price and the best quotes prevailing in the market at the time the order arrived at the market or market maker;[20]

B. Material differences in price disimprovement (situations in which a customer receives a worse price at execution than the best quotes prevailing in the market at the time the order arrived at the market or market maker);

C. The likelihood of execution of limit orders;

D. Other material differences in execution quality such as the speed of execution, size of execution, and transaction cost;

E. Customer needs and expectations; and

F. The existence of internalization or payment for order flow arrangements (which must not interfere with a firm's best execution obligation.) [21]

5. Has the SEC provided guidance with respect to the level of specificity that must be applied to the review?

The SEC has stated that the review must be conducted on a security-by-security, type-of-order basis (*e.g.*, limit order, market order, and market on open order). "If different markets may be suitable for different types of orders or particular securities, the broker/dealer will also need to consider such factors."[22]

6. How should procedures to conduct such a review be structured?

As with any element of a firm's supervisory system, these procedures must be tailored to the particular business mix of the firm and must reasonably be designed to achieve compliance with the applicable securities laws and regulations concerning the duty of best execution. At a minimum, firms must demonstrate procedures that describe who at the firm is responsible for conducting the regular and rigorous review; how the review is going to be conducted; the frequency with which the review will be conducted; and how the review will be evidenced. Some firms have established best execution committees that meet quarterly or more frequently to conduct this review and determine, if necessary, to modify the firm's order routing and execution arrangements. Members should review the guidance that the NASD has provided in previous *NASD Notices to Members* concerning adequate supervisory systems and supervisory procedures.[23]

7. How often should a regular and rigorous review be conducted?

Again, this depends on the business mix and level of sales and trading activity being conducted at the firm. At a minimum, firms should conduct such reviews on a quarterly basis; however, members should consider, based on the firm's business, whether more frequent reviews are needed, particularly in light of the monthly market center statistics made available under Rule 11Ac1-5.

8. Where can a member firm obtain information about the quality of execution of its customers' orders and the quality of executions received at other market makers or market centers?

A. Information Concerning Execution of Firms' Own Orders

(i) Some firms have developed internal reports that identify situations where trades are executed outside the NBBO and where price improvement has been obtained.

(ii) NASD Regulation issues "Compliance Report Cards" for best execution to member firms. This report card assists members by reflecting the percentage of each firm's transactions where the firm apparently has executed trades under a certain size at a price inferior to the NBBO. This report card sets forth in percentage terms the extent to which a member firm has (or has not) executed transactions at the NBBO and ranks such firms against others member firms that execute a similar number of transactions.

(iii) Outside services provide periodic reviews of a firm's executions, including reviews for executions as compared to the NBBO, timeliness of execution, size improvement opportunities and price improvement and disimprovement opportunities.

(iv) A firm can examine its own report created pursuant to Rule 11Ac1-5 under the Exchange Act.

B. Sources of Information About Other Markets or Market Centers

(i) Commencing at the end of June 2001 (covering trading that took place in May 2001), members can use the monthly electronic reports produced pursuant to Rule 11Ac1-5 under the Exchange Act to learn more about the quality of executions of other markets or market centers. These reports will contain uniform statistical measures of execution quality on a security-by-security basis. The uniform statistical measures required by the rule should make a member's review more accurate and easier to accomplish because it will allow the member to compare market centers through the use of statistics generated pursuant to mandated formulae. This rule will require basic measures of execution quality such as, among other things, effective spread, rate of price improvement and disimprovement, fill rates and speed of execution. As the SEC stated, "[a]lthough these statistics are by no means determinative of best execution, the Commission expects that the monthly reporting of the uniform statistical measures required by the Rule will provide broker-dealers with a clearer sense of execution quality among market centers, and will be helpful to broker-dealers in seeking to fulfill their duty of best execution."[24] A member firm should include the use of these reports in its regular and rigorous review of execution quality, but more information regarding the firm's orders will, in all likelihood, be needed to satisfy its regular and rigorous review obligations.

(ii) Some firms distribute information about their order handling procedures and the quality of the executions they provide to firms that send them order flow.

(iii) An introducing firm should request from its executing broker/dealer a copy of any analysis that the executing broker/dealer has done (either on its own or by a third-party vendor) to evaluate the execution quality of customer orders that the introducing broker/dealer routed to the executing broker/dealer for execution. In addition (or alternatively), the introducing broker/dealer can conduct its own evaluation of the quality of execution that its customers' orders have received from its executing broker/dealer.

(iv) An introducing firm also may request from its executing broker/dealer a copy of the "Compliance Report Card" for best execution that NASD Regulation has made available to it.

(v) Firms can send questionnaires to market makers or market centers about their order handling procedures and quality of executions.

(a) Should firms send questionnaires to every market maker or market centers?

At a minimum, a firm should send such questionnaires to a cross section of market makers and market centers, and document the market makers and market centers to which questionnaires are sent. It is not reasonable to require that questionnaires be sent to every market maker or market center.

(b) What if a market maker or market center does not respond to the questionnaire?

Firms can only conduct the review with information that they receive. If a market maker or market center fails to return the questionnaire, that is a factor that should be taken into consideration in determining whether or not to route order flow to that firm. However, the failure to return a questionnaire should not, by itself, be a reason for altering order routing decisions.

(vi) Firms that elect to use questionnaires should evaluate their business mix in developing them. The type of information a firm should consider requesting in a questionnaire includes, but is not limited to, the following:

(a) How does the market maker or market center monitor for compliance with its best

execution obligations and the quality of its executions?

(b) What are the market maker or market center's order execution algorithms?

(c) How does the market maker or market center operate its order execution facilities in turbulent market conditions?[25]

(d) What are the market maker or market center's automatic execution procedures?

(e) How does the market maker or market center execute orders at opening and close?

(f) How and when does the market maker or market center display and protect limit orders?

(g) Does the market maker or market center use ECNs? Which ones?

(h) How does the market maker or market center define price improvement?

(i) What are the firm's recent statistics on price improvement, speed of execution, price disimprovement, cost of trades and size improvement?

(j) Has the firm been subject to any recent disciplinary actions?

9. Must a member firm only perform a regular and rigorous review on orders for which it receives payment for order flow?

This obligation to perform a regular and rigorous review applies to all broker/dealers that route orders for execution regardless of whether they receive payment for directing that order flow. If a broker/dealer, however, receives an order routing inducement, such as payment for order flow, or trades as principal with customer orders, it must not let that inducement interfere with its duty of best execution nor may that inducement be taking into account in analyzing market quality.

10. Must the firm's regular and rigorous review compare the execution quality provided by different market centers in the execution of options orders?

Yes. Members executing customers' orders in options classes traded on more than one exchange must conduct a regular and rigorous review for execution quality. As the SEC has stated, "[w]hen an option is listed on only one exchange, brokers do not have to decide where to route an order, and consequently, satisfying their best execution obligations is simpler than when they must consider the relative merits of routing an order to two or more market centers. With as many as five options exchanges trading certain options classes, brokers are required to regularly and rigorously evaluate the execution quality available at each options exchange."[26]

11. Is a broker/dealer required to route Nasdaq® market-on-open orders to a market maker or market center that provides mid-point pricing or some other form of price improvement to the execution of market-opening orders?

While there is no express requirement that broker/dealers route their customers' market-opening orders to such market centers, a member firm, in conducting its regular and rigorous review, should take into account these alternative methods in determining how to obtain best execution for those customer orders.[27] The SEC has emphasized that broker/dealers are subject to a best execution duty in executing customer orders at the opening.

Additionally, each member firm should communicate clearly to customers the choices available for execution of opening orders, as well as the broker/dealer's policy for obtaining best execution of such orders.[28]

This *NASD Notice to Members* is designed to assist the membership in complying with its best execution obligations and should be read in conjunction with previous NASD *Notices to Members*, including NASD *Notices to Members 00-42* (June 2000), 99-12 (February 1999), 99-11 (February 1999), 98-96 (December 1998), 97-57 (September 1997), and 96-65 (October 1996).

Members also should be advised that, during the course of examinations or where appropriate, NASD Regulation staff will request and review the firm's written supervisory procedures concerning the firm's obligation to conduct a regular and rigorous review of the quality of the executions it provides to its customers. In this connection, examiners will request and review the documentation evidencing that such review has been conducted. Members also should be advised that the SEC is actively examining this area.

Endnotes

1 *See infra* notes 13 and 14 accompanying text.

2 The SEC's Office of Compliance Inspections and Examinations recently stated that it found, after conducting a review of the compliance by broker/dealers with the duty of best execution, that "many broker-dealers were not meeting their best execution obligations because they sent all of their order flow to their clearing firm and conducted no independent review of execution quality, they limited their review to those markets to which they currently routed order flow, or otherwise appeared not to conduct a thorough analysis of execution quality likely to be obtained from various markets." *Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations*, at 8 (January 25, 2001).

3 *See NASD Notices to Members 00-42* (June 2000), *99-12* (February 1999), *99-11* (February 1999), *98-96* (December 1998), *97-57* (September 1997), and *96-65* (October 1996).

4 *See, e.g.*, Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 135 F.3d 266, 270 (3d Cir. 1998) (en banc) (citation omitted), cert. denied sub nom. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Kravitz, 525 U.S. 811 (1998).

5 Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48322-48323 (September 12, 1996) (hereinafter cited as "SEC Order Handling Release"). This Release is copied in its entirety as published in the Federal Register in the Appendix to *NASD Notice to Members 96-65* (October 1996). For the convenience of the reader, this *Notice* also will cite to *NASD Notice to Members 96-65* when referencing this particular SEC Release. *NASD Notice to Members 96-65* at 540-541.

6 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote and quotation omitted).

7 Newton, 135 F.3d at 271.

8 For example, NASD Regulation and Nasdaq have stressed that the use of the Primex Auction System™, or any other system operated by Nasdaq or other market centers, does not assure best execution in and of itself. Broker/dealers must exercise similar diligence in evaluating these systems as in making other order routing decisions. See *NASD Notice to Members 00-65* at 478 (September 2000) ("Nasdaq will offer the Primex facility to any NASD member that chooses to use this type of system to obtain price improvement or enhanced liquidity for its customer or principal orders. The facility is meant to serve as a means, but certainly not as the exclusive acceptable means, for obtaining price improvement. No NASD rule will require an NASD member to use Primex in meeting a member's best execution obligations.").

9 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote omitted).

10 *Id.* (citation omitted). The ECN Rule, Rule 11Ac1-1(c)(5) of the Securities Exchange Act of 1934 ("Exchange Act"), requires market makers to publicly display limit orders that they place into ECNs that are priced better than their public quote, unless the ECN satisfies certain enumerated conditions. SEC Order Handling Release at 48331, *NASD Notice to Members 96-65* at 549. While the adoption and implementation of Regulation ATS by the SEC has certainly reduced the number of instances in which better-priced orders are resident in ECNs but not publicly disseminated, even with Regulation ATS, there are instances where this can still occur (i.e., where an ECN accounts for less than five percent of the reported volume in a security).

11 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541.

12 *Id.*

13 While the SEC has noted on several occasions that regular and rigorous reviews should be conducted for "retail" or "small" sized orders routed on a collective basis, the SEC has not defined what constitutes a "retail" or "small" sized order or stated explicitly that regular and rigorous reviews should be limited to "retail" or "small" orders. Nevertheless, given that the execution of larger sized orders often requires more judgment in terms of market timing and capital commitment, NASD Regulation believes that routing or internally executing larger sized orders but subjecting them only to a regular and rigorous review (as opposed to an order-by-order review) may raise best execution concerns.

14 See, *e.g.*, Securities Exchange Act Release No. 15671 (March 22, 1979) ("The Commission continues to believe that a broker routing retail orders in a particular security to a single market (whether by automated or other means) must at least make periodic assessments of the quality of competing markets to assure that it is taking all reasonable steps under the circumstances to seek out best execution of customers' orders."); Securities Exchange Act Release No. 16590 (February 19, 1980) ("[T]he Commission has also indicated that it expects that those broker-dealers that automatically route retail customer orders in a particular security to a predesignated market, at a minimum, make periodic assessments as to the quality of such market....Furthermore, the Commission believes that broker-dealers who choose to automatically route their customer orders to a designated market should be alert for unusual market conditions in the designated market which would require brokers to take additional measures (such as disclosure of market conditions or special handling of customer orders). Examples of such unusual market conditions would include substantial price disparity between [sic] the designated market and other markets, extreme volatility of the market in the security and unusual trading patterns. In addition, the Commission notes that a broker's fiduciary responsibility to obtain best execution of a customer's order under the circumstances may continue beyond the initial routing decision."); Securities Exchange Act Release No. 17583 (February 27, 1981) (quoting Securities Exchange Act Release No. 15671 (March 22, 1979)); Securities Exchange Act Release No. 26870 (May 26, 1989) (quoting Securities Exchange Act Release No. 16590 (February 19, 1980)); Market 2000: An Examination of Current Equity Market Developments, at V-4 (January 1994)

("Currently, most small order flow routing decisions are predetermined.... The Division believes that an automated routing environment can be consistent with the achievement of best execution. Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order.") (footnote omitted); Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55009 (November 2, 1994) ("The Commission traditionally has concluded that a broker-dealer routing customer orders for automated execution could satisfy its best execution obligations so long as the broker-dealer assesses periodically the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for its customers' orders.") (footnote omitted); Securities Exchange Act Release No. 37046 (March 29, 1996), 61 FR 15322, 15327-15328 (April 5, 1996) ("[B]roker-dealers choosing where to automatically route orders must assess periodically the quality of competing markets to assure that order flow is directed to markets providing the most advantageous terms for their customers' orders.") (footnote omitted); and SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 ("In the past, the Commission has recognized the practical necessity of automating the handling of small orders. ...At the same time, the Commission has emphasized that best execution obligations require that broker-dealers routing orders for automatic execution must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.... The Commission believes that broker-dealers deciding where to route or execute small customer orders in listed or OTC securities must carefully evaluate the extent to which this order flow would be afforded better terms if executed in a market or with a market maker offering price improvement opportunities.") (footnotes omitted).

15 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnotes omitted).

16 Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414 (December 1, 2000); See *NASD Notice to Members 01-16* (February 2001).

17 Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75437 (December 1, 2000).

18 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote omitted).

19 Such broker/dealers usually are precluded by the NASD or their clearing firm, or both, from executing transactions, and are only permitted to act as introducing brokers with respect to customer order flow. In fact, some clearing firms will provide clearing services only if the introducing firm routes all of its orders to the clearing firm. NASD Regulation also acknowledges that other broker/dealers, while not precluded by the NASD or its clearing firm from executing customer orders, choose not to execute such orders for business reasons.

20 SEC Order Handling Release at 48323 fn.357, *NASD Notice to Members 96-65* at 541 fn.357.

21 In this regard, the SEC stated that, "in light of a broker-dealer's obligation to assess the quality of the markets to which it routes packaged order flow absent specific instructions from customers, the Commission does not believe that a broker-dealer violates its best execution obligation merely because it receives payment for order flow or trades as principal with customer orders." SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote omitted).

22 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541.

23 See *NASD Notices to Members 99-45* (June 1999) and 98-96 (December 1998).

24 Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75432 (December 1, 2000).

