

**INFORMATIONAL**

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**Margin**

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**NASD Regulation Files Rule Proposal With SEC Requiring Delivery Of Margin Disclosure Statement To Customers****SUGGESTED ROUTING**

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

- Executive Representatives
- Legal & Compliance
- Operations
- Senior Management

**KEY TOPICS**

- Customer Disclosures
- Margin

**Executive Summary**

On September 5, 2000, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) filed with the Securities and Exchange Commission (SEC) a rule proposal that would require members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin. Members would be permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated statement and incorporates all of the relevant concepts. The rule proposal would require that the disclosure statement be provided to customers prior to or at the opening of a margin account and to all margin customers on an annual basis. As proposed, members would be required to provide the disclosure statement to existing margin customers at the time of the next annual statement to the customer, but not to exceed 180 days from the effective date of the rule change. (See SR-NASD-00-55). A copy of this rule filing can be found at the NASDR Web Site (See [www.nasdr.com/filings/rf00\\_55.htm](http://www.nasdr.com/filings/rf00_55.htm)).

The SEC will publish the proposed rule change in the *Federal Register*, indicating a time period during which members and other interested parties may comment. When SEC publication has taken place, NASD Regulation will notify members of the comment period in the NASD Regulation executive representative weekly e-mail broadcast. Those interested in commenting on the proposed rule change should submit comments directly to the SEC prior to the close of the comment period indicated in the *Federal Register* release. Before becoming effective, the proposed rule change must be approved by the SEC. Members,

however, should consider providing the margin disclosure statement described in this *Notice* to customers on a voluntary basis prior to SEC action on the proposed requirements.

Attachment A provides a sample disclosure statement.

**Questions/Further Information**

Questions concerning this proposal may be directed to Stephanie M. Dumont, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

**Background**

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

In this regard, a recent report issued by the General Accounting Office (GAO) noted that the SEC has determined from the customer complaints it has received that

many investors who traded online did not understand margin requirements.<sup>1</sup> The lack of disclosures relating to when firms would sell securities in a margin account to cover margin loans was among the leading margin-related complaints that the SEC received.

The GAO Report also collected and summarized information from 12 online broker/dealers.<sup>2</sup> All of the online firms contacted did provide their customers the limited information currently required on margin trading.<sup>3</sup> Some firms also provided additional information relating to margin, such as requirements for account opening, procedures for selling securities to cover account losses, or special requirements for volatile stocks. However, nearly half of the firms contacted automatically<sup>4</sup> opened margin accounts for new customers without providing the customer with information relating to the risks associated with margin trading. At three firms that automatically opened margin accounts, customers would find out about their account type only if they read and understood their account agreements, which SEC staff indicated were written in legal language and may be difficult for investors to understand. Three of the 12 online broker/dealers contacted did take “extra measures” to ensure that their customers understood that stocks could be sold to cover outstanding loans in a margin account. These firms included information on their Web sites that explained that accounts could be liquidated in fast-moving markets before the customary period.

The GAO Report concluded that better investor protection information, including information relating to margin requirements, was needed on Web sites of some

online broker/dealers. In this regard, the GAO Report recommended that the SEC ensure that broker/dealers with online trading systems include accurate and complete information on their Web sites regarding, among other things, margin requirements.

### **Specific Areas Of Concern**

Based on customer complaints and inquiries it has received, NASD Regulation staff identified several areas associated with margin trading that may have generated confusion and misunderstanding between customers and members. These include:

#### ***Margin Calls – Notification***

Some investors hold the mistaken belief that their broker/dealer must contact them for a margin call to be valid, and that their broker/dealer cannot liquidate securities in their account to meet the call unless a specified number of days have passed and/or the broker/dealer has contacted the customer. There are no such restrictions in Regulation T or National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 2520. Moreover, securities that have been purchased on margin by a customer are collateral for the margin loan and are, therefore, subject to the security claim of the broker/dealer until they are fully paid. Thus, if a broker/dealer believes that the collateral for the margin loan is at risk, the broker/dealer is entitled to take any steps necessary to protect its financial interests, including immediate liquidation without notice to the customer. Some broker/dealers will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a broker/dealer has contacted a customer and provided a specific date by which

the customer can meet a margin call, the broker/dealer can still take necessary steps to protect its financial interests, including immediate liquidation, without further notice to the customer.

#### ***Extensions Of Time On Margin Calls***

Some investors believe they are automatically entitled to an extension of time to meet margin calls. While an extension of time to meet *initial* margin requirements may be available to the customer under certain conditions, it is only granted if the clearing firm chooses to request an extension from its Designated Examining Authority; the customer does not have a right to an automatic extension.

In addition, some investors believe that when a *maintenance* margin call has been issued that they are entitled to one or more extensions of time to meet the call; however, there is no mechanism for extending maintenance margin calls. If the customer fails to meet a maintenance margin call, the broker/dealer can, under certain circumstances, take a charge to its net capital in lieu of collecting the call, but the broker/dealer is not required to do so, and the customer has no right to demand it.

#### ***Right To Dictate Which Security Is Liquidated***

Some investors believe that they have the right to control which securities are liquidated to meet a maintenance margin call if there is more than one security in the account. There is no provision in the margin rules that gives the customer the right to control liquidation decisions. As discussed above, because the securities are collateral for the margin loan, the broker/dealer has the right to control the disposition of the collateral in order to protect its

interests. In this regard, the broker/dealer may choose which securities in the margin account to liquidate, and this selection need not relate to factors associated with the individual customer. For example, the broker/dealer may choose a particular security in a customer's account to liquidate based on a high concentration of the security held by customers firm-wide.

