

March 27, 2001

Mr. Jack Drogin
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-00-55, Delivery of a Margin Disclosure Statement to Non-Institutional Customers; Amendment No. 2 and Response to Comments

Dear Mr. Drogin:

NASD Regulation, Inc. (“NASD Regulation”) hereby responds to the comment letters received by the Securities and Exchange Commission (“Commission” or “SEC”) in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-00-55.¹ In addition, NASD Regulation hereby submits Amendment No. 2 to SR-NASD-00-55. The proposed rule language provided in Attachment A amends the proposed rule language previously filed with the Commission in Amendment No. 1 to SR-NASD-00-55 on September 25, 2000.

The proposed rule change in SR-NASD-00-55 would require members to deliver to non-institutional customers, prior to or at the opening of a margin account, a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin. The proposed rule change also would require members to deliver the disclosure statement to all non-institutional customers with margin accounts on an annual basis.

The Commission received eight comment letters in response to the *Federal Register* publication of SR-NASD-00-55.² The comments submitted to the Commission are summarized by issue below.

¹ Securities Exchange Act Release No. 43441, File No. SR-NASD-00-55 (October 12, 2000), 65 Fed. Reg. 63275 (October 23, 2000). The public comment period announced in the *Federal Register* expired on November 13, 2000.

² Comment letters were submitted by the following: Singer Frumento, LLP (“Singer”); Securities Industry Association (“SIA”), Self-Regulation and Supervisory Practices Committee (“SIA Self-Regulation Committee”); Edward D. Jones & Co., Inc. (“Edward Jones”); The Credit Division of the SIA (“SIA Credit Division”); John Jay Legal Services, Inc. (“John Jay”); Charles Schwab and Co., Inc. (“Charles Schwab”); A.G. Edwards & Sons, Inc. (“A.G. Edwards”); and Merrill, Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch”).

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Margin Disclosure Statement

Several commenters stated that the proposal needs to be more flexible and that a “one-size-fits-all” disclosure statement on margin trading is not appropriate for all firms.³ Commenters indicated that firms should be permitted to develop a method of disclosure that is best suited to their individual business as long as they provide the specific disclosure information recommended in the proposal.

NASD Regulation generally agrees with the commenters in this regard, and the proposal includes language to that effect. Specifically, paragraph (d) of proposed Rule 2341 provides that, in lieu of providing the margin disclosure statement specified in the proposed rule, a member may provide to the customer an alternative disclosure statement, provided that the alternative disclosure statement is substantially similar to the disclosure statement specified in the proposed rule.

One commenter indicated that the proposal should be directed only at customers who trade on-line, and not those being assisted by a registered representative.⁴ The commenter stated that the proposed rule should address more directly the concerns of a recent General Accounting Office (“GAO”) report⁵ that determined that on-line traders do not understand margin requirements. The commenter suggested that the disclosure statements would best serve on-line customers who do not have accounts with full-service firms that can provide appropriate education on margin trading.

Although customer accounts of on-line brokerage firms were the focus of the GAO report, margin-related complaints received by NASD Regulation and the Commission have originated from customers of both on-line and full-service firms. Accordingly, NASD Regulation believes that the misconceptions about the operation of a margin account and margin requirements are not limited to those investors who trade on-line, and that all investors would benefit significantly from the information provided in the proposed margin disclosure document.

Separate Document

Several commenters opposed the requirement that the margin disclosure be made in a separate disclosure document, stating that such a requirement is unnecessary, duplicative, and economically burdensome.⁶ These commenters also indicated that presenting the disclosure statement in a separate

³ See comment letters from Singer, SIA Self-Regulation Committee, Merrill Lynch and SIA Credit Division.

⁴ See comment letter from Merrill Lynch.

⁵ See *On-Line Trading, Better Investor Protection Information Needed*, Report to Congressional Requesters, GAO, General Government Division, 00-43 (May 2000).

⁶ See comment letters from SIA Self-Regulation Committee, Merrill Lynch and A.G. Edwards.

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document could confuse customers by giving them the impression that it is more important than other disclosure requirements not presented in the same format, or by leading customers to believe it amends or voids their original agreements. In this regard, certain commenters indicated that such mistaken beliefs by customers could lead to costly legal challenges for firms.

NASD Regulation believes that the initial delivery of the margin disclosure statement should be made in a separate document. In requiring a separate document, NASD Regulation was concerned that the proposed disclosures may be hidden within other documentation and possibly overlooked by customers. With respect to the comment that a separate document may confuse customers, members would be permitted to provide additional statements necessary to clarify the purpose of the disclosure document, including that the disclosures do not change or supersede the margin agreement in any way. In addition, with respect to the annual delivery requirement, the proposed rule does permit members to provide the disclosure statement within or as part of other documentation, such as the customer account statement.

One commenter, while supporting the proposed margin disclosure requirement, also indicated that customers should be educated about margin trading by their firms, and firm employees should be readily available to customers via dedicated telephone numbers and e-mail addresses posted on the firms' Internet sites.⁷ This commenter suggests that when communication fails, customers should document attempts to contact firms, and firms should be held liable for margin-related damages. As a general matter, NASD Regulation agrees that members should be prepared to answer customer questions relating to margin, and the proposed margin disclosure statement is not intended to replace members' responsibilities to respond to customer inquiries.