25 See *NASD Notice to Members 99-12* (February 1999).

26 Securities Exchange Act Release No. 43591 (November 17, 2000), 65 FR 75439, 75439-75440 (December 1, 2000).

27 Disclosure or Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000).

28 Id.

INFORMATIONAL

Online Suitability

Suitability Rule And Online Communications

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Senior Management
- Legal & Compliance
- Executive Representative

KEY TOPICS

- Suitability
- Online Communications

Executive Summary

In light of the dramatic increase in the use of the Internet for communication between broker/dealers and their customers, NASD Regulation, Inc. (NASD Regulation) is issuing a Policy Statement to provide members[1] with guidance concerning their obligations under the National Association of Securities Dealers, Inc. (NASD®) general suitability rule, Rule 2310,[2] in this electronic environment.[3] NASD Regulation filed this Policy Statement on March 19, 2001, with the Securities and Exchange Commission (SEC). Pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and SEC Rule 19b-4(f)(1), the Policy Statement became immediately effective upon filing.

The Policy Statement briefly discusses some of the issues created by the intersection of online activity and the suitability rule. The Policy Statement then provides examples of electronic communications that NASD Regulation considers to be either within or outside the definition of "recommendation" for purposes of the suitability rule.[4] In addition, the Policy Statement sets forth guidelines to assist members in evaluating whether a particular communication could be viewed as a "recommendation," thereby triggering application of the suitability rule.[5]

NASD Regulation emphasizes, however, that this current Policy Statement does not (1) alter member obligations under the suitability rule or (2) establish a "bright line" test for determining whether a communication does or does not constitute a "recommendation" for purposes of the suitability rule. No single factor discussed below, standing alone, necessarily dictates the outcome of the analysis.

NASD Regulation recognizes that brokerage firms are using technology to offer many new beneficial services to customers, and it supports the continued development and use of technology to enhance investor education and access to information. These technological advances may have regulatory implications in the context of rules other than the suitability rule, and, therefore, we expect to issue future statements or guidance on the subject of online activities in the securities industry. NASD Regulation is aware, however, that technology is developing rapidly, and we want to avoid impeding the growth of new technological services for investors.

Questions/Further Information

Questions or comments concerning the information contained in this Policy Statement may be directed to either Nancy C. Libin, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8835 or *nancy.libin@nasd.com,* or James S. Wrona, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8270 or *jim.wrona@nasd.com.*

NASD Regulation Policy Statement Regarding Application Of The NASD Suitability Rule To Online Communications

Background

Technological developments in recent years have profoundly affected the securities industry.[6] One of the most dramatic changes is the way in which brokerage firms use the Internet to communicate with their customers. In addition to more traditional channels of communication such as the telephone and postal mail, broker/dealers and

customers now transmit information to each other through broker/dealers' Web Sites, e-mail, Web phones, personal digital assistants, and hand-held pagers. Broker/dealers also use the Internet to provide lower-cost, unbundled services to customers. Among other things, broker/dealers have used the Internet to provide investors with new tools to obtain access to important analytical information, conduct their own research, and place their own orders. Technological advancements have provided many benefits to investors and the brokerage industry. These technological innovations, however, also have presented new regulatory challenges, including those arising from the application of the suitability rule to online activities.

The NASD's suitability rule states that in recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer. As the rule states, a member's suitability obligation applies to securities that the member "recommends" to a customer.[7] The NASD's suitability rule generally has been violated when a broker/dealer "recommends" a security to a customer that might be suitable for some investors, but is unsuitable for that particular customer.

Applicability Of The Suitability Rule To Electronic Communications

There has been much debate recently about the application of the suitability rule to online activities.[8] Two major questions have arisen: first, whether the current suitability rule should even apply to online activities, and second, if so, what types of online communications constitute "recommendations" for purposes of the rule.

In answer to the first question, NASD Regulation believes that the suitability rule applies to all "recommendations" made by members to customers—including those made via electronic means—to purchase, sell, or exchange a security. Electronic communications from broker/dealers to their customers clearly can constitute "recommendations." The suitability rule, therefore, remains fully applicable to online activities in those cases where the member "recommends" securities to its customers.

With regard to the second question, NASD Regulation does not seek to identify in this Policy Statement all of the types of electronic communications that may constitute "recommendations." As NASD Regulation has often emphasized, "[w]hether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances."[9] That is, the test for determining whether any communication (electronic or traditional) constitutes a "recommendation" remains a "facts and circumstances" inquiry to be conducted on a case-by-case basis.

NASD Regulation also recognizes that many forms of electronic communications defy easy characterization. Nevertheless, we offer as guidance the following general principles for member firms to use in determining whether a particular communication could be deemed a "recommendation." As illustrated by the examples provided below, the "facts and circumstances" determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether—given its content, context, and manner of presentation—a particular communication from a broker/dealer to a customer reasonably would be viewed as a "call to action," or suggestion that the customer engage in a securities transaction. Members should bear in mind that an analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the customer and consideration of any other facts and circumstances, such as any accompanying explanatory message from the broker/dealer.[10] Another principle that members should keep in mind is that, in general, the more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a "recommendation."[11]

Scope Of The Term "Recommendation": Examples

In order to provide guidance to members, NASD Regulation offers some examples of electronic communications that could be viewed as within or outside the definition of "recommendation." These examples are intended to show the application of the above-mentioned general principles.

In addition to when a member acts merely as an order-taker regarding a particular transaction,[12] NASD Regulation generally would view the following activities and communications as falling outside the definition of "recommendation":

- A member creates a Web Site that is available to customers or groups of customers. The Web Site has research pages or "electronic libraries" that contain research reports (which may include buy/sell recommendations from the author of the report), news, quotes, and charts that customers can obtain or request.

- A member has a search engine on its Web Site that enables customers to sort through the data available about the performance of a broad range of stocks and mutual funds, company fundamentals, and industry sectors. The data is not limited, for instance, to, and does not favor, securities in which the member makes a market or has made a "buy" recommendation. Customers use and direct this tool on their own. Search results from this tool may rank securities using any criteria selected by the customer, and may display current news, quotes, and links to related sites.[13]

- A member provides research tools on its Web Site that allow customers to screen through a wide universe of securities (*e.g.*, all exchange-listed and Nasdaq securities) or an externally recognized group of securities (*e.g.*, certain indexes) and to request lists of securities that meet broad, objective criteria (*e.g.*, all companies in a certain sector with 25 percent annual earnings growth). The member does not impose limits on the manner in which the research tool searches through a wide universe of securities, nor does it control the generation of the list in order to favor certain securities. For instance, the member does not limit the universe of securities to those in which it makes a market or for which it has made a "buy" recommendation. Similarly, the algorithms for these tools are not programmed to produce lists of securities based on subjective factors that the member has created or developed, nor do the algorithms, for example, produce lists that favor those securities in which the member makes a market or for which the member has made a "buy" recommendation.

- A member allows customers to subscribe to e-mails or other electronic communications that alert customers to news affecting the securities in the customer's portfolio or on the customer's "watch list." Such news might include price changes, notice of pre-scheduled events (such as an imminent bond maturation), or generalized information. The customer selects the scope of the information that the firm will send to him or her.

NASD Regulation generally would view the following communications as falling within the definition of "recommendation":

- A member sends a customer-specific electronic communication (*e.g.*, an e-mail or pop-up screen) to a targeted customer or targeted group of customers encouraging the particular customer(s) to purchase a security.[14]

- A member sends its customers an e-mail stating that customers should be invested in stocks from a particular sector (such as technology) and urges customers to purchase one or more stocks from a list with "buy" recommendations.

- A member provides a portfolio analysis tool that allows a customer to indicate an investment goal and input personalized information such as age, financial condition, and risk tolerance. The member in this instance then sends (or displays to) the customer a list of specific securities the customer could buy or sell to meet the investment goal the customer has indicated.[15]

- A member uses data-mining technology (the electronic collection of information on Web Site users) to analyze a customer's financial or online activity—whether or not known by the customer—and then, based on those observations, sends (or "pushes") specific investment suggestions that the customer purchase or sell a security.

Members should keep in mind that these examples are meant only to provide guidance and are not an exhaustive list of communications that NASD Regulation does or does not consider to be "recommendations." As stated earlier, many other types of electronic communications are not easily characterized. In addition, changes to the factual predicates upon which these examples are based (or the existence of additional factors) could alter the determination of whether similar communications may or may not be viewed as "recommendations." Members, therefore, should analyze all relevant facts and circumstances, bearing in mind the general principles noted earlier and discussed below, to determine whether a communication is a "recommendation," and they should take the necessary steps to fulfill their suitability obligations. Furthermore, these examples are based on technological

services that are currently used in the marketplace. They are not intended to direct or limit the future development of delivery methods or products and services provided online.

Guidelines For Evaluating Suitability Obligations

NASD Regulation believes that members should consider, at a minimum, the following guidelines when evaluating their suitability obligations. None of these guidelines is determinative. Each is but one factor to be considered in evaluating all of the facts and circumstances surrounding the communication.

- A member cannot avoid or discharge its suitability obligation through a disclaimer where the particular communication reasonably would be viewed as a "recommendation" given its content, context, and presentation.[16] NASD Regulation, however, encourages members to include on their Web Sites (and in other means of communication with their customers) clear explanations of the use and limitations of tools offered on those sites.
- Members should analyze any communication about a security that reasonably could be viewed as a "call to action" and that they direct, or appear to direct, to a particular individual or targeted group of individuals—as opposed to statements that are generally made available to all customers or the public at large—to determine whether a "recommendation" is being made.[17]
- Members should scrutinize any communication to a customer that suggests the purchase, sale, or exchange of a security—as opposed to simply providing objective data about a security—to determine whether a "recommendation" is being made.[18]
- A member's transmission of unrequested information will not necessarily constitute a "recommendation." However, when a member decides to send a particular customer unrequested information about a security that is not of a generalized or administrative nature (*e.g.*, notification of a stock split or a dividend), the member should carefully review the circumstances under which the information is being provided, the manner in which the information is delivered to the customer, the content of the communication, and the original source of the information. The member should perform this review regardless of whether the decision to send the information is made by a representative employed by the member or by a computer software program used by the member.
- Members should be aware that the degree to which the communication reasonably would influence an investor to trade a particular security or group of securities—either through the context or manner of presentation or the language used in the communication—may be considered in determining whether a "recommendation" is being made to the customer.

NASD Regulation emphasizes that the factors listed above are guidelines that may assist members in complying with the suitability rule. Again, the presence or absence of any of these factors does not by itself control whether a "recommendation" has been made or whether the member has complied with the suitability rule. Such determinations can be made only on a case-by-case basis taking into account all of the relevant facts and circumstances.

Conclusion

The foregoing discussion highlights some suggested guidelines to assist in determining when electronic communications constitute "recommendations," thereby triggering application of the NASD's suitability rule. NASD Regulation acknowledges the numerous benefits that are enjoyed by members and their customers as a result of the Internet and online brokerage services. NASD Regulation emphasizes that it neither takes a position on nor seeks to influence any firm's or customer's choice of a particular business model in this electronic environment. At the same time, however, NASD Regulation urges members both to consider all compliance implications when implementing new services and to remember that customers' best interests must continue to be of paramount importance in any setting, traditional or online.

As new technologies and/or services evolve, NASD Regulation will continue to provide statements or guidance regarding the application of the suitability rule and other rules.[19] To date, NASD Regulation has worked to resolve various suitability-related issues with federal and state regulators, NASD Regulation's e-Brokerage Committee, the NASD's Legal Advisory Board and Small Firm Advisory Board, NASD Regulation's Standing and District Committees, and the NASD membership. This open dialogue has been beneficial, and NASD Regulation will continue to work with regulators, members of the

industry and the public on these and other important issues that arise in the online brokerage environment.

Endnotes

1 For purposes of this Policy Statement, the terms "member" and "broker/dealer" include both firms and their associated persons.

2 NASD Rule 2310 provides in pertinent part:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer,...a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member...in making recommendations to the customer.

NASD Rule 2310 applies to equity and certain debt securities, but not to municipal securities. Municipal securities are covered by Municipal Securities Rulemaking Board (MSRB) Rule G-19 ("Suitability of Recommendations and Transactions; Discretionary Accounts").

3 Although the focus of this Policy Statement is on the application of the suitability rule to electronic communications, much of the discussion is also relevant to more traditional communications, such as discussions made in-person, over the telephone, or through postal mail.

4 This Policy Statement focuses on "customer-specific" suitability under NASD Conduct Rule 2310. The word "recommendation" appears in quotation marks whenever it is discussed in the context of a customer-specific suitability obligation. A broker/dealer must also have a reasonable basis "to believe that the recommendation could be suitable for at least *some* customers." *In re F.J. Kaufman and Company of Virginia,* 50 S.E.C. 164, 168, 1989 SEC LEXIS 2376, *10 (1989) (emphasis in original). This is called "reasonable basis" suitability, and it "relates only to the particular recommendation, rather than to any particular customer." *Id. See also In re Charles E. Marland & Co., Inc.,* 45 S.E.C. 632, 636, 1974 SEC LEXIS 2458, *10 (1974) (recommending mutual fund switching creates rebuttable presumption of unsuitability); *In re Thomas Arthur Stewart,* 20 S.E.C. 196, 207, 1945 SEC LEXIS 318, *25 (1945) ("[T]he lack of reasonable grounds for recommending [switching shares of mutual funds]" was the basis for finding broker had violated NASD's suitability rule based on a "reasonable basis" theory.).

Although not directly addressed in this Policy Statement, in certain instances, a suitability violation also can be based on an inappropriate frequency of trades, often referred to as excessive trading or churning. *See* IM-2310-2, Fair Dealing With Customers ("Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are.... [e]xcessive activity in a customer's account."). A broker/dealer could violate the suitability rule, for example, where it recommended to a customer an excessive (and, based on the customer's financial situation and needs, an inappropriate) number of securities transactions and the customer routinely followed the broker/dealer's recommendations. *See, e.g., In re Harry Gliksman,* Exchange Act Rel. No. 42255, at 4, 1999 SEC LEXIS 2685, at *6 (Dec. 20, 1999) ("Under [Rule 2310], recommendations may be unsuitable if the trading is excessive based on the customer's objectives and financial situation."); *In re Rafael Pinchas,* Exchange Act Rel. No. 41816, at 11-12, 1999 SEC LEXIS 1754, at *22 (Sept. 1, 1999) ("[E]xcessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading").

5 While other NASD rules may cover circumstances where members are making recommendations (*see, e.g.,* Rule 2210, "Communications with the Public"), this Policy Statement is limited to a discussion of the suitability rule.

6 *See* SEC Guidance on the Use of Electronic Media ("Use of Electronic Media"), Release Nos. 34-7856, 34-42728, IC-24426, 65 Fed. Reg. 25843, 25843, 2000 SEC LEXIS 847, at *4 (Apr. 28, 2000) ("By facilitating rapid and widespread information dissemination, the Internet has had a significant impact on capital-raising techniques and, more broadly, on the structure of the securities industry.").