### ***Members Raising Their Maintenance Margin Requirements***

Some members have increased their "house" maintenance margin requirements as a result of concerns about the volatility and extreme price run-ups on certain stocks and the risks to their customers and the member's own potential exposure to losses from margin defaults. These changes in policy often take effect immediately and will result in the issuance of a maintenance margin call. A customer's failure to satisfy the call will usually cause the member to liquidate a portion of the customer's account.

Some investors believe that a member must provide 30 days written notice before implementing this type of change. While SEC Rule 10b-16 requires members to disclose to customers the credit terms (interest rates and methods of calculating interest) for margin transactions and requires advance written notice of such changes, it does not require advance notice of the amount of margin required.

### **NASD Regulation Web Page Relating To Margin**

To increase investor and member awareness of issues relating to margin, NASD Regulation created a Web page ([www.nasdr.com/5700.htm](http://www.nasdr.com/5700.htm)) dedicated to margin-related

information for members and investors. An easily accessible direct link to this Web page has been provided on the NASD Regulation homepage. Among other things, the Web page provides investor guidance on margin, including some basic facts about the mechanics of margin accounts, specific examples illustrating the operation of a margin transaction and statistics on outstanding margin debt. In addition, NASD Regulation provides an "account statement stuffer," which describes basic information about purchasing on margin and managing a margin account. NASD Regulation has received requests for over 600,000 copies of this statement stuffer. In addition, approximately 20 firms have requested electronic copies of this statement stuffer for in-house printing purposes.

### **Proposed Requirements**

Although NASD Regulation recognizes that some members are providing disclosures to customers relating to margin, the content of these disclosures is not consistent from firm to firm and may not always be in a form that is understandable to investors. As such, NASD Regulation has filed with the SEC a proposed rule change that would require members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin.<sup>5</sup> Members would be required to deliver the disclosure statement, in writing or electronically, to customers on an individual basis,<sup>6</sup> prior to or at the opening of a margin account. The proposed rule change also would require members to deliver the disclosure statement annually to all non-institutional customers with

margin accounts. Members would be required to provide the disclosure statement to existing margin customers at the time of the next annual statement to the customer, but not to exceed 180 days from the effective date of the rule change. A sample margin disclosure statement is provided as Attachment A, which:

- describes the operation of a margin account;
- emphasizes that customers should carefully review their margin agreements; and
- clarifies some of the risks associated with margin trading, including that the customer can lose more funds than initially deposited, the firm can force the sale of the securities in the customer's account without notice to the customer, the firm can dictate which security is selected for liquidation, and the customer is not entitled to an extension of time on a margin call.

Members would be permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated statement and incorporates all of the relevant concepts. Under the proposed rule, disclosure at or prior to the opening of the account must be made in a separate document, even if a member chooses to deliver the disclosures as part of or within the margin agreement or other opening account documentation. However, with respect to the annual disclosure requirement, members would be permitted to provide the disclosures within other documentation, such as the customer account statement.

### Publication Of Proposed Rule

The SEC will publish the proposed rules in the *Federal Register*, indicating a time period during which members and other interested parties may comment. When SEC publication has taken place, NASD Regulation will notify members of the comment period in the NASD Regulation executive representative weekly e-mail broadcast. Those interested in commenting on the proposed rule change should submit comments directly to the SEC prior to the close of the comment period indicated in the *Federal Register* release. Among other issues, members and other interested parties may wish to comment on the following, which were raised by NASD Regulation standing and District committees: (1) the permissible methods of delivery of the disclosure statement for both the initial and the annual disclosure requirements; (2) whether providing only the "bulleted" information in the margin disclosure statement would be appropriate for fulfilling the annual disclosure requirement; and (3) whether 180 days from the effective date is an appropriate amount of time for the first delivery of the disclosure statement to all existing margin customers.

Before becoming effective, the proposed rule change must be approved by the SEC. Members, however, should consider providing

the margin disclosure statement described in this *Notice* to customers on a voluntary basis prior to SEC action on the proposed requirements.

### Endnotes

<sup>1</sup> See *On-Line Trading, Better Investor Protection Information Needed*, Report to Congressional Requesters, GAO, General Government Division, 00-43 (May 2000) (GAO Report). According to the GAO Report, between January 1998 and June 1999, 140 margin-related complaints concerning online trading firms were submitted to the SEC.

<sup>2</sup> These firms represented less than 10 percent of the total estimated number of firms that offer online trading. However, they accounted for about 90 percent of the online **trading volume** during early 1999.

<sup>3</sup> Rule 10b-16 of the Securities Exchange Act of 1934 (SEC Rule 10b-16) requires that broker/dealers that extend credit to customers to finance securities transactions furnish, in writing, specified information regarding the terms of the loan. These disclosures must be made on both an initial and periodic basis. For instance, at the time a customer opens a margin account, a broker/dealer must provide the customer with a written statement disclosing, among other things, the annual rate of interest, the method of computing interest, and what other credit charges may be imposed.

<sup>4</sup> Those firms that provided clear indications of the type of account to be opened offered

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

<sup>5</sup> The term "non-institutional customer" would mean a customer who does not qualify as an "institutional account" under NASD Rule 3110(c)(4). Rule 3110(c)(4) defines "institutional account" to mean the account of: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing similar functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

<sup>6</sup> Members would be required to deliver the disclosure statement to each customer individually. For example, a member firm posting the disclosure statement on its Web site would not fulfill the proposed delivery requirements, although such supplemental disclosure would be beneficial to investors.

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## **Attachment A — Sample 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 in your account, 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 in your account.

**The firm can force the sale of securities in your account.** If the equity in your account falls below the maintenance margin requirements under the law, or the firm's higher "house" requirements, the firm can sell the securities in your account to cover the margin deficiency. You also will be responsible for any shortfall in the account after such a sale.

**The firm can sell your securities 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 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 security in your margin account is 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 with 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.

**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.