Annual Delivery

Several commenters oppose the proposed requirement that the disclosure statement be delivered annually. Commenters indicated that it would present an undue burden and expense for firms and would be excessive, redundant and counter-productive in light of the amount of documentation and disclosure statements already sent to customers.⁸ One commenter stated that his firm already receives numerous complaints from its customers about the amount of paperwork being mailed to them.⁹ Another commenter was concerned that repeated statements about the risks of margin trading would undermine legitimate products associated with central asset accounts.¹⁰

⁷ See comment letter from Singer.

⁸ See comment letters from Charles Schwab, SIA Credit Division and A.G. Edwards.

⁹ See comment letter from Merrill Lynch.

¹⁰ See comment letter from SIA Credit Division.

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NASD Regulation continues to believe that providing customers with information about the operation of margin accounts at account opening and annually thereafter will be of significant value to customers in understanding the operation of a margin account. However, given that the full margin disclosure statement would be provided to customers at account opening, NASD Regulation believes that providing an abbreviated version of the disclosures would be appropriate for the annual disclosure requirement. Accordingly, NASD Regulation is amending the rule to permit members, at their option, to provide an abbreviated version of the disclosures to comply with the annual disclosure requirement (See amendments to proposed Rule 2341(b) in Attachment A), provided that, at a minimum, the following language (or substantially similar language) is included in bold in the annual disclosure:

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.**

Timing of Account Opening Delivery Requirement

One commenter indicated that the proposal needs to better clarify when the initial disclosure statement should be delivered.¹¹ According to the commenter, the proposal directs that the initial disclosure statement be delivered when the margin account is opened; however, the proposal does not indicate what constitutes the opening of the account. The commenter questioned whether an account would be considered opened when the customer loan agreement is signed or when a loan is extended to the customer by the firm on margin. Another commenter requested clarification on whether "Personal

¹¹ See comment letter from Edward Jones.

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Line of Credit” accounts would invoke the proposed margin disclosure requirements.¹² To address these comments, NASD Regulation is clarifying that, under the proposal, the margin disclosure statement is required to be sent at the time a margin account is opened, irrespective of whether a margin loan is extended. If a “Personal Line of Credit” account is treated by the member as an extension of credit via a margin account, the proposed disclosure requirement would apply.

Other Comments

One commenter indicated that the proposed delivery of the disclosure statement, “in writing or electronically,” is confusing and suggests that the proposed rule confuses format with delivery.¹³ To clarify, the proposed disclosure statement may be sent “in writing” meaning, delivered to the customer in a hard copy, paper format. The proposed disclosure statement also may be delivered “electronically,” meaning via an electronic delivery system (internet, e-mail, etc.), provided that it is sent individually to the customer by such means.

Another commenter indicated that the proposed margin disclosure statement should be clarified to state that any asset held by the customer, not just securities, can be liquidated.¹⁴ The commenter believed that this clarification would be an important piece of information for the customer to understand. In addition, the commenter indicated that certain crucial language on the statement should be boldface for better emphasis, and that disclosures using industry jargon, such as “equity,” “house requirements” and “maintenance margin,” should be avoided.

The staff agrees that a clarification that *any asset* held by the firm on behalf of the customer, not just securities, can be liquidated, is appropriate to include in the proposed disclosure statement. Accordingly, the attached proposed rule language has been amended such that the language of the proposed margin disclosure statement indicates, as appropriate, that the firm can liquidate securities or other assets held in the customer’s accounts. With respect to the comment regarding the use of industry jargon, the staff does not believe that the use of those terms is confusing within the context of the overall statement and has endeavored to use a minimal amount of industry jargon in the proposed margin disclosure statement.

Finally, one commenter stated that each customer should be required to sign the disclosure statement to acknowledge receipt and understanding of it. NASD Regulation believes that such a requirement would be overly burdensome for members to comply with, and would not significantly increase the informational value to the customer of the margin disclosure statement.

¹² See comment letter from Edward Jones.

¹³ See comment letter from Merrill Lynch.

¹⁴ See comment letter from John Jay.

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Clarifying Change to Rule Language

NASD Regulation is amending proposed Rule 2341(a) to clarify that the initial margin disclosure document must be delivered in a separate document. The separate document requirement was described in the NASD Regulation's Statement of Purpose in SR-NASD-00-55; however, the proposed rule language is amended to clarify this requirement as follows:

(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:

* * *

If you have any questions, please feel free to contact Stephanie Dumont, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Very truly yours,

Jeffrey S. Holik
Vice President and
Acting General Counsel

Attachment

Attachment A

**Proposed Rule Language, as amended by
Amendment No. 2 to SR-NASD-00-55**

Proposed additions to the rule language by Amendment No. 2 are underlined (or *italicized* where the text is underlined as part of the proposed rule); proposed deletions are in brackets.

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).
- **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.

(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.**

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