7 A member or associated person who simply effects a trade initiated by a customer without a related "recommendation" from the member or associated person is not required to perform a suitability analysis, although members may elect to determine whether a security is suitable under such circumstances for their own business reasons. *See In re Thomas E. Warren, III,* 51 S.E.C. 1015, 1019 n.19, 1994 SEC LEXIS 508, *11 n.19 (1994) ("We do not believe the suitability claims brought against the Applicant are supported by the record. There is no evidence that Warren recommended the transactions that were effected in these accounts."), *aff'd,* 69 F.3d 549 (10th Cir. 1995) (table format); SEC Announcement of Final Rule on Sales Practice Requirements for Certain Low-Priced Securities, Release No. 34-27160, 54 Fed. Reg. 35468, 1989 SEC LEXIS 1603, at *52 (Aug. 22, 1989) ("[T]he NASD and other suitability rules have long applied only to 'recommended' transactions."); Clarification of Notice to Members ("NtM") 96-60, 1997 NASD LEXIS 20 (FYI, Mar. 1997) (stating that a member's suitability obligation under Rule 2310 applies only to securities that have been recommended by the member). Similarly, the suitability rule does not apply where a member merely gathers information on a particular customer, but does not make any "recommendations." This is true even if the information is the type of information generally gathered to satisfy a suitability obligation.

Members should nonetheless remember that, under NASD Rule 2110, they are required to comply with know-your-customer obligations. Pursuant to these obligations, members must make reasonable efforts to obtain certain basic financial information from customers so that members can protect themselves and the integrity of the securities markets from customers who do not have the financial means to pay for transactions. *See* NtM 96-32, 1996 NASD LEXIS 51 (May 1996) (reminding members of their know-your-customer obligations), *supplemented and clarified on different grounds by* NtM 96-60 (Sept. 1996); see also NtM 99-11, 1999 NASD LEXIS 77 (Feb. 1999) ("While [this Notice] 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."); NtM 98-66, 1998 NASD LEXIS 81 (Aug. 1998) (noting that members should provide a description of "any internal system protocols designed to fulfill a member's 'know your customer' obligations"). Unlike the suitability rule, the NASD's know-your-customer requirements apply to members regardless of whether they have made a "recommendation."

8 *See generally* SEC Commissioner Laura Unger, *Online Brokerage: Keeping Apace of Cyberspace* (Nov. 1999) ("Unger Report") (discussing various views espoused by online brokerage firms, regulators and academics on the topic of online suitability). The Unger Report can be accessed through the SEC Web Site at *www.sec.gov/news/spstindx.htm* (last modified on May 4, 2000). *See also Developments in the Law—The Law of Cyberspace, 112 Harv. L. Rev. 1574,* 1582-83 (1999) (The article highlights the broader debate by academics and judges over whether "to apply conventional models of regulation to the Internet.").

9 Clarification of NtM 96-60, 1997 NASD LEXIS 20 (FYI, Mar. 1997).

10 For example, if a broker/dealer transmitted a research report to a customer at the customer's request, that communication may not be subject to the suitability rule; whereas, if the same broker/ dealer transmitted the very same research report with an accompanying message, either oral or written, that the customer should act on the report, the suitability analysis would be different.

11 *See* Online Brokerage Services and the Suitability Rule, NASD Regulatory & Compliance Alert, at 20 (Summer 2000) (noting that the more individualized and particular the communication about a security, the closer the communication is to being viewed as a "recommendation"). The *Regulatory & Compliance Alert* article is also available at *www.nasdr.com/rca_summer00.htm. See also* Thomas L. Taylor III & Alan S. Petlak, Q&A Online: Chat, Research, Compliance Reporter, July 31, 2000, at 11 (stating that a factor to consider when determining whether a communication is a "recommendation" is the degree to which it is individualized and specific).

12 *See supra* note 7 and accompanying text.

13 Note, however, that hyperlinks conceivably could create suitability obligations, depending, for example, on the information provided to and from the hyperlinked site, the extent to which a member endorses the content of the hyperlinked site, the nature of the firm's relationship to the hyperlinked site, and other attendant facts and circumstances. It should also be noted that NASD Regulation has previously issued guidance regarding the responsibility of members for the content of hyperlinked sites. *See* Letter from Thomas Selman, Vice President, NASD Regulation, Disclosure and Investor Protection to Craig Tyle, General Counsel, Investment Company Institute, Nov. 11, 1997. This letter can be accessed through NASD Regulation's Web Site at *www.nasdr.com /2910/2210_01.htm. See also* Use of Electronic Media, *supra* note 6, at 65 Fed. Reg. at 25848-25849, *32-49 (discussing responsibility for hyperlinked information). In addition, NASD Regulation has provided guidance to firms regarding the use of "chat rooms" and "bulletin boards." *See* NtM 96-50, 1996 NASD LEXIS 60 (July 1996).

14 Note that there are instances where sending a customer an electronic communication that highlights a particular security (or securities) will not be viewed as a "recommendation." For instance, while each case requires an analysis of the particular facts and circumstances, a member generally would not be viewed as making a "recommendation" when, pursuant to a customer's request, it sends the customer (1) electronic "alerts" (such as account activity alerts, market alerts, or price, volume, and earnings alerts) or (2) research announcements (*e.g.*, a firm's "stock of the week") that are not tailored to the individual customer, as long as neither—given their content, context, and manner of presentation—would lead a customer reasonably to believe that the firm is suggesting that the customer take action in response to the communication.

15 Note, however, that a portfolio analysis tool that merely generates a suggested mix of general classes of financial assets (*e.g.*, 60 percent equities, 20 percent bonds, and 20 percent cash equivalents), without an accompanying list of securities that the customer could purchase to achieve that allocation, would not trigger a suitability obligation. On the other hand, a series of actions which may not constitute "recommendations" when considered individually, may amount to a "recommendation" when considered in the aggregate. For example, a portfolio allocator's suggestion that a customer could alter his or her current mix of investments followed by provision of a list of securities that could be purchased or sold to accomplish the alteration could be a "recommendation." Again, however, the determination of whether a portfolio analysis tool's communication constitutes a "recommendation" will depend on the content, context, and presentation of the communication or series of communications.

16 Although, as noted previously, a broker/dealer cannot disclaim away its suitability obligation, informing customers that generalized information provided is not based on the customer's particular financial situation or needs may help clarify that the information provided is not meant to be a

"recommendation" to the customer. Whether the communication is in fact a "recommendation" would still depend on the content, context, and presentation of the communication. Accordingly, a member that sends a customer or group of customers information about a security might include a statement that the member is not providing the information based on the customers' particular financial situations or needs. Members may properly disclose to customers that the opinions or recommendations expressed in research do not take into account individual investors' circumstances and are not intended to represent "recommendations" by the member of particular stocks to particular customers.

Members, however, should refer to previous guidelines ssued by the SEC and NASD that may be relevant to these and/or related topics. For instance, the SEC has issued guidelines regarding whether and under what circumstances third-party information is attributable to an issuer, and the SEC noted that the guidance also may be relevant regarding the responsibilities of broker/dealers. Use of Electronic Media, *supra* note 6, at 65 Fed. Reg. at 25848-25849, *32-49 (discussing entanglement and adoption theories). *See also supra* note 13 and discussion therein.

17 We note that there are circumstances where the act of sending a communication to a specific group of customers will not necessarily implicate the suitability rule. For instance, a broker/dealer's business decision to provide only certain types of investment information (*e.g.*, research reports) to a category of "premium" customers would not, without more, trigger application of the suitability rule. Conversely, members may incur suitability obligations when they send a communication to a large group of customers urging those customers to invest in a security.

18 As with the other general guidelines discussed in this Policy Statement, the presence of this factor alone does not automatically mean that a "recommendation" has been made. For example, where a customer affirmatively requests to be alerted (by e-mail or pop-up screen) when a security reaches a specific price-point, when a company issues an earnings release, or when an analyst changes his or her recommendation of a particular security, the broker/dealer's decision to send the customer the requested information, without more, would not necessarily trigger a suitability obligation.

19 In this regard, NASD Regulation is considering further discussion of the application of the suitability rule to electronic communications involving initial public offerings in future guidance.

INFORMATIONAL

Performance Fees

SEC Approves Proposed Changes To Rule 2330(f)(2) Relating To Performance Fees

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Registered Representatives

KEY TOPICS

- Rule 2330
- Performance Fee Arrangements
- Investment Advisers

Executive Summary

On February 15, 2001, the Securities and Exchange Commission (SEC or Commission) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2330(f)(2), to permit NASD members and associated persons that act as investment advisers to share in the customer account profits and gains, subject to the provisions of Rule 205-3 under the Investment Advisers Act of 1940 ("Advisers Act").[1] The amendments are effective on April 21, 2001.

Questions/Further Information

Questions concerning this *Notice* may be directed to Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation), at (202) 728-8176; or Joseph Savage, Counsel, Advertising/Investment Companies Regulation, NASD Regulation, at (240) 386-4534.

The text of the amendments to Rules 2330 is provided in Attachment A.

Background And Discussion

NASD Rule 2330(f) prohibits members and persons associated with members from sharing in customer account profits and gains except under certain conditions. Subparagraph (f)(1) permits sharing in customer account profits and gains where the firm has authorized it and the sharing is proportionate to the member's or associated person's contributions to the account.

Subparagraph (f)(2) also permits members or registered representatives to charge a performance fee (an advisory fee based on a percentage of the capital gains or capital appreciation of an account), under the conditions provided for in Rule 2330(f)(2). The conditions provided in Rule 2330(f)(2) have always closely tracked the requirements of Rule 205-3 under the Advisers Act. However, effective August 20, 1998, the Commission amended Rule 205-3 to provide greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding these arrangements.[2]

Because the NASD had specifically incorporated the requirements of Rule 205-3 into NASD Rule 2330(f)(2) rather than only referencing the rule generally, upon the amendment of Rule 205-3, NASD Rule 2330(f)(2) and Rule 205-3 were no longer consistent.

To restore consistency under current requirements and ensure consistency in the future if Rule 205-3 is amended, the NASD has amended Rule 2330(f)(2) to permit members and their associated persons that act as investment advisers (whether or not registered as such) to share in customer account profits and gains if the member or person associated with a member seeking such compensation (1) obtains prior written authorization from the member carrying the account; and (2) complies with the provisions of Rule 205-3 under the Advisers Act. Accordingly, Rule 2330(f)(2) is amended to eliminate the specific conditions of Rule 205-3 set forth previously in the rule and to incorporate, by reference, the terms of Rule 205-3, as may be amended from time to time. Thus, in the future, Rule 2330(f)(2) will conform to any subsequent amendments by the Commission to Rule 205-3.

Generally, Rule 205-3 permits an investment adviser to enter into an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains or the capital appreciation of the client's funds, provided that the client entering into the contract is a "qualified client." Under Rule 205-3, a "qualified client" includes:

(1) An individual or company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;

(2) An individual or company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

   (A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or

   (B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into; or

(3) An individual who immediately prior to entering into the contract is (A) an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

A copy of Rule 205-3 of the Advisers Act is provided in Attachment B.

The staff would like to emphasize that members that share in the profits or gains of an account must comply with the provisions of Rule 2330(f)(1) or (2) to receive such compensation, whether or not that member is required under the Advisers Act to register as an investment adviser. In this regard, the SEC has proposed a new rule under the Advisers Act that, among other things, would not deem a registered broker/dealer to be an investment adviser under the Advisers Act based solely on its receipt of "special compensation," subject to certain conditions.[3] The staff also has received a number of inquiries relating to the possible application of Rule 2330(f) to brokerage fees that are calculated based on the total assets in a customer account. The staff is clarifying that such brokerage fees that are calculated based on a share of the total assets in the account would not be considered sharing in the profits or gains of an account for the purposes of Rule 2330(f).

Endnotes

1 *See* Securities Exchange Act Release No. 43973 (February 15, 2001), 66 FR 11623 (February 26, 2001) (File No. SR-NASD-99-42).

2 *See* Investment Advisers Act Release No. 1731 (July 15, 1998), 63 FR 39022 (July 21, 1998).

3 *See* Securities Exchange Act Release No. 42099, Investment Advisers Act Release No. 1845, 64 FR 61226 (November 10, 1999).

ATTACHMENT A

New language is underlined; deletions are in brackets.

2300. TRANSACTIONS WITH CUSTOMERS

2330. Customers' Securities or Funds

(a) through (e) (No change)

(f) Sharing in Accounts; Extent Permissible

(1)(A) and (B)(No change)

(2) Notwithstanding the prohibition of paragraph (f)(1), a member or person associated with a member that is acting as an investment adviser (whether or not registered as such) may receive compensation based on a share in profits or gains in an account if [all of the following conditions are satisfied:*]

[(A) T]the member or person associated with a member seeking such compensation obtains prior written authorization from the member carrying the account[;], and all of the conditions in Rule 205-3 of the Investment Advisers Act of 1940 (as the same may be amended from time to time) are satisfied.

[(B) The customer has at the time the account is opened either a net worth which the member or person associated with a member reasonably believes to be not less than $1,000,000, or the minimum amount invested in the account is not less than $500,000;]

[(C) The member or person associated with a member reasonably believes the customer is able to understand the proposed method of compensation and its risks prior to entering into the arrangement;]

[(D) The compensation arrangement is set forth in a written agreement executed by the customer and the member;]

[(E) The member or person associated with a member reasonably believes, immediately prior to entering into the arrangement, that the agreement represents an arm's-length arrangement between the parties;]

[(F) The compensation formula takes into account both gains and losses realized or accrued in the account over a period of at least one year; and]

[(G) The member has disclosed to the customer all material information relating to the arrangement including the method of compensation and potential conflicts of interest which may result from the compensation formula.]

[* It is the position of the Division of Investment Management of the Commission that compensation received by a member or person associated with a member under this Rule would constitute "special compensation" for purposes of the broker/dealer exception to the definition of "investment adviser" in Section 202(a)(11)(C) of the Investment Advisers Act of 1940 (Advisers Act). Any member or person associated with a member, required to be registered under the Advisers Act, or state law, who receives compensation based on a share of profits or capital appreciation of a customer's account must comply with Section 205(l) and Rule 205-3 under the Advisers Act, or applicable state law, with respect to such compensation. (SEC Release 34-24355, 52 Fed. Reg. 13778, April 24, 1987).]

ATTACHMENT B

Rule 205-3 of the Investment Advisers Act of 1940 — Exemption from the compensation prohibition of section 205(1) for investment advisers.

(a) General. The provisions of section 205(a)(1) of the Act (15 U.S.C. 80b-5(a)(1)) will not be deemed to prohibit an investment adviser from entering into, performing, renewing or extending an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client, provided, that the client entering into the contract subject to this section is a qualified client, as defined in paragraph (d)(1) of this section.

(b) Identification of the client. In the case of a private investment company, as defined in paragraph (d)(3) of this section, an investment company registered under the Investment Company Act of 1940, or a business development company, as defined in section 202(a)(22) of the Act (15 U.S.C. 80b-2(a)(22)), each equity owner of any such company (except for the investment adviser entering into the contract and any other equity owners not charged a fee on the basis of a share of capital gains or capital appreciation) will be considered a client for purposes of paragraph (a) of this section.

(c) Transition rule. An investment adviser that entered into a contract before August 20, 1998 and satisfied the conditions of this section as in effect on the date that the contract was entered into will be considered to satisfy the conditions of this section; provided, however, that this section will apply with respect to any natural person or company who is not a party to the contract prior to and becomes a party to the contract after August 20, 1998.

(d) Definitions. For the purposes of this section:

(1) The term qualified client means:

(i) A natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;

(ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

(A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or

(B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(51)(A)) at the time the contract is entered into; or

(iii) A natural person who immediately prior to entering into the contract is:

(A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or

(B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

(2) The term company has the same meaning as in section 202(a)(5) of the Act (15 U.S.C. 80b-2(a)(5)), but does not include a company that is required to be registered under the Investment Company Act of 1940 but is not registered.

