# Special NASD Notice to Members 99-33

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

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- □ Continuing Education
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- ■ Executive Representatives
- □ Government Securities
- □ Institutional
- □ Insurance
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- □ Municipal
- □ Mutual Fund
- ■ Operations
- □ Options
- ■ Registered Representatives
- □ Registration
- □ Research
- □ Syndicate
- □ Systems
- ■ Trading
- □ Training
- □ Variable Contracts


## Executive Summary

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

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

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


## Discussion

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

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

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

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

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

## Current Margin Requirements

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

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

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

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

## Increased Maintenance Margin

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

## Identifying Stocks For Increased Maintenance Margin

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

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

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

## Disclosure Of Credit Terms To Customers

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

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

## Request For Comment

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

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

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

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

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

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

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

Comments should be mailed to:

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

or e-mailed to:
*pubcom@nasd.com*

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

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

## Endnotes

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

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

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

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

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

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

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

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

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

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



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