INFORMATIONAL

Margin Disclosure

SEC Approves NASD Rule Proposal Requiring Delivery Of Margin Disclosure Statement To Non-Institutional Customers

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KEY TOPICS

- Customer Disclosures
- Margin

Executive Summary

On April 26, 2001, the Securities and Exchange Commission (SEC) approved National Association of Securities Dealers, Inc. (NASD®) Rule 2341, which requires all NASD members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin (the "rule change").[1] The rule change requires that the margin disclosure statement be provided to margin customers in a separate document prior to or at the opening of a margin account. The rule change also requires that the margin disclosure statement or an abbreviated version of the disclosure statement be provided to margin customers on an annual basis, either in a separate document or as part of other account documentation. Members are permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated statement and incorporates all of the relevant concepts.

The text of the rule change is provided in Attachment A. Sample initial and annual margin disclosure statements are provided in Attachments B and C, respectively. The rule change becomes effective on **June 4, 2001**. Members are required to provide the initial disclosure statement to existing margin customers at the time of the next annual statement to the customer, but no later than **November 30, 2001**.

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 Susan DeMando, Director, Financial Operations, Member Regulation, NASD Regulation, at (202) 728-8411.

Background

The growth in the level of customer margin account balances, coupled with the increase in customer inquiries and complaints to NASD Regulation and the SEC relating to the handling of margin accounts, has raised concerns as to whether investors understand the operation and risks associated with margin trading. NASD Regulation staff believes that investors' misconceptions about margin requirements, particularly with respect to maintenance margin, may cause investors to underestimate the risks of margin trading and to misunderstand the operation of and reasons for margin calls. Investors who cannot satisfy margin calls have had substantial portions of their accounts liquidated to satisfy these margin calls. Such liquidations can create realized losses for these customers that may far exceed the risk of loss they would have faced if they had not traded on margin.

A report issued last year by the General Accounting Office (GAO) noted that the SEC has determined from the customer complaints it has received that many investors who traded online did not understand margin requirements.[2] The lack of disclosure relating to when firms would sell securities in a margin account to cover margin loans was among the leading margin-related complaints that the SEC received.

The GAO Report also collected and summarized information from 12 online broker/dealers.[3] All of the

online firms contacted did provide their customers the limited information currently required on margin trading.[4] Some firms also provided additional information relating to margin, such as requirements for account opening, procedures for selling securities to cover account losses, or special requirements for volatile stocks. However, nearly half of the firms contacted automatically[5] opened margin accounts for new customers without providing the customer information relating to the risks associated with margin trading. At three firms that automatically opened margin accounts, customers would find out about their account type only if they read and understood their account agreements, which SEC staff indicated were written in legal language and might be difficult for investors to understand. Three of the 12 online broker/dealers contacted did take "extra measures" to ensure that their customers understood that stocks could be sold to cover outstanding loans in a margin account. These firms included information on their Web sites that explained that accounts could be liquidated in fast-moving markets before the customary period.

The GAO Report concluded that better investor protection information, including information relating to margin requirements, was needed on Web sites of some online broker/dealers. In this regard, the GAO Report recommended that the SEC ensure that broker/dealers with online trading systems include accurate and complete information on their Web sites regarding, among other things, margin requirements.

Description Of Rule Change

Although NASD Regulation recognizes that some members are providing disclosures to customers relating to margin, the content of these disclosures is not consistent from firm to firm and may not always be in a form that is understandable to investors. As such, the rule change requires members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin.[6] The rule change also requires members to deliver the disclosure statement or an abbreviated version of the disclosure statement annually to all non-institutional customers with margin accounts.

A sample initial margin disclosure statement and an abbreviated version of the disclosure statement for use in meeting the annual delivery requirement are provided in Attachments B and C, respectively. Members are permitted to develop alternative margin disclosure statements to meet these requirements, provided that the alternative disclosure statements are substantially similar to the mandated initial or annual statements and incorporate all of the relevant concepts.

Members are required to deliver the initial and annual disclosure statement, in writing or electronically, to customers on an individual basis.[7] The initial disclosure at or prior to the opening of the account must be made in a separate document, even if a member chooses to deliver the disclosures as part of or within the margin agreement or other opening account documentation. However, with respect to the annual disclosure requirement, members are permitted to provide the disclosures within other documentation, such as the account statement.

Both the clearing firm and the introducing firm are responsible for ensuring that the customer receives the required disclosures under new Rule 2341. However, pursuant to NASD Rule 3230, the clearing firm and introducing firm may specify, as part of the clearing agreement, which party is responsible for delivery of the initial and annual disclosure statements to the customer.

Endnotes

1 *See* Securities Exchange Act Release No. 44223 (April 26, 2001), 66 FR 22274 (May 3, 2001) (File No. SR-NASD-00-55). The requirements described herein apply to ***all NASD members***, regardless of the member's designated examining authority (DEA) for margin purposes.

2 *See On-Line Trading, Better Investor Protection Information Needed*, Report to Congressional Requesters, GAO, General Government Division, 00-43 (May 2000) (the "GAO Report"). According to the GAO Report, between January 1998 and June 1999, 140 margin-related complaints concerning online trading firms were submitted to the SEC.

3 These firms represented less than 10 percent of the total estimated number of firms that offer online trading. However, they accounted for approximately 90 percent of the online *trading volume* during early 1999.