(3) The term private investment company means a company that would be defined as an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exception provided from that definition by section 3(c)(1) of such Act (15 U.S.C. 80a-3(c)(1)).

(4) The term executive officer means the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the investment adviser.

INFORMATIONAL

Limit Order Protection

SEC Approves Extension Of Limit Order Protection Principles To Certain OTCBB Securities On A Pilot Basis

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Registered Representatives
- Trading & Marketing

KEY TOPICS

- Limit Order Protection
- OTCBB

***NASD Notice to Members 01-25* has been withdrawn.**

INFORMATIONAL

Day-Trading Margin

SEC Approves Proposed Rule Change Relating To Day-Trading Margin Requirements

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Operations

KEY TOPICS

- Rule 2520
- Margin
- Day Trading

Executive Summary

On February 27, 2001, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2520 relating to margin requirements for day traders (the "amendments").[1] The amendments become effective on September 28, 2001 and are substantially similar to amendments by the New York Stock Exchange (NYSE) to its margin rules.[2]

The text of the amendments and *Federal Register* version of the SEC Approval Order are attached (see Attachments A & B). For a detailed description of the amendments, as well as specific examples of certain margin calculations under the amendments, members should review the attached SEC Approval Order (see Attachment B).

Questions concerning this *Notice* may be directed to Susan DeMando, Director, Financial Operations, Member Regulation, NASD Regulation, Inc. (NASD Regulation), at (202) 728-8411, or Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

Because Regulation T initial margin requirements and NASD/NYSE standard maintenance margin requirements[3] are calculated only at the end of each day, a day trader who has no positions in his or her account at the end of the day would not incur a Regulation T initial margin nor a standard maintenance margin requirement, assuming no losses in the account from that day's trading. Current NASD/NYSE initial margin provisions, however, generally require a customer to deposit margin of at least $2,000, unless in excess of the cost of the security.

Although the day trader may end the day with no position, the day trader's clearing firm is at risk during the day if credit is extended. To address this risk, the NASD and NYSE require day traders to demonstrate that they have the ability to meet the initial margin requirements for at least their largest open position during the day. Specifically, under current margin requirements, a customer who meets the definition of day trader under the rule must deposit in his or her account the margin that would have been required under Regulation T (*i.e.*, the 50 percent initial margin requirement) if the customer had not liquidated the position during the trading day. If the customer day trades, but is not considered a "day trader," the customer is still required to post 25 percent of the position held during the day.[4] Currently, this payment is due after the risk has been incurred. Therefore, the funds are not available during the trading day when the clearing firm is at risk.

Currently, if a customer's day trading results in a day-trading margin call, the customer has seven days to meet the call by depositing cash or securities in the account. Because day traders typically end the day flat and this day-trading "margin" deposit is not securing a margin loan, the customer is not required to leave the margin deposit in the account and may withdraw the deposit the day after the deposit is made. If the customer fails to meet a day-trading margin call, no specific action to the customer account is required to be taken by the firm. There are no securities to liquidate, as there would be for an existing position, because day traders typically end the day flat.

Description Of Amendments

The amendments address the deficiencies that have been identified with existing rules relating to day-trading margin activities. Specifically, the amendments provide for the following changes to current margin requirements:

(1) Definition of "pattern day trader." Under the amendments, "pattern day traders" are defined as those customers who day trade four or more times in five business days. If day-trading activities do not exceed six percent of the customer's total trading activity for the five-day period, the clearing firm is not required to designate such accounts as pattern day traders. The six percent threshold is designed to allow clearing firms to exclude from the definition of pattern day trader those customers whose day-trading activities comprise a small percentage of their overall trading activities.

In addition, if the firm knows or has a reasonable basis to believe that the customer is a pattern day trader (for example, if the firm provided training to the customer on day trading in anticipation of the customer opening an account), the customer must be designated as a pattern day trader immediately, instead of delaying such determination for five business days.

(2) Minimum equity requirement. The amendments require that a pattern day trader have deposited in his or her account minimum equity of $25,000 on any day in which the customer day trades. The required minimum equity must be in the account prior to any day-trading activities; however, firms are not required under the rule to monitor the minimum equity requirements on an intra-day basis. The minimum equity requirement addresses the additional risks inherent in leveraged day trading activities and ensures that customers cover losses incurred in their accounts from the previous day before continuing to day trade.

(3) Day-trading buying power. The amendments limit day-trading buying power to four times the day trader's maintenance margin excess. This calculation is based on the customer's account position as of the close of business of the previous day.

(4) Day-trading margin calls. Under the amendments, in the event a day-trading customer exceeds his or her day-trading buying power limitations, additional restrictions are imposed on the pattern day trader that more adequately protect the firm from the additional risk and help prevent a recurrence of such prohibited conduct. Members are required to issue a day-trading margin call to pattern day traders that exceed their day-trading buying power. Customers have five business days to deposit funds to meet this day-trading margin call. The day-trading account is restricted to day-trading buying power of two times maintenance margin excess based on the customer's daily total trading commitment, beginning on the trading day after the day-trading buying power is exceeded until the earlier of when the call is met or five business days. If the day-trading margin call is not met by the fifth business day, the account must be further restricted to trading only on a cash-available basis for 90 days or until the call is met.

(5) Two-day holding period requirement. The amendments require that funds used to meet the day-trading minimum equity requirement or to meet a day-trading margin call must remain in the customer's account for two business days following the close of business on any day when the deposit is required.

(6) Prohibition of the use of cross-guarantees. Under the amendments, pattern day traders are not permitted to meet day-trading margin requirements through the use of cross-guarantees. Each day-trading account is required to meet the applicable requirements independently, using only the financial resources available in the account. Accordingly, pattern day traders are prohibited from using cross-guarantees to meet the minimum equity requirements or to meet day-trading margin calls.

In addition, the amendments revise the current interpretation that requires the sale and repurchase on the same day of a position held from the previous day to be treated as a day trade. The amendments treat the sale of an existing position as a liquidation and the subsequent repurchase as the establishment of a new position not subject to the rules affecting day trades. Similarly, if a short position is carried overnight, the purchase to close the short position and subsequent new sale would not be considered a day trade.

For a more detailed description of the amendments, as well as specific examples of certain margin calculations under the amendments, members should review the attached SEC Approval Order.

Endnotes

1 *See* Securities Exchange Act Release No. 44009 (February 27, 2001), 66 FR 13608 (March 6, 2001) (File No. SR-NASD-00-03) ("SEC Approval Order").

2 The SEC issued a joint approval order for the NASD's and NYSE's proposed rule changes relating to day-trading margin requirements. The NYSE rule filing number is SR-NYSE-99-47.

3 NASD Rule 2520 and NYSE Rule 431, the margin provisions for the NASD and the NYSE, respectively, are substantially similar.

4 The firm has the option to calculate day-trading margin requirements based on either the largest open position at any given time during the day, or on the customer's total trading commitment during the day. If the firm chooses to base day-trading margin requirements on the customer's largest open position during the day, the firm must maintain "time and tick" records documenting the sequence in which each day trade is completed.

ATTACHMENT A

SR-NASD-00-03, Proposed Rule Language, as amended

Proposed new language is underlined; proposed deletions are in brackets.

2520. Margin Requirements

(a) Definitions No change.

(b) Initial Margin

For the purpose of effecting new securities transactions and commitments, the customer shall be required to deposit margin in cash and/or securities in the account which shall be at least the greater of:

(1) through (3) No change.

(4) equity of at least $2,000 except that cash need not be deposited in excess of the cost of any security purchased (this equity and cost of purchase provision shall not apply to "when distributed" securities in a cash account). The minimum equity requirement for a "pattern day trader" is $25,000 pursuant to paragraph (f)(8)(B)(iv)a. of this Rule.

Withdrawals of cash or securities may be made from any account which has a debit balance, "short" position or commitments, provided it is in compliance with Regulation T of the Board of Governors of the Federal Reserve System and after such withdrawal the equity in the account is at least the greater of $2,000 ($25,000 in the case of a "pattern day trader") or an amount sufficient to meet the maintenance margin requirements of this [paragraph] Rule.

(c) through (f)(8)(A)(iii) No change.

(f)(8)(B) **Day[-] Trading**

(i) The term "day[-] trading" means the purchasing and selling or the selling and purchasing of the same security on the same day in a margin account except for:

a. a long security position held overnight and sold the next day prior to any new purchase of the same security, or

b. a short security position held overnight and purchased the next day prior to any new sale of the same security.

(ii) [A "day- trader" is any customer whose trading shows a pattern of day- trading.] The term "pattern day trader" means any customer who executes four or more day trades within five business days. However, if the number of day trades is 6% or less of total trades for the five business day period, the customer will not be considered a pattern day trader and the special requirements under paragraph (f)(8)(B)(iv) of this Rule will not apply. In the event that the

organization at which a customer seeks to open an account or to resume day trading knows or has a reasonable basis to believe that the customer will engage in pattern day trading, then the special requirements under paragraph (f)(8)(B)(iv) of this Rule will apply.

(iii) The term "day-trading buying power" means the equity in a customer's account at the close of business of the previous day, less any maintenance margin requirement as prescribed in paragraph (c) of this Rule, multiplied by four for equity securities.

Whenever day[-] trading occurs in a customer's margin account the special maintenance margin required for the day trades in equity securities [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.] 25% of the cost of all the day trades made during the day. For non-equity securities, the special maintenance margin shall be as required pursuant to the other provisions of this Rule. Alternatively, when two or more day trades occur on the same day in the same customer's account, the margin required may be computed utilizing the highest (dollar amount) open position during that day. To utilize the highest open position computation method, a record showing the "time and tick" of each trade must be maintained to document the sequence in which each day trade was completed.

(iv) Special Requirements for Pattern Day Traders

a. Minimum Equity Requirement for Pattern Day Traders - The minimum equity required for the accounts of customers deemed to be pattern day traders shall be $25,000. This minimum equity must be deposited in the account before such customer may continue day trading and must be maintained in the customer's account at all times.

b. Pattern day traders cannot trade in excess of their day-trading buying power as defined in paragraph (f)(8)(B)(iii) above. In the event a pattern day trader exceeds its day-trading buying power, which creates a special maintenance margin deficiency, the following actions will be taken by the member:

1. The account will be margined based on the cost of all the day trades made during the day,

2. The customer's day-trading buying power will be limited to the equity in the customer's account at the close of business of the previous day, less the maintenance margin required in paragraph (c) of this Rule, multiplied by two for equity securities, and

3. "time and tick" (*i.e.*, calculating margin using each trade in the sequence that it is executed, using the highest open position during the day) may not be used.

c. Pattern day traders who fail to meet their special maintenance margin calls as required within five business days from the date the margin deficiency occurs will be permitted to execute transactions only on a cash available basis for 90 days or until the special maintenance margin call is met.

d. Pattern day traders are restricted from using the guaranteed account provision pursuant to paragraph (f)(4) of this Rule for meeting the requirements of paragraph (f)(8)(B).

e. Funds deposited into a pattern day trader's account to meet the minimum equity or maintenance margin requirements of paragraph (f)(8)(B) of this Rule cannot be withdrawn for a minimum of two business days following the close of business on the day of deposit.

(C) When the equity in a customer's account, after giving consideration to the other provisions of this [paragraph (c)] Rule, is not sufficient to meet the requirements of [subparagraph (i) or (ii) hereof] paragraph (f)(8)(A) or (B), additional cash or securities must be received into the account to meet any deficiency within [seven] five business days of the trade date.

In addition, on the sixth business day only, members are required to deduct from Net Capital the amount of unmet maintenance margin calls pursuant to SEC Rule 15c3-1.

(f)(9) and (f)(10) No change.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR–NASD–01–06 and should be submitted by March 27, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[6]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 01–5329 Filed 3–5–01; 8:45 am]

BILLING CODE 8010–01–M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–44009; File Nos. SR–NYSE–99–47 and SR–NASD–00–03]

Self-Regulatory Organizations; New York Stock Exchange, Inc., and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes Relating to Margin Requirements for Day Trading; Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 to Each Proposed Rule Change

February 27, 2001.

I. Introduction

On December 13, 1999, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b–4 thereunder,[2] a proposal to amend NYSE Rule 431, *Margin Requirements.* The proposed rule change would establish margin requirements for day trading in customer accounts of the Exchange's member organizations. On January 25, 2000, the NYSE rule proposal was published for public comment in the **Federal Register**.[3]

On January 13, 2000, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Regulation, Inc., also filed a proposed rule change to establish day trading margin requirements by amending NASD Rule 2520, *Margin Requirements.* On February 18, 2000, the NASD proposal was published for comment in the **Federal Register**.[4]

Although the NYSE and NASD rule proposals were substantially similar, they diverged on certain issues.[5] To reconcile the differences between, and provide for uniform application of, the two proposals, the NYSE and NASD each filed amendments to their respective proposals. The NYSE filed its amendment on September 8, 2000.[6] The NASD filed its amendment on October 3, 2000.[7] The Commission received 49 letters regarding the NASD proposal and 214 letters regarding the NYSE proposal.[8] The NYSE provided a response to comments on September 20, 2000.[9] The NASD filed its response to comments on October 3, 2000.[10] This order approves the NYSE and NASD rule change proposals, as amended.

II. Description of the Proposed Rule Changes

A. Margin Trading and Regulation

Trading securities on margin involves the use of credit to finance securities purchases. A margin transaction takes place where a customer purchases a security in reliance on an extension of credit (*i.e.*, a loan) from his or her broker-dealer. Use of a margin loan increases both the customer's potential return on investment and his or her financial risk.[11]

Section 7(a) of the Act grants authority to the Board of Governors of the Federal Reserve System ("Federal Reserve") to regulate the use of margin credit in order to prevent the excessive use of credit for the purchase or carrying of securities.[12] Pursuant to this authority, the Federal Reserve promulgated Regulation T[13] to govern extensions of credit by brokers and dealers. Regulation T contains "initial" margin requirements, which limit the amount of credit that can be extended by a broker-dealer on certain securities transactions. Briefly, Regulation T generally allows broker-dealers to

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[6] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Securities Exchange Act Release No. 42343 (January 14, 2000), 65 FR 4005.

[4] Securities Exchange Act Release No. 42418 (February 11, 2000), 65 FR 8461.

[5] The NYSE and NASD rule proposals were the result of deliberations by the 431 Committee, which convenes regularly on margin issues. The Committee is generally comprised of NYSE and NASD staff, attorneys from the NYSE's outside counsel, the Board of Governors of the Federal Reserve System, and representatives from several clearing firms and broker-dealers. *See* letter from Alden Adkins, Senior Vice President and General Counsel, NASD, to Katherine England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated October 3, 2000 ("NASD Response to Comments").

[6] *See* letter from James Buck, Senior Vice President, NYSE, to Nancy Sanow, Assistant Director, Division, Commission, dated September 8, 2000 ("Amendment No. 1 to the NYSE Proposal"). The amendment clarified that the proposed "knows or has a reasonable basis to believe" standard not only applies in the situation where a customer seeks to open an account, but also in the case where he or she seeks to resume day trading in an existing account. For further discussion of the "knows or has a reasonable basis to believe" standard, *see infra*, Section II, "Description of the Proposed Rule Changes."

