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]

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[6] 17 CFR 200.30–3(a)(12).

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

[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.

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.

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

[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).

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

[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]
BILLING CODE 6717–01–M

[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).