4 Rule 10b-16 of the Securities Exchange Act of 1934 ("SEC Rule 10b-16") requires that broker/dealers that extend credit to customers to finance securities transactions furnish, in writing, specified information regarding the terms of the loan. These disclosures must be made on both an initial and periodic basis. For instance, at the time a customer opens a margin account, a broker/dealer must provide the customer with a written statement disclosing, among other things, the annual rate of interest, the method of computing interest, and what other credit charges may be imposed.

5 Those firms that provided clear indications of the type of account to be opened offered their customers the option on the Web site to choose either a cash or margin account, or both. However, those firms that automatically opened margin accounts only offered new customers a choice with respect to account ownership, such as joint or individual account.

6 The term "non-institutional customer" is defined in the rule change as a customer that does not qualify as an "institutional account" under NASD Rule 3110(c)(4). Rule 3110(c)(4) defines "institutional account" as the account of: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing similar functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

7 Members are required to deliver the disclosure statement to each customer individually. For example, a member firm posting the disclosure statement on its Web site would not fulfill the delivery requirements, although such supplemental disclosure would be beneficial to investors.

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ATTACHMENT A – RULE TEXT

Rule 2341. Margin Disclosure Statement

(a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a non-institutional customer, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in writing or electronically, and in a separate document, the following margin disclosure statement:

Your brokerage firm is furnishing this document to you to provide some basic facts about purchasing securities on margin, and to alert you to the risks involved with trading securities in a margin account. Before trading stocks in a margin account, you should carefully review the margin agreement provided by your firm. Consult your firm regarding any questions or concerns you may have with your margin accounts.

When you purchase securities, you may pay for the securities in full or you may borrow part of the purchase price from your brokerage firm. If you choose to borrow funds from your firm, you will open a margin account with the firm. The securities purchased are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities or other assets in any of your accounts held with the member, in order to maintain the required equity in the account.

It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- **You can lose more funds than you deposit in the margin account.** A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities or assets in your account(s).
- **The firm can force the sale of securities or other assets in your account(s).** If the equity in your account falls below the maintenance margin requirements or the firm's higher "house" requirements, the firm can sell the securities or other assets in any of your accounts held at the firm to cover the margin deficiency. You also will be responsible for any short fall in the account after such a sale.
- **The firm can sell your securities or other assets without contacting you.** Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities or other assets in their accounts to meet the call unless the firm has contacted them first. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without notice to the customer.
- **You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.** Because the securities are collateral for the margin loan, the firm has the right to decide which security to sell in order to protect its interests.
- **The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.** These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause the member to liquidate or sell securities in your account(s).

- **<u>You are not entitled to an extension of time on a margin call.</u>** While an extension of time to meet margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension.

(b) Members shall, with a frequency of not less than once a calendar year, deliver individually, in writing or electronically, the disclosure statement described in paragraph (a) or the following bolded disclosures to all non-institutional customers with margin accounts:

Securities purchased on margin are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities or other assets in any of your accounts held with the member, in order to maintain the required equity in the account. It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- **You can lose more funds than you deposit in the margin account.**
- **The firm can force the sale of securities or other assets in your account(s).**
- **The firm can sell your securities or other assets without contacting you.**
- **You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.**
- **The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.**
- **You are not entitled to an extension of time on a margin call.**

The annual disclosure statement required pursuant to this paragraph may be delivered within or as part of other account documentation, and is not required to be provided in a separate document.

(c) In lieu of providing the disclosures specified in paragraphs (a) and (b), a member may provide to the customer an alternative disclosure statement, provided that the alternative disclosures shall be substantially similar to the disclosures specified in paragraphs (a) and (b).

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

ATTACHMENT B – SAMPLE INITIAL MARGIN DISCLOSURE STATEMENT

Your brokerage firm is furnishing this document to you to provide some basic facts about purchasing securities on margin, and to alert you to the risks involved with trading securities in a margin account. Before trading stocks in a margin account, you should carefully review the margin agreement provided by your firm. Consult your firm regarding any questions or concerns you may have with your margin accounts.

When you purchase securities, you may pay for the securities in full or you may borrow part of the purchase price from your brokerage firm. If you choose to borrow funds from your firm, you will open a margin account with the firm. The securities purchased are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities or other assets in any of your accounts held with the member, in order to maintain the required equity in the account.

It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- **You can lose more funds than you deposit in the margin account.** A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities or assets in your account(s).
- **The firm can force the sale of securities or other assets in your account(s).** If the equity in your account falls below the maintenance margin requirements or the firm's higher "house" requirements, the firm can sell the securities or other assets in any of your accounts held at the firm to cover the margin deficiency. You also will be responsible for any short fall in the account after such a sale.
- **The firm can sell your securities or other assets without contacting you.** Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities or other assets in their accounts to meet the call unless the firm has contacted them first. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without notice to the customer.
- **You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.** Because the securities are collateral for the margin loan, the firm has the right to decide which security to sell in order to protect its interests.
- **The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.** These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause the member to liquidate or sell securities in your account(s).
- **You are not entitled to an extension of time on a margin call.** While an extension of time to meet margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension.

ATTACHMENT C – SAMPLE ANNUAL DISCLOSURE STATEMENT

Securities purchased on margin are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities or other assets in any of your accounts held with the member, in order to maintain the required equity in the account. It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- **You can lose more funds than you deposit in the margin account.**
- **The firm can force the sale of securities or other assets in your account(s).**
- **The firm can sell your securities or other assets without contacting you.**
- **You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.**
- **The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.**
- **You are not entitled to an extension of time on a margin call.**