[7] *See* letter from Alden Adkins, Senior Vice President and General Counsel, NASD, to Katherine England, Assistant Director, Division, Commission, dated October 3, 2000 ("Amendment No. 1 to the NASD Proposal"). The amendment: (1) Deleted a provision relating to a 90-day period in which a day trader could be designated as a Pattern Day Trader; (2) clarified that the proposed "knows or has a reasonable basis to believe" standard would apply not only where a customer seeks to open an account, but also where a customer seeks to resume day trading in an existing account; (3) clarified that a two-day funds deposit requirement would apply only to customers who have been designated Pattern Day Traders; and (4) extended from 30 days to six months the proposed period for implementing the proposed rule change.

[8] Some commenters sent letters in response to both the NYSE and NASD rule proposals. The public files for the NYSE and NASD rule proposals, including all comment letters received on the proposals and a List of Commenters that was prepared by Commission staff, are located at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549–0609. *See infra*, footnote 28.

[9] *See* letter from James Buck, Senior Vice President and Secretary, NYSE, to Nancy Sanow, Assistant Director, Division, Commission, dated September 20, 2000 ("NYSE Response to Comments").

[10] NASD Response to Comments.

[11] Since trading securities on margin permits a customer to purchase securities valued at an amount greater than the equity available to his or her account, an increase in the value of those securities yields a higher return on equity than is possible if the size of the customer's purchases is limited to his or her available equity. On the other hand, trading securities on margin also makes it possible for a customer to generate losses that exceed his or her available equity.

[12] 15 U.S.C. 78g(a).

[13] 12 CFR 220 *et seq.* Regulation T "imposes, among other things, obligations, initial margin requirements, and payment rules on securities transactions." 12 CFR 220.1(a).

[14] The definition of "margin equity security" includes any equity security (as defined in Section 3(a)(11) of the Act) which is registered or has unlisted trading privileges on a national securities exchange or the Nasdaq Market. 12 CFR 220.2.

[15] 12 CFR 220.12(a).

extend credit to customers on "margin equity securities" [14] at 50 percent of the particular security's market value.[15]

Regulation T establishes minimum margin requirements, but expressly does not preclude any registered securities exchange or registered national securities association "from imposing additional requirements or taking action for its own protection."[16] Accordingly, the NYSE and NASD have, consistent with Regulation T, established their own maintenance margin requirements, including special maintenance margin requirements pertaining to "day-traders."

B. NYSE Proposal

According to the NTSE, the primary purpose of its rule proposal is to require that certain levels of equity be deposited and maintained in day trading accounts, and that these levels be sufficient to support the risks associated with day trading activities. The proposal would amend NYSE Rule 431, *Margin Requirements,* to establish special maintenance margin requirements for customers who engage in day trading, and to specify minimum equity requirements and buying power limitations for customers who demonstrate a pattern of day trading. The Exchange observed that advances in technology have contributed to a dramatic increase in day trading by customers. In the Exchange's view, these advancements have also contributed to the establishment of broker-dealers whose primary business is to provide customers with direct links to the securities markets, allowing customers to trade their respective portfolios on-line. According to the Exchange, in this environment, day traders attempt to profit from intra-day price movements of securities.

Under current NYSE rules, certain margin requirements must be calculated based on a customer's "open" positions [17] at the end of the trading day. If a customer only day trades, he or she has no "open" positions at the end of the day upon which a margin calculation would otherwise yield a margin call. Nevertheless, the same customer has generated financial risk throughout the day. The NYSE's rules for day trading address this risk by imposing a margin requirement for day trading that is calculated based on a day trader's largest open position during the day, rather than on his or her open positions at the *end* of the day. A customer who meets the NYSE definition of "day-trader" [18] must deposit in his or her account the amount of margin that would have been required had he or she not closed his or her largest open position before the end of the trading day (*i.e.,* generally 50 percent of the largest open position). If a customer day trades, but does not satisfy the definition of "day-trader," he or she is still required in general to deposit 25 percent of the amount of his or her open positions during the day.

The NYSE proposes to amend its margin rules covering day trading because, among other things, the current rule does not adequately address the risks inherent in certain patterns of day trading [19]and has encouraged practices, such as the use of cross-guarantees, which do not require customers to demonstrate actually financial ability to engage in day trading.

1. Proposed Definition of "Day Trading"

Proposed NYSE Rule 431(f)(8)(B) generally would redefine "day trading" as "purchasing and selling or selling and purchasing the same security in the same day in a margin account." An exception to this proposed definition is provided where a customer: (1) carries a long position in a security overnight and sells the security the next day prior to any new purchases of the security; or (2) carries a short security position in a security overnight and purchases the security the next day prior to any new sales of the security (*i.e.,* closing transactions to wrap-up the previous day's activities before any new purchases or sales of the same security).

2. Proposed Definition of "Pattern Day Trader"

A customer would be considered a "pattern day trader" if the customer made four or more day trades within five business days in his or her account, provided that the number of day trades was more than six percent of the total trades in the account during that period ("Pattern Day Trader"). The NYSE represented that the six percent threshold is designed to ensure that customers who engage in a large number of transactions overall are not inappropriately deemed Pattern Day Traders solely because there are four or more day trades in their accounts over the five-day period. Accordingly, a customer that, for example, transacts four day trades within five business days and also has a total of 100 transactions during that period, would not be deemed a Pattern Day Trader, since less than six percent of that customer's total trades would have been day trades.

Proposed Margin Requirement for Pattern Day Traders

The NTSE's rule proposal would require Pattern Day Traders to maintain special maintenance margin commensurate with their levels of day trading activity ("Day Trading Margin"). For day trades in equity securities, the required Day Trading Margin ("Day Trading Margin Requirement") would be 25 percent of either: (1) The cost of all day trades made during the day; or (2) the largest open position during that day. If a customer's Day Trading Margin Requirement is to be calculated based on his or her largest open position during the day, the customer's firm must maintain "time and tick" records documenting the sequence in which each day trade is completed. For non-equity securities, the amount of Day Trading Margin would be computed using applicable special maintenance margin requirements pursuant to other provisions of NYSE Rule 431.

4. Proposed Time To Meet Margin Calls

The NYSE's rule proposal also would reduce the time allowed for Pattern Day Traders to meet special maintenance margin calls from seven business days to five business days. If a Pattern Day Trader did not meet a Day Trading Margin call within five business days from the time his or her Day Trading Margin deficiency occurred, the customer would be restricted to executing transactions on a cash available basis for 90 days, or until he or she had met the Day Trading Margin call. The NYSE member organizations would incur a one-time capital charge for the amount of any unmet deficiency on the sixth business day after a customer receives a Day Trading Margin call.

5. Proposed Day Trading Minimum Equity Requirement

Currently, NYSE rule 431 requires $2,000 minimum equity for a customer to open a margin account. The NYSE rule proposal would require that accounts of Pattern Day Traders maintain minimum equity of $25,000 ("Day Trading Minimum Equity Requirement"). If the account of a Pattern Day Trader fell below its Day Trading Minimum Equity Requirement, the account would be restricted from further day trades until the Day Trading Minimum Equity Requirement was satisfied. In addition, if an NYSE

[16] 12 CFR 220.1(b)(2)

[17] A customer has an "open" position in a security if, for example, he or she has purchased, but not resold it.

[18] The rules define "day-trader" as "any customer whose trading shows a pattern of day-trading." NYSE Rule 431(f)(8)(B).

[19] NYSE Response to Comments.

member organization knew, or had reasonable basis to believe, that a new account would pattern day trade, or that a customer would resume day trading in an existing account, the member organization would require the customer to deposit the minimum $25,000 equity into his or her account before he or she began trading.[20]

6. Proposed Day Trading Buying Power

Under the proposed Rule 431 revisions, the accounts of Pattern Day Traders would be restricted based upon their "Day Trading Buying Power." For equity securities, Day Trading Buying Power would be equal to the equity in the customer's account at the close of business of the previous day, less any maintenance margin, multiplied by four. For non-equity securities, Day Trading Buying Power would be computed using applicable special maintenance margin requirements pursuant to other provisions of NYSE Rule 431.

7. Proposed Account Restrictions

The NYSE's rule proposal also would restrict the accounts of Pattern Day Traders who trade in excess of their Day Trading Buying Power. If a customer exceeded his or her Day Trading Buying Power, he or she would generate a Day Trading margin call. Until the customer meet the margin call, the NYSE member organization would be required to: (1) Margin the account based on the cost of all day trades made during the day; and (2) limit the customer's day trading buying power to the equity in the customer's account at the close of business on the previous day, less any maintenance margin, multiplied by two. If the Day Trading Margin call were not met within 5 business days, the NYSE member organization would then be required to restrict the account to trading on a cash available basis only.

8. Proposed Non-Withdrawal Requirement

The NYSE represented that, in order to provide greater financial stability to the accounts of Pattern Day Traders, its rule proposal would require that: (1) a day trading customer deposit into the day trading account a sufficient amount of money to meet the Day Trading Minimum Equity Requirement or a Day Trading Margin Requirement; and (2) such deposits not be withdrawn for at least two business days ("Non-Withdrawal Requirement").

9. Proposed Prohibition on Cross-Guarantees

In addition, the NYSE's rule proposal would require the NYSE member organizations to prohibit Pattern Day Traders from using guarantees between customer accounts at the same broker-dealer ("Cross-Guarantees") to meet the Day Trading Minimum Equity Requirement or a Day Trading Margin Requirement. According to the NYSE, this change is designed to address those instances where maintenance margin calls for day trading accounts would be avoided by having guarantees from the accounts of other customers at the same broker-dealer. Under the NYSE proposal, each Pattern Day Trader account would be required to meet its applicable requirements independently by using funds on deposit in that account.

10. Proposed Implementation

The NYSE proposal would become operational six months after Commission approval of the proposed rule change.[21]

C. NASD Proposal

Although the NYSE and NASD proposals differ somewhat in their structure, they are fundamentally comparable in their substance. The NASD rule proposal would amend NASD Rule 2520, *Margin Requirements,* to impose stricter margin requirements for customers who are Pattern Day Traders. The NASD observed that the expansion of day trading activity has brought increased scrutiny of margin requirements by self-regulatory organizations ("SROs"). The NASD asserted that its rule proposal would help to protect the safety and soundness of member firms and ensure the overall financial well being of the securities markets.

The NASD's current rules on day trading are similar in substance to those of the NYSE.[22] In its proposal, the NASD describes that initial margin requirements under Regulation T[23] and certain standard maintenance margin requirements under the NYSE and NASD rules currently are calculated only at the end of each day. Therefore, a day trader with no outstanding positions, including losses, in his or her account at the end of the day currently does not incur either an initial margin or maintenance margin requirement.

Although a day trader may end the day without any positions, the day trader and the member firm are nonetheless at risk during the day, if credit is extended. To address the risk, the NASD currently requires day traders to demonstrate that they have the ability to meet margin requirements for at least their open positions during the day. Specifically, a customer who meets the definition of "day-trader"[24] under the current rules must deposit in his or her account the margin that would have been required had the customer not liquidated his or her open positions during the trading day (*i.e.*, generally 50 percent of the largest open position). Under current rules, if the customer day trades, but does not fit the definition of "day trader," the customer is still required to deposit 25 percent of his or her open position during the day. The NASD proposed to amend its margin rules covering day trading because current rules are not adequate to address added risks in leveraged pattern day trading.[25]

1. Proposed Definition of Pattern Day Trader

The NASD stated that its proposal would define Pattern Day Trader to cover "true" day traders only, not merely incidental or occasional day traders. According to the NASD, the current definition of a day trader is overly broad: it includes customers, such as institutions and other large individual accounts, that have a high volume of trading activity and that occasionally day trade not as a strategy, but in response to a specific investment decision or in response to particular events. Accordingly, the NASD's proposal, like the NYSE proposal, would define as Pattern Day Traders those customers who execute four or more day trades within five business days, unless the number of their day trades is six percent or less of their total trades for that period.

[20] As originally filed, the NYSE proposal would require the member organization to obtain from a customer seeking to open a new account a deposit in satisfaction of the Day Trading Minimum Equity Requirement if the firm "knows or has a reasonable basis to believe" that the customer will pattern day trade. Amendment No. 1 to the NYSE rule proposal would expand the application of the "knows or has a reasonable basis to believe" standard to customers who resume pattern day trading in an existing account.

[21] Telephone conversation among Donald Van Weezel, Managing Director, Credit Regulation, NYSE; Albert Lucks, Director, Credit Regulation, NYSE; Mary Anne Furlong, Director, Rules and Interpretive Standards, NYSE; Olga Davis, Principal Specialist, Credit Regulation, NYSE; and Nancy Sanow, Assistant Director; Thomas McGowan, Assistant Director; Joseph Morra, Special Counsel; and Steven Johnson, Special Counsel, Division, Commission, January 23, 2001 ("January 23, 2001 Call with NYSE Staff") (confirming operative date of proposed rule change).

[22] *See* explanation of NYSE's current rules in Section II.B., *supra.*

[23] 12 CFR 220 *et seq.*

[24] Current NASD Rule 2520 defines a "day-trader" as "any customer whose trading shows a pattern of day-trading." The rule defines "day-trading" as "the purchasing and selling of the same security on the same day." NASD Rule 2520(f)(8)(b).

[25] NASD Response to Comments.

The NASD's proposed rule change would also require a firm that knows or has a reasonable basis to believe that a customer is a Pattern Day Trader to designate the customer as a Pattern Day Trader immediately. Under the NASD proposal, a firm would have a reasonable basis for believing that a customer is a Pattern Day Trader if, for example, the firm provided training to the customer on day trading in anticipation of the customer opening an account. Amendment No. 1 to the NASD Proposal deleted the provision that would have required a Pattern Day Trader to cease trading for 90 days before he or she would be free of that designation. According to NASD Regulation, the provision originally proposed is unnecessary because, even without the provision, a Pattern Day Trader could, under the proposed rules, shed the Pattern Day Trader designation by informing his or her broker-dealer that he or she would not day trade. This amendment also clarified that if a Pattern Day Trader claimed he or she was no longer a day trader, but then resumed day trading, he or she could be designated as a Pattern Day Trader based on the firm's knowledge or reasonable belief that the customer fit the proposed definition of a Pattern Day Trader.[26]

2. Proposed Day Trading Minimum Equity Requirement

The NASD's proposed rule change also would establish a Day Trading Minimum Equity Requirement that is identical to that proposed by the NYSE. The NASD represents that the current minimum equity requirement of $2,000 may not be large enough to prevent day traders from continuing to generate losses, without any additional deposit of funds into their accounts. Under the NASD proposal, a Pattern Day Trader, in order to meet the Day Trading Minimum Equity Requirement, would be required to maintain $25,000 in his or her account on any day in which he or she day trades. The NASD represents that the Day Trading Minimum Equity Requirement more appropriately addresses the additional risks inherent in leveraged day trading activities and ensures that customers cover losses incurred in their accounts from the previous day before continuing to day trade.

[26] Amendment No. 1 to the NASD Proposal. Telephone conversation between Stephanie Dumont, Counsel, NASD Regulation, and Steven Johnston, Special Counsel, Division, Commission, January 31, 2001 (clarifying the purpose of Amendment No. 1).

3. Proposed Day Trading Buying Power

Like the NYSE proposal, the NASD proposal would permit the use of Day trading Buying Power at a level up to four times the difference between the equity in a customer's account at the close of business on the previous day and any maintenance margin required. The NASD represents that this limitation on a customer's Day Trading Buying Power, along with the Day Trading Minimum Equity Requirement, more appropriately addresses the intra-day risks created by customer day trading. At the firm's option, the Day Trading Margin Requirement could be calculated based on either the largest open position at any time during the day (if the customer's firm maintains "time and tick" records) or the aggregate total of the customer's day trades during the day.

4. Proposed Account Restrictions

In addition, the NASD proposed rule change would impose a Day Trading Margin call if a customer exceeded his or her Day Trading Buying Power. Customers would have five business days to deposit funds to meet Day Trading Margin calls. Until the customer met the Day Trading Margin call, his or her Day Trading Buying Power would be limited to the equity in his or her account at the close of business on the previous day, less any maintenance margin, multiplied by two for equity securities. The Day Trading Margin Requirement would be calculated based on the aggregate cost of the customer's total day trades in a day. If the customer did not meet the Day Trading Margin call by the fifth business day, the account would be further restricted to trading on a cash available basis for 90 days or until the margin call was met.

5. Proposed Non-Withdrawal Requirement

A deposit made to meet the Day Trading Minimum Equity Requirement or a Day Trading Margin Requirement would have to remain in a customer's account for two business days following the close of business on any day when the deposit is required. Amendment No. 1 to the NASD proposal clarified that the non-Withdrawal Requirement would apply only to the accounts of Pattern Day Traders and not to the accounts of all day traders.[27]

6. Proposed Prohibition on Cross-Guarantees

Under the NASD proposal, Cross-Guarantees could not be used when calculating the Day Trading Minimum Equity Requirement or the Day Trading Margin requirement. Each day trading account would be required to satisfy independently the proposed rule's requirements, based solely on the financial resources available in the account.

[27] Amendment No. 1 to the NASD Proposal.

7. Proposed Change to Definition of "Day Trade"

Finally, the NASD rule proposal would amend provisions of NASD Rule 2520, which currently requires that the sale and repurchase on the same day of a position held from the previous day be treated as a day trade. Under the NASD proposal, the sale of an existing position would be treated as liquidation, and a subsequent repurchase would be viewed as the establishment of a new position. Therefore, the sale of an existing position and subsequent repurchase would not be subject to NASD rules affecting day trades. Similarly, if a short position were carried overnight, the purchase to close the short position and the subsequent new sale would not be considered a day trade under the NASD's proposal.

8. Proposed Implementation Date

Amendment No. 1 to the NASD Proposal would change the proposed operational date of the proposal from 30 days after the date the NASD issues a notice to NASD members announcing that the proposal has been approved by the Commission to six months from the date of such notice.

III. Summary of Comments

The Commission received 214 letters commenting on the NYSE proposal and 49 letters commenting on the NASD proposal.[28] Comment letters expressed various degrees of opposition or support to the approach taken by the proposed rule changes, although most commenters opposed the proposals. The commenters generally addressed issues

[28] The public files for the NYSE and NASD rule proposals are located at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549–0609. The public files for both rule proposals contain: (1) All comment letters on the proposals, including a list of all commenters on the proposals, which was prepared by Commission staff; (2) "Report of Examinations of Day-Trader Broker-Dealers," Office of Compliance Inspections and Examinations, Commission ("OCIE Report") dated February 25, 2000; and (3) "Securities Operations: Day Trading Requires Continued Oversight," the U.S. General Accounting Office, dated February 24, 2000. The public file for the NYSE rule proposal also contains: (1) The original NYSE Proposal; (2) Amendment No. 1 to the NYSE Proposal; and (3) NYSE Response to Comments. The public file for the NASD rule proposal also contains: (1) The original NASD proposal; (2) Amendment No. 1 to the NASD Proposal; and (3) NASD Response to Comments.

falling into one or more of the categories discussed below. In addition, the NYSE and NASD submitted responses [29] to the comments received by the Commission regarding the proposed rule changes. These responses are also incorporated below.

A. Definition of Pattern Day Trader

The proposed rule changes would define as Pattern Day Traders customers who execute four or more day trades [30] within five business days, unless the number of day trades is six percent or less of the total day trades for that five-day period. The NYSE stated that this definition is directed toward active Pattern Day Traders and the risk surrounding their activities.[31] A relatively small number of individuals raised specific objections to this definition. These individuals, along with a broker-dealer [32] and the Industry Day-Trading Advisory Task Force ("Task Force"),[33] expressed concern that the proposed definition could encourage customers to hold positions overnight that they might otherwise have liquidated, thus giving rise to additional risk of financial loss.[34]

In addition, a broker-dealer, the Task Force, and the Discount Brokerage Committee ("Brokerage Committee") and Ad Hoc Committee on Technology and Regulation ("Technology Committee") of the Securities Industry Association ("SIA") [35] (collectively, the "SIA Brokerage and Technology Committees") indicated concern over the impact that the proposed definition could have upon professional or institutional investors. These commenters stated that the definition lacks adequate exclusions for those types of investors.[36] Broker-dealers also opposed the definition of Pattern Day Trader because it would encompass so-called "incidental" or "inadvertent" day traders.[37] In this regard, a few firms proposed exceptions for customers who, as a result of "inadvertent" or "non-willful" error, temporarily met the proposed definition of Pattern Day Trader.[38] The SIA Brokerage and Technology Committees and SIA Office of General Counsel recommended that the proposed definition be revised to explicity exempt specific types of trading activity, such as the exercise of a profitable options position.[39] A law firm commenting on the proposed rule changes recommended exceptions to the proposed definition of Pattern Day Trader for certain institutional investors, arguing that sophisticated investors with large accounts do not need to be protected by the proposed rule changes.[40] The NASD responded to this comment by reasserting its belief that the proposed six percent exception adequately addresses institutional trading. The NASD argued that this exception was not intended to exempt all institutions that frequently day trade, but only those whose day trading represented a small proportion of their overall trading activity.[41]

Finally, the Task Force opposed the definition because it is based on transactional activity instead of the amount of available leverage. The Task Force asserted, for example, that a customer that completed five day trades within a "week" [42] would meet the definition of Pattern Day Trader "even though the customer ha[d] not taken on any greater level of financial risk or leverage." [43]

B. "Knows or Has a Reasonable Basis to Believe" Standard

Several securities industry commenters opposed the requirement to treat as Pattern Day Traders current or new customers whom a trading firm "knows or has a reasonable basis to believe" will engage in pattern day trading.[44] One securities firm opposed the "knows or has a reasonable basis to believe" standard because it calls for a firm to "subjectively consider the manner of trading a new customer might pursue." [45]

The NYSE responded to these criticisms by explaining that a firm could have a reasonable basis to believe that a customer would engage in Pattern Day Trading if this were indicated by information obtained from a customer's representations or by prior trading patterns of the customer at the firm.[46] The NASD responded that the proposed standard is based on a firm's knowledge or reasonable belief only, and would not require a firm to anticipate a new customer's activity unless the firm had knowledge or a reasonable belief that the customer would engage in pattern day trading. The NASD stated that if, for example, a firm provided a customer with training on day trading in anticipation of that customer opening an account with that firm, then the firm would have a reasonable basis to believe that customer would pattern day trade in his or her account.[47]

This standard was supported by comments from the North American Securities Administrators Association ("NASAA"). NASAA contended that brokerage firms have an affirmative duty to assess a prospective client's suitability to trade, and therefore firms should determine whether the client fits the definition of Pattern Day Trader. According to NASAA, this assessment should not be overly burdensome to make. NASAA noted as an example that where a firm trains a customer in day trading techniques, that firm would be presumed to know or have a reasonable basis to believe that such a customer would engage in pattern day trading.[48]

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[29] NYSE Response to Comments; NASD Response to Comments.

[30] Under the proposed rules, a day trade is, generally, the purchase and sale or the sale and purchase of the same security on the same day.

[31] NYSE Response to Comments.

[32] Letter from Cornerstone Securities Corporation ("Cornerstone Letter").

[33] The Task Force is comprised of representatives from 15 firms: Advanced Clearing, Inc.; All-Tech Direct, Inc.; Ameritrade, Inc.; Charles Schwab & Co., Inc.; EDGETRADE.com, Inc.; E-Trade Group, Inc.; iClearing Corporation; Momentum Securities; NextTrend, Inc.; On-Line Investments Services, Inc.; Southwest Securities, Inc.; Spear, Leedst & Kellog; Terra Nova Trading LLC; Tradescape LLC; and US Clearing (Division Fleet Securities). Letter from the Task Force ("Task Force Letter").

[34] *See, e.g.*, E-mail from Steven Petrizzi, E-mail from M. Spetman; Cornerstone Letter; Task Force Letter.

[35] According to the SIA, the organization "brings together the shared interests of more than 740 securities firms to accomplish common goals." Letter from SIA Brokerage and Technology Committees ("SIA Brokerage and Technology Committees Letter").

[36] Letter from Momentum Securities, LLC ("Momentum Letter"); Task Force Letter; SIA Brokerage and Technology Committees Letter.

[37] *See, e.g.*, Momentum Letter.

[38] *See, e.g.*, Letter from Empire Programs.

[39] SIA Brokerage and Technology Committees Letter; Letter from the SIA Office of General Counsel ("SIA General Counsel Letter"). The SIA Brokerage and Technology Committees and SIA General Counsel recommended adding the following exceptions to the proposed definition of day trading: (1) Exercising a profitable option position; (2) reopening a long option position that had been closed out earlier the same day; (3) reopening a short option position that had been closed out earlier the same day; and (4) the purchase of a security by a customer and the sale of the same security by the customer in a repurchase or other financing transaction.

[40] Letter from Brunelle and Hadjikow.

[41] NASD Response to Comments.

[42] Status as a Pattern Day Trader is determined on a rolling five-business-day basis. Telephone conversation among Donald Van Weezel, Managing Director, Regulatory Affairs, NYSE; Albert Lucks, Director, Credit Regulation, NYSE; and Nancy Sanow, Assistant Director; Thomas McGowan, Assistant Director; Joseph Morra, Senior Special Counsel; and Melinda Diller, Attorney; Division, Commission, January 7, 2000.

[43] Task Force Letter.

[44] *See, e.g.*, Momentum Letter.

[45] Momentum Letter.

[46] NYSE Response to Comments.

[47] NASD Response to Comments.

[48] NASAA is a voluntary association of state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico. Letter from NASAA ("NASAA Letter"). *See also* Section II., Description of the Proposed Rule Changes, *supra*, for further discussion of "knows or has a reasonable basis to believe" standard.

C. Day Trading Minimum Equity Requirement

The majority of comments the Commission received on the proposals' Day Trading Minimum Equity Requirement were from individuals, many of whom identified themselves as day traders. Nearly all of these individuals characterized the Day Trading Minimum Equity Requirement as unfair to small investors.[49] Individual commenters asserted that the Day Trading Minimum Equity Requirement would act as a barrier to persons seeking to enter the day trading market.[50] Individual commenters also asserted that the requirement was designed to exclude small investors from a type of trading traditionally dominated by professional traders.[51] A securities firm, as well as a significant number of individual commenters, argued that the proposed Day Trading Minimum Equity Requirement would be "paternalistic." These commenters asserted that the risks of day trading are widely known; therefore, it is unnecessary for the NYSE or NASD to protect investors from those risks.[52] The SIA Brokerage and Technology Committees stated, however, that they had no objection to the proposed dollar amount of the Day Trading Minimum Equity Requirement (*i.e.*, $25,000).[53]

Most securities firms commenting on the proposed rule changes opposed the Day Trading Minimum Equity Requirement wholly or partially.[54] For example, one firm challenged the premise that there is a relationship between the size of a customer's account and his or her investment success. The same firm argued that the imposition of a higher equity requirement could encourage investors to put more of their capital at risk than they would absent the proposed rules.[55] Securities firms also took the position that imposing the Day Trading Minimum Equity Requirement on Pattern Day Traders would fail to protect either member firms or the securities markets.[56] One of the firms argued that the health of the securities markets is not threatened by accounts that have only small equity balances, and there is no data to suggest that a higher equity requirement for day trading would reduce the risk to securities firms.[57] As an alternative, one securities firm recommended applying a $25,000 minimum equity requirement to customers who seek and receive approval to trade at a 4:1 margin ratio, but not to customers who trade at a 2:1 ratio.[58]

In response to this alternative, the NASD stated that it believes an objective standard based on the level of day trading activity, which can be applied uniformly to all customers, is an important component to regulation in this area. In this regard, the frequency of day trading is a relevant indicator of intra-day risk, which in turn is important in determining whether additional requirements, such as the Day Trading Minimum Equity Requirement, are necessary. The NASD further stated that it believed requiring minimum equity of $25,000 would provide a significant "cushion" to prevent day traders from continuing to generate losses in their accounts and, at the same time, avoid imposition of excessive restrictions on day traders with limited capital.[59]

In response to comment letters objecting to the proposed imposition of the Day Trading Minimum Equity Requirement,[60] the NYSE stated that the current equity requirement of $2,000 does not sufficiently address the speculative nature and potential volatility of pattern day trading. Further, the NYSE stated that the amount of the proposed minimum Day Trading Minimum Equity Requirement appropriately addresses the financial exposure of firms and the potential for significant monetary losses by customers. In the NYSE's view, the Day Trading Minimum Equity Requirement should provide some "staying power" to day traders (*i.e.*, enable them to continue day trading) should they incur trading losses.[61] The NASD added that the current equity requirement of $2,000 does not adequately address day trading risks.[62] The NASD represents that given the speculative nature of day trading the proposed Day Trading Minimum Equity Requirement would provide a better "cushion" in case of financial losses by customers.[63]

NASAA and the U.S. Senate Permanent Subcommittee on Investigations ("Senate Subcommittee") supported substantial increases in the size of the equity requirement for day trading.[64] Following increased public and private sector concern over the risks associated with day trading, the Senate Subcommittee conducted an eight-month investigation of the day trading industry. Based on the investigation, the Senate Subcommittee found that "[securities] industry leaders agreed that a day trader's chance of success is directly and proportionally related to the amount of capital with which a person starts trading."[65] NASAA stated that the Day Trading Minimum Equity Requirement should reduce the frequency of margin calls, increase the chances that day traders will be able to independently meet margin calls, and provide a "cushion" when market corrections occur.[66]

Finally, the Senate Subcommittee submitted detailed alternative proposals regarding, among other things, the required level of equity and suggested restrictions on accounts that do not meet the equity requirement. For example, the Senate Subcommittee proposed that day trading rules establish a rebuttable presumption "such that a firm must initially presume that a day trading customer who does not have $50,000 with which to open an account in inappropriate for day trading." The presumption could be overcome if a firm concluded that other factors outweighed the fact that the customer did not have $50,000 with which to open an account. Under the Senate Subcommittee's proposal, a firm would be required, among other things, to state its reasons for concluding that a day trading strategy was appropriate for such a customer.[67]

In response to recommendations by the Senate Subcommittee that the equity requirement for Pattern Day Traders be increased to $50,000,[68] the NYSE stated that it believes $25,000 is a sufficient level of equity, given the fact that firms may further increase equity requirements based on their own policies and procedures, known as "house requirements."[69] The NASD stated that the proposed Day Trading Minimum Equity Requirement should

[49] *See, e.g.*, E-mail from Susie Brown ("Brown Letter").

[50] *See, e.g.*, Letter from Serg Palanov.

[51] *See, e.g.*, E-mail from Brent Aston.

[52] Datek Online Holdings Corporation Letter ("Datek Letter"); *See also* May letter.

[53] The SIA Brokerage and Technology Committees are opposed, however, to imposing the Day Trading Minimum Equity Requirement when a firm "knows or has a reasonable basis to believe" a customer will in engage in pattern day trading. SIA Brokerage and Technology Committees Letter.

[54] *See, e.g.*, Cornerstone Letter.

[55] Datek Letter.

[56] *See, e.g.*, Momentum Letter.

[57] Datek Letter.

[58] Momentum Letter. The Task Force also recommended that the day trading rules differentiate between customers who trade at a 4:1 ratio and those who trade at a 2:1 ratio. Task Force Letter.

[59] NASD Response to Comments.

[60] *See, e.g.*, Brown Letter.

[61] NYSE Response to Comments.

[62] NASD Response to Comments.

[63] NASD Response to Comments.

[64] NASAA Letter; Senate Subcommittee Letter.

[65] Senate Subcommittee Letter.

[66] NASAA Letter.

[67] Senate Subcommittee Letter.

[68] *Id.*

[69] NYSE Response to Comments.

provide protection against continued losses in day trading accounts while refraining from excessive restrictions on day traders with limited capital. The NASD also observed that firms have the option of increasing equity requirements on day traders by imposing house requirements.[70]

In addition, the Senate Subcommittee recommended that customers who fail to maintain sufficient funds in their accounts be restricted to trading on a cash basis only.[71] In response to this suggestion, the NASD stated that if a customer continued to day trade in his or her account without maintaining the proposed Day Trading Minimum Equity Requirement, the NASD would expect that the customer's firm would restrict that account to trading on a cash available basis.[72]

D. Margin Ratio

A small number of individual commenters expressed opposition to increasing to a 4:1 ration the amount of leverage available to customers who satisfy the Day Trading Minimum Equity Requirement.[73] These individual commenters, as well as the Senate Subcommittee, expressed concern that increasing the margin ratio would multiply any losses of, and increase speculation by, those persons who trade at the higher ratio.[74] On the other hand, securities firms generally did not object to allowing customers to trade at a 4:1 ratio.[75]

In response to concerns about increasing the amount of leverage available to Pattern Day Traders,[76] the NYSE and NASD represented that permitting the use of leverage at a 4:1 ratio is appropriate when considered in conjunction with other provisions of the proposed rule changes.[77] The NYSE stated that as a whole, its proposal would encourage customers to avoid margin calls by trading only within their Day Trading Buying Power. The NYSE and NASD also indicated that allowing pattern Day Traders to trade at the 4:1 ratio would bring day trading accounts into parity with ordinary margin accounts, where the standard maintenance margin is also 25 percent.[78]

E. Method of Computing Margin Calls

A substantial number of individuals and securities firms commenting on the rule proposals were opposed to the proposed method of computing the Day Trading Margin call.[79] Some of these commenters objected to calculating the margin call based on all day trades during a day, once a Pattern Day Trader had exceeded his or her Day Trading Buying Power.[80] Individual commenters asserted that using this method would result in customers receiving margin calls many times larger than the amount of equity in the customer's account. A few of these comments apparently believed that a customer with no outstanding Day Trading margin calls who exceeded his or her Day Trading Buying Power would, under the proposed rules, face a Day Trading Margin call equal to 50 percent of the total cost of all day trades executed on the day in which the customer exceeded his or her Day Trading Buying Power.[81] The NYSE has clarified that if a Pattern Day Trader had no outstanding Day Trading Margin calls, his or her Day Trading Margin Requirement would equal 25 percent of either (1) the customer's highest open position during the day,[82] or (2) 25 percent of the total cost of the customer's day trades during the day.[83] Many of the individual and industry commenters lodging concerns regarding the calculation of Day Trading Margin calls stated that such margin calls would be unfairly punitive to day traders.[84]

The NYSE and NASD explained the calculation of Day Trading Margin calls as follow.[85] In accounts not subject to restrictions under the proposed rules, Day Trading Margin calls would be calculated based on a customer's highest open position in a day.[86] For example, assume that a customer who is a Pattern Day Trader had $30,000 cash equity and no security positions in his or her account at the close of business on Day 0. The customer's Day Trading Buying Power for Day 1 would be $120,000 (four times the equity in the customer's account at the close of business on Day 0).[87] Also assume that the customer executed two day trades on Day 1—a $50,000 purchase and sale, followed by a $200,000 purchase and sale.[88] Under these conditions, the customer's highest open position on Day 1 is $200,000.[89] Since the customer's highest open position exceeds her or her Day Trading Buying Power, the customer incurs a Day Trading Margin call of $20,000, calculated as followings:

$200,000	(largest open position on Day 1)
−120,000	(Day Trading Buying Power)
80,000	
x .25	(Day Trading Margin)
$20,000	(Day Trading Margin call)

In addition to incurring a Day Trading Margin call on Day 1, the customer's account is restricted until the margin call is met. On Day 2, for example, the customer's Day Trading Buying Power is restricted to $60,000 (*two* times the assumed equity[90] in the customer's account at the close of business on Day 1). Further, the customer's account is margined based on the total cost of all day trades executed on Day 2. For example, assume that on Day 2 the customer executes two day trades—a $40,000 purchase and sale and $30,000

[70] NASD Response to Comments.

[71] Senate Subcommittee Letter.

[72] NASD Response to Comments.

[73] *See, e.g.*, Letter from Jay Marting ("Marting Letter").

[74] *See, e.g.*, Marting Letter; Senate Subcommittee Letter.

[75] *See, e.g.*, Momentum Letter.

[76] *See, e.g.*, Letter from Matthew Panza ("Panza Letter"); Letter from EDGETRADE.com ("EDGETRADE Letter").

[77] NYSE Response to Comments; NASD Response to Comments.

[78] NYSE Response to Comments; NASD Response to Comments.

[79] *See, e.g.*, Panza Letter; EDGETRADE Letter.

[80] *See e.g.*, Panza Letter; Letter from Ed Naylor ("Naylor Letter").

[81] *See e.g.*, Naylor Letter.

[82] For the Day Trading Margin Requirement to be based on a customer's highest open position, the customer's firm must maintain "time and tick" records documenting the sequence in which each day trade was completed.

[83] NYSE Response to Comments. January 23, 2001 Call with NYSE Staff (clarifying that this formula applies solely to Pattern Day Traders who have no outstanding day trading margin calls).

[84] *See e.g.*, Ray Letter; Momentum Letter.

[85] January 23, 2001 Call with NYSE Staff (clarifying operation of NYSE proposed rules). Telephone conversation between Susan Demando, Director, of Finance/Operations, Member Regulation, NASD and Thomas McGowan, Assistant Director, Division, Commission, January 24, 2001 ("January 24, 2001 Call with NASD Staff") (clarifying operation of NASD proposed rules).

[86] For a customer's Day Trading Margin Requirement to be based on his or her highest open position, the customer's firm must maintain "time and tick" records of the customer's transactions; otherwise, the customer's Day Trading Margin Requirement must be calculated based on the total cost of a customer's day trades during the day.

[87] The proposed rules would define Day Trading Buying Power for equity securities as the equity available in a customer's account as of the close of business on the previous day less any maintenance margin requirement, multiplied by four. Because, in this example, the customer has no open positions in his or her margin account, the customer has no maintenance margin requirement.

[88] The example assumes that the customer closes one position before opening the next. This would be the case, for example, if the customer: (1) Purchased "Security A" for $50,000 at 10:00 a.m.; (2) sold "Security A" for $50,000 at 11:00 a.m.; (3) purchased "Security B" for $200,000 at 1:00 p.m.; and (4) sold "Security B" for $200,000 at 3:30 p.m.

[89] Had the customer not closed the position in "Security A" before purchasing "Security B," the customer's highest open position would have been $250,000, the sum of positions open simultaneously.

[90] The example assumes that there are no profits or losses in the account, no commission or interest charges, and no other items that would affect the account balance. Therefore, the amount of equity in the account at the end of Day 0.

purchase and sale. Since the total cost of the customer's day trades ($70,000) exceeds his or her Day Trading Buying Power ($60,000), the customer incurs a second Day Trading Margin call of $5,000, calculated as follows:

$70,000	(cost of all day trades on Day 2)
−60,000	(Day Trading Buying Power)
10,000	
× [91].50	
$5,000	(Day Trading Margin call)

F. Time Allowed to Meet Margin Call

Some [91] commenters stated that they were opposed to the requirement that, once a customer receives a Day Trading Margin call, he or she must meet the margin call within five business days.[92] One commenter, for example, protested that along with other provisions of the proposed rule changes, this requirement would force customers to liquidate positions based on non-market considerations.[93] In response to objections to reducing the time to meet a margin call from seven to five business days, the NYSE stated that this change was made to conform its proposed rule revisions to the time frame included in Regulation T for standard margin accounts.[94]

G. Actions Required When Day Trading Buying Power Is Exceeded

A significant number of comment letters from individuals, and roughly half of the letters from securities industry commenters, addressed the subject of the actions to be taken if a customer exceeds his or her Day Trading Buying Power.[95] For example, individual commenters objected to the provisions restricting use of leverage to a 2:1 ratio once a Pattern Day Trader has incurred a Day Trading Margin call.[96] A securities firm and the SIA Brokerage and Technology Committees criticized provisions that would reduce the degree of leverage available to customer who has received a Day Trading Margin call because, they argued, it departs from the approach used in Regulation T.[97] This firm and the SIA Brokerage and Technology Committees were opposed to the imposition of immediate restrictions on the accounts of individuals who exceeded their Day Trading Buying Power, and the SIA Brokerage and Technology Committees favored imposing as few restrictions as possible during the five-business-day period for meeting a Day Trading Margin call.[98] Finally, the Task Force proposed that no restrictions be imposed on the account of a Pattern Day Trader during the five business days specified for meeting a Day Trading Margin call.[99]

In response, the NYSE stated that the proposed actions are appropriate and will help to minimize financial risk to securities firms and markets.[100] In response to concerns that the companion actions required may "penalize" customers,[101] the NASD represented that immediate consequences are necessary to discourage customers from exceeding their Day Trading Buying Power.[102]

The Senate Subcommittee supported the proposed restrictions on Pattern Day Traders who exceed their Day Trading Buying Power.[103] NASAA also supported the Day Trading Margin call provisions and other restrictions imposed by the proposed rule changes. NASAA described the proposed measures as the placement of regulatory "speed bumps" to ensure compliance with reasonable margin risk levels and to enforce penalties for day trading in accounts with little or no equity.[104]

H. Non-Withdrawal Requirement

Most securities firms, and The Rules and Regulations Committee of the SIA's Credit Division ("SIA Rules and Regulations Committee"), opposed the requirement that funds deposited into a customer's account to satisfy the Day Trading Margin Requirement or Day Trading Minimum Equity Requirement of the proposed rule changes must remain in the account for two business days.[105] One trading firm, for example, stated that the Non-Withdrawal Requirement is unnecessary because positions are not held overnight and, therefore, funds are not at risk. The firm also contrasted the proposed Non-Withdrawal Requirement with the treatment of deposits made to satisfy Regulation T [106] margin calls. The firm observed that customers are permitted to withdraw those deposits the day after the deposits have been made.[107]

The SIA Rules and Regulations Committee argued that the Non-Withdrawal Requirement is overly restrictive, and that customers should be able to use funds available in their accounts, absent a pattern of activity demonstrating that they lack sufficient financial resources to engage in Pattern Day trading.[108] The NYSE, however, represented that the effectiveness of other provisions of its proposed rule change could be limited if a customer were permitted to withdraw funds prior to trading on the day after that customer had been required by the proposal to deposit them. The NYSE explained that if a customer is permitted to withdraw such funds prior to the next day's trading, he or she could shield the funds from day trading losses through overnight borrowing. The NYSE observed that overnight borrowing to meet margin calls does not demonstrate a customer's fitness to engage in Pattern Day Trading.[109]

The NYSE and NASD stated that they believe the Non-Withdrawal Requirement would result in greater caution by entities lending funds to customers who must meet Day Trading Margin calls. In their view, this is because funds deposited to meet Day Trading Margin calls would be placed at risk of day trading losses.[110] This, the NYSE argued, may encourage entities lending funds to more carefully evaluate the creditworthiness of Pattern Day Traders. The NYSE believed that this increased caution should provide a better foundation for reducing financial risk to the securities industry and to individual investors.[111] The NASD believed that the Non-Withdrawal Requirement would also force Pattern Day Traders to more frequently rely upon their own funds and assets in meeting margin requirements and thereby decrease financial risk to securities firms.[112]

I. Cross-Guarantees

Many individual commenters, as well as a significant number of firms, expressed opposition to the exclusion of Cross-Guarantees from the calculation of

[91] The Day Trading Margin rises to 50 percent because the customer has an outstanding Day Trading Margin call. January 23, 2001 Call with NYSE Staff; January 24, 2001 Call with NASD Staff (both clarifying use of 50 percent margin under proposed rules).

[92] *See, e.g.*, Letter from Terry Laughlin ("Laughlin Letter").

[93] Laughlin Letter.

[94] NYSE Response to Comments; 12 CFR 220.2; 12 CFR 220.4(c)(3)(i).

[95] *See, e.g.*, Naylor Letter; Cornerstone Letter (addressing imposition of 2:1 ratio).

[96] *See, e.g.*, E-mail from Jeff Landau.

[97] Cornerstone Letter; SIA Brokerage and Technology Committees Letter. 12 CFR 220 *et seq.*

[98] SIA Brokerage and Technology Committees Letter; Cornerstone Letter.

[99] Task Force Letter.

[100] NYSE Response to Comments

[101] *See, e.g.*, Letter from Brent Johnson.

[102] NASD Response to Comments.

[103] Senate subcommittee Letter.

[104] NASAA Letter

[105] *See, e.g.*, Cornerstone Letter. Letter from SIA Rules and Regulations Committee ("SIA Rules and Regulations Committee Letter").

[106] 12 CFR 220 *et seq.*

[107] Cornerstone Letter.

[108] SIA Rules and Regulations Committee Letter.

[109] NYSE Response to Comments.

[110] NYSE Response to Comments; NASD Response to Comments.

[111] NYSE Response to Comments.

[112] NASD Response to Comments.

the Day Trading Margin Requirement.[113] In addition, one commenter proposed to exclude accounts trading at the 2:1 ratio from the application of the proposed provisions on Cross-Guarantees.[114] The NYSE believes that the provision in its rule proposal on Cross-Guarantees "suitably addresses concerns of whether [a] customer has the financial resources to day trade, and allows for separate evaluation of customers' day trading risks."[115] The NASD also believes that its proposed provision on Cross-Guarantees is necessary to address those concerns.[116]

NASAA also expressed support for the proposed provisions on Cross-Guarantees. NASAA suggested that Cross-Guarantees circumvent the purpose of margin requirements. In addition, NASAA expressed concern regarding the potential harm to investors if securities firms that are strongly recommending an investment or an investment strategy to a customer also take steps to arrange margin guarantees for that same customer.[117] Similarly, the Senate Subcommittee stated that Cross-Guarantees would "undermine margin requirements" and could "evade the purpose" of equity requirements as well.[118]

J. Burdens on Firms

Most securities industry commenters expressed concern over the implementation, administration, and enforcement burden that they believed would be placed upon securities firms by the proposed rule changes.[119] The SIA Brokerage and Technology Committees argued, for example, that the system enhancements required to monitor such parameters as Day Trading Buying Power and to impose restrictions on accounts would be "significant, complicated, and costly." The SIA Brokerage and Technology Committees asserted that such burdens should not be imposed on firms that do not promote day trading strategies. The committees also expressed particular concern regarding the burden of implementing provisions of the proposed rule changes that would exclude from the definition of Pattern Day Trader those customers whose day trades represent six percent or less of their total trades.[120] In addition, the Task Force argued that the proposed rule changes would require firms to classify and monitor their entire customer base on a daily basis.[121] As an alternative, one firm proposed that customers desiring to trade at a 4:1 ratio should be required to apply for approval to trade at that level, and that broker-dealers should only be required to monitor the accounts trading at a 4:1 ratio. The firm believed this would reduce a firm's burden of implementing day trading margin rules.[122]

Responding to these concerns, the NYSE stated that the programming and monitoring of its proposed rule would not be unduly burdensome, and stated that it would delay the operative date by six months from the date of commission approval, in order to allow firms to implement its proposed rule.[123] In response to specific concerns regarding the burden of implementing the proposed exclusion from the definition of Pattern Day Trader for customers whose day trades represent six percent or less of their total trades, the NYSE stated that the exclusion is not mandatory, *i.e.*, members may choose not to exclude such investors from the operation of the NYSE's proposed rules.[124] With regard to the same concern, the NASD responded that its staff consulted with members of the Rule 431 Committee who advised that programming and monitoring the exception would not be overly burdensome.[125]

IV. Discussion of the NYSE and NASD Proposed Rule Changes

Day trading generally refers to a kind of trading system involving frequent, rapid-fire purchase and sale transactions (or sale and purchase transactions) in securities in a single day. Day trading transactions are often effected by persons who typically have computerized links to market centers and who attempt to capture small differences in stock prices.[126] As day trading activity increased, so did media attention and public concern over the risks inherent in day trading.[127] Given the potential for significant losses to those persons who engage in day trading activities, legislators and regulators have scrutinized the practice and have taken steps to protect investors and limit financial risks to investors, broker-dealers, and securities markets.

For example, from October 1998 through September 1999, the Commission's Office of Compliance Inspections Examinations ("OCIE") examined 47 registered broker-dealers that were providing day trading facilities to the general public. In February 2000, OCIE issues a report of its findings and recommendations, addressing risk disclosure, net capital compliance, lending arrangements, supervisory infrastructure, and other issues associated with day trading.[128]

In addition, the Senate Subcommittee held hearings on day trading that focused on investor suitability, the use of margin, advertising, and profitability.[129] Moreover, various SROs filed, and the Commission approved, other rule proposals regulating day trading practices.[130] The NYSE and NASD rule proposals relating to margin requirements for day traders represent further regulatory responses to issues raised by day trading.

The rule proposals submitted by the NYSE and NASD were the result of collaborative efforts by these SROs, through the Rule 431 Committee—comprised of NYSE and NASD staff, attorneys from the NYSE's outside counsel, staff of the Board of Governors of the Federal Reserve, and representatives from several broker-dealers and clearing firms—to develop special margin rules that better reflect the risks inherent in day trading. Because initial margin requirements under Regulation T and standard maintenance margin requirements under current NYSE and NASD rules are calculated only at the end of the day incurred, a day trader with no

[113] *See, e.g.*, Momentum Letter.

[114] Momentum Letter. *See also* Task Force Letter.

[115] NYSE Response to comments.

[116] NASD Response to Comments.

[117] NASAA Letter.

[118] Senate Subcommittee Letter.

[119] *See, e.g.*, SIA General Counsel Letter.

[120] SIA Brokerage and Technology Committees Letter.

[121] Task Force Letter.

[122] Datek Letter (referring to Task Force recommendations).

[123] NYSE Response to Comments. January 23, 2001 Call with NYSE Staff (confirming operative date of proposed rule change).

[124] NYSE Response to Comments.

[125] NASD Response to Comments.

[126] A day trading strategy is "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." Senate Subcommittee Letter (Citing definition in proposed NASD Rule 2360(e)).

[127] *See, e.g.*, "State Securities Regulators Investigate Practices of Securities Firms as Part of a Broad-Based Inquiry Into Day Trading," *The Wall Street Journal*, Sec. C., pp. 1, col. 6, August 25, 1999; "Critical Report by North American Securities Administrators Association," *The Wall Street Journal*, Sec. A, pp. 26, col. 1; "Senators Lambaste Actions by Day Traders," *USA Today*, Sec. B, pp. 2, February 25, 2000; "Day Trading: A Study in Temptation; Senate Panel to Investigate Risk Disclosure," *The Washington Post*, February 24, 2000, Sec. E., pp. 1.

[128] OCIE Report.

[129] Day Trading: An Overview: Hearing Before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, 106th Cong., 1st Sess. 106–285 (1999). The Senate Subcommittee also reviewed and provided recommendations concerning the NYSE and NASD rule proposals on the use of margin. Senate Subcommittee Letter.

[130] *See e.g.*, Securities Exchange Act Release No. 43021 (July 10, 2000), 65 FR 44082 (July 17, 2000) (File No. SR–NASD–99–41) (approving new rules pertaining to the opening of day trading accounts and delivery of a risk disclosure statement).

outstanding positions, including losses, in his or her account at the end of the day currently incurs neither an initial margin nor a maintenance margin requirement. Although current NYSE and NASD special maintenance margin requirements apply to day traders, those requirements do not adequately address the potential financial risks posed by day trading, and may have encouraged practices, such as the use of Cross-Guarantees, that do not require customers to demonstrate actual financial ability to engage in day trading.

The Commission has reviewed the NYSE and NASD proposed rule changes, and has considered carefully the comment letters submitted in response to these proposals, as well as the NYSE and NASD responses to the comment letters, and finds that the proposed rule changes are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and national securities association, respectively. The Commission finds that the NYSE proposal is consistent with section 6(b)(5) of Act,[131] which requires the rules of a national securities exchange to be designed to prevent fraudulent and manipulative act and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. Section 15A(b)(6) of the Act[132] imposes the same requirement on a national securities association. The Commission also finds that the NASD proposal is consistent with section 15A(b)(6) of the Act.

In addition, the Act specifically grants to SROs the authority to establish and enforce standards of financial responsibility among their members. Section 6(c)(3)(A) of the Act[133] provides, among other things, for a national securities exchange to deny or condition membership privileges on compliance with the exchange's own financial responsibility rules. Section 15A(g)(3)(A) of the Act[134] grants the same authority to national securities association. Pursuant to this authority, the SROs are authorized to promulgate rules governing the financial responsibility requirements of their members. The Commission finds that the NYSE proposal is consistent with goals of section 15a(g)(3)(A) of the Act and the NASD proposal is consistent with the goals of section 15A(g)(3)(A) of the Act.

The Commission finds that the NYSE and NASD proposals are designed to protect Pattern Day Traders, the firms where those traders have their accounts, and the markets on which they trade. The intra-day risk of substantial losses to both the customer and the firm increases in day trading accounts that do not have sufficient equity capital. Moreover, customers' and firms' reliance on cross-guarantees among customer accounts to meet margin requirements exacerbate these risks. These potential losses can be magnified if a sudden and substantial adverse movement were to occur in the prices of securities popular among day traders or in the markets as a whole. In the Commission's view, the integrity of U.S. financial markets will be better protected through appropriate margin and similar requirements on customers who engage in day trading practices.

The proposed NYSE and NASD rules are not designed to prevent day trading, but to reduce the risk of financial losses by Pattern Day Traders and their firms. For example, by increasing the minimum equity requirement for Pattern Day Trades, the proposed rule help ensure that day traders have an appropriate amount of equity for the potential losses that may be incurred through day trading. Finally, the Commission finds that overall market integrity is increased by rules, such as those here proposed by the NYSE and NASD, that are designed to reduce excessive and unnecessary risk of financial loss to market participants.

The Commission finds that the proposed definition of Pattern Day Trader takes a reasonable approach to specifying the type of trading activity for which the use of margin should be further regulated. In particular, the definition focuses on day trading behavior, while providing an exception for accounts where the number of day trades executed represents only a small percentage of all trading activity. The Commission finds that it is reasonable for the NYSE and NASD to use objective standards to identify and regulate accounts that may be at greatest risk as a result of day trading.

The Commission also finds that the proposed Day Trading Minimum Equity Requirements strikes a balance between, and responds to, the diverging concerns of the various commenters on this issue. While there was a range of views regarding the dollar amount of equity that should be required in connection with day trading, the Commission finds that the proposed rule changes are designed to accomplish the objective of assuring the financial well-being of broker-dealers, which in turn promotes the integrity of the securities markets.

Regarding the imposition of Day Trading Margin calls on Pattern Day Traders, the Commission notes that the proposed rules would impose relatively larger margin calls for accounts that have already generated but not yet satisfied a Day Trading Margin call. In those accounts, Day Trading Buying Power would be limited to a 2:1 ratio for leverage and Day Trading Margin would be calculated based on the aggregate cost of all day trades that occurred in a single day. The Commission finds that provisions would reduce Day Trading Buying Power, and those that would produce relatively larger Day Trading Margin calls for accounts already under restrictions, are in keeping with the NYSE and NASD's stated objectives of reducing risk by encouraging Pattern Day Traders to assume increased financial responsibility for their trading activities.[135]

The Commission also finds that the proposed rule changes take reasonable steps to require investors who day trade to assume a greater obligation for the intra-day financial risks associated with Pattern Day Trading. The Commission observes, for example, that the use of Cross-Guarantees in the calculation of Day Trading Margin calls could dilute the impact of proposed provisions designed to encourage greater independent financial responsibility. The Commission finds that this approach is consistent with Regulation T, which does not permit initial margin requirements to be met through the use of a guarantee for a customer's account.[136]

Finally, the Commission recognizes the concerns of commenters regarding the burden on securities firms of implementing the proposed rules. The Commission understands that practical implementation of the proposed rules may require systems changes by firms. However, the Commission finds that, by the NYSE and NASD delaying the operative dates of the proposed rule changes for six months, there should be sufficient time for securities firms to institute measures for monitoring and enforcing the new rules and to bring any interpretive issues to the attention of the NYSE or NASD.

The Commission finds good cause for approving Amendment No. 1 to the NYSE proposal and Amendment No. 1 to the NASD proposal prior to the

[131] 15 U.S.C. 78f(b)(5).

[132] 15 U.S.C. 78o–3(b)(6).

[133] 15 U.S.C. 78f(c)(3)(A).

[134] 15 U.S.C. 78o–3(g)(3)(A).

[135] For further discussion of Cross-Guarantees, *see*, Section II, *supra*, Description of the Proposed Rule Charges.

[136] 12 CFR 220.3(d).

thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 1 to the NYSE proposal ensures that the NYSE and NASD approaches to the regulation of day trading margin rules are consistent so that they can be applied and interpreted uniformly. Amendment No. 1 to the NASD's rule proposal also ensures that the NASD's and NYSE's approaches to the regulation of day trading are consistent and provides for additional time for firms to implement its proposed rule change. For these reasons, the Commission finds good cause for accelerating approval of both amendments.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the Amendment No. 1 to each proposed rule change, including whether they are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule changes between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section. Copies of Amendment No. 1 to the NYSE proposed rule change will also be available for inspection and copying at the principal office of the NYSE. Copies of Amendment No. 1 to NASD proposed rule change will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File Nos. SR–NYSE–99–47 or SR–NASD–00–03 and should be submitted by March 27, 2001.

VI. Conclusion

It is Therefore Ordered, pursuant to section 19(b)(2) of the Act,[137] that the proposals SR–NYSE–99–47 and SR–NASD–00–03 as amended, be and hereby are approved.[138]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 01–5402 Filed 3–5–01; 8:45 am]

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[137] 15 U.S.C. 78s(b)(2).

[138] In approving the proposals, the Commission has considered their impact on efficiency, competition, and capital formation.

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–44010; File No. SR–PCX–00–37]

Self-Regulatory Organizations; the Pacific Exchange, Inc.; Order Granting Approval to Proposed Rule Change to Increase Fines for Violations of Exchange Rules Under the Exchange's Minor Rule Plan

February 27, 2001.

I. Introduction

On December 11, 2000, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b–4 thereunder,[2] a proposed rule change to increase fines for members, floor brokers and market makers for violating Exchange rules under the Minor Rule Plan. The Exchange amended the proposal on January 8, 2001.[3] The proposed rule change was published for comment in the **Federal Register** on January 23, 2001.[4] The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

II. Description of the Proposal

The Exchange proposes to amend PCX Rule 10.13(k) governing Minor Rule Plan violations to increase most of the fines. The PCX believes the current average Minor Rule Plan fine of $250 is too low to deter violations of PCX rules. The Exchange believes that an increase in fines will more adequately sanction violations of the PCX's order handling and investigating rules, many of which are processed under the Minor Rule Plan.

Most PCX Minor Rule Plan violations currently specify a fine of $250 for a first violation, $500 for a second, and $750 for a third. Multiple violations are calculated on a two-year basis. Under the proposed increases, most fines will be $1,000 for a first violation, $2,500 for a second and $3,500 for a third,[5] calculated on the same two-year basis. Some violations, such as disruptive conduct or abusive language on the options floor, will be $500 for a first violation, $2,000 for a second, and $3,500 for a third.

Other violations, such as a member's failure to cooperate with a PCX examination of its financial responsibility or operational condition, will be fined $2,000 for a first violation, $4,000 for a second, and $5,000 for a third. A member that impedes or fails to cooperate in an Exchange investigation will be fined $3,500 for a first violation, $4,000 for a second, and $5,000 for a third. Less serious violations, such as fines for improper dress under the PCX dress code, remain unchanged at $100 for the first violation, $200 for the second, and $500 for the third.

Under the proposal, the Enforcement Department would continue to exercise its discretion under PCX Rule 10.13(f) and take cases out of the Minor Rule Plan to pursue them as formal disciplinary matters if the facts or circumstances warrant such action.

III. Discussion

The Commission has reviewed carefully the PCX's proposed rule change and finds, for the reasons set forth below, that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange,[6] and with the requirements of section 6(b).[7] In particular, the Commission finds the proposal is consistent with section 6(b)(5)[8] of the Act in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* January 5, 2001 letter from Cindy L. Sink, Senior Attorney, Regulatory Policy, PCX to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), SEC and attachments ("Amendment No. 1"). In response to a request from the Division, the PCX converted the proposal from effective upon filing pursuant to section 19(b)(3)(A) of the Act, to being considered pursuant to Section 19(b)(2) in Amendment No. 1. 15 U.S.C. 78s(b)(3)(A). 15 U.S.C. 78s(b)(2).

[4] Securities Exchange Act Release No. 43846 (January 16, 2001). 66 FR 7526.

[5] The Commission notes that when the PCX imposes a sanction in excess of $2,500, it must comply with Rule 19d–1 under the Act. 17 CFR 240.19d–1.

[6] In approving this rule, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[7] 15 U.S.C. 78f(b).

[8] 15 U.S.C. 78f(b)(5).