

June 21, 2000

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Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001

**Re: File No. SR-NASD-99-41 Approval Procedures for Day-Trading Accounts;  
Response to Comments and Amendment Number 2**

Dear Ms. Sanow:

NASD Regulation, Inc. (“NASD Regulation”) hereby responds to the comment letters received by the United States Securities and Exchange Commission (“Commission” or “SEC”) following the second publication in the *Federal Register* of Notice of Filing of SR-NASD-99-41,<sup>1</sup> regarding approval procedures for day-trading accounts. Further, NASD Regulation hereby submits Amendment Number 2 to this filing. The proposed rule language set forth herein amends the proposed rule language filed with the Commission on August 20, 1999, and amended on February 18, 2000.<sup>2</sup>

**Background**

To address investor protection concerns arising from day-trading activities, NASD Regulation is proposing to amend the National Association of Securities Dealers, Inc. (“NASD”) Rules to include new Rules 2360 and 2361. As described in the rule filing and subsequent amendments, the proposed rule change would require a member firm that is promoting a day-trading strategy to furnish a risk disclosure statement to a non-institutional customer prior to opening an account for the customer and either to (1) approve the customer’s account for a day-trading strategy or (2) obtain from the customer a written agreement that the customer does not intend to use the account for day-trading purposes. As part of the account approval process, the firm would be required to make a threshold determination that day trading is appropriate for the customer.

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<sup>1</sup> Exchange Act Release No. 42452, 65 Fed. Reg. 11353 (Mar. 2, 2000). The public comment period announced in the *Federal Register* expired on March 23, 2000.

<sup>2</sup> This letter discusses four versions of the day-trading proposal: (1) the version published in the *Special Notice to Members* 99-32 (“NTM 99-32”); (2) the version filed with the Commission on August 20, 1999, and published in the *Federal Register* on September 21, 1999 (“Rule Filing”); (3) the revised version filed with the Commission on February 18, 2000, and published in the *Federal Register* on March 2, 2000 (“Amendment Number 1”); and (4) the version set forth in the attached amended rule language (“Amendment Number 2”).

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In April 1999, NASD Regulation issued *Special Notice to Members 99-32* (“NTM 99-32”) to solicit comment on the proposed rules regarding approval procedures for day-trading accounts. In response to NTM 99-32, NASD Regulation received 39 comment letters. The majority of letters generally supported NASD Regulation’s efforts to address the investor protection concerns raised by individuals engaging in day-trading activities. Commenters, however, raised varied suggestions on how best to regulate day-trading activities and presented disparate views on the scope of the activities that should be covered by the rules.

NASD Regulation modified the proposed day-trading rules outlined in NTM 99-32, in response to the comment letters. Many of these changes were significant and included: limiting the application of the rules to those firms that are “promoting a day-trading strategy,” as compared to “recommending an intra-day-trading strategy”; applying the rules to all non-institutional customers; requiring firms promoting a day-trading strategy to have reasonable grounds for believing that the strategy is appropriate for the customers and to exercise reasonable diligence to ascertain the essential facts relative to the customers; revising the definition of “intra-day-trading strategy”; requiring firms promoting a day-trading strategy to deliver the risk disclosure statement to all non-institutional customers prior to opening an account for such customers; and revising the risk disclosure statement to include the additional key point that day trading generally is not appropriate for persons of limited resources and limited investment or trading experience and low risk tolerance.

In September 1999, the Commission published NASD Regulation’s modified proposal in the *Federal Register* (“Rule Filing”). The Commission specifically solicited comments on: whether the proposal should cover existing day-trading accounts; whether the proposed definition of “day-trading strategy” is appropriate; whether the proposed risk disclosure statement is adequate; and whether the firms should be required to obtain a customer’s acknowledgment of receipt of the risk disclosure document. The Commission received three comment letters in response to the September 1999 *Federal Register* publication. In addition to the specific questions for which the Commission solicited input, the commenters expressed their views on a variety of other issues. Many of the issues raised by the commenters in response to the Rule Filing also were raised in the comments in response to NTM 99-32.

In February 2000, the Commission published the NASD Regulation’s amended proposal in the *Federal Register* (“Amendment Number 1”). The changes included: modifying the disclosure statement; revising the prescribed method for delivering the disclosure statement; describing certain activities that will not trigger application of the proposed day-trading rules; and clarifying information-gathering requirements. In addition, Amendment 1 clarified some issues raised by commenters. For example, a firm will not be subject to the day-trading rules unless it is promoting day-trading at the firm level.

In response to the publication of Amendment Number 1, comment letters were submitted by North American Securities Administrators Association, Inc. (“NASAA”), Securities Industry

Association (“SIA”), All-Tech, Inc., and Senators Collins, Levin and Durbin (“Senators”).<sup>3</sup> After considering this most recent set of comment letters, NASD Regulation is proposing a second set of amendments to the proposal (“Amendment Number 2”). The text of the rule language provided herein reflects Amendment Number 2, which consists of modifications to the risk disclosure statement. Further, the discussion below clarifies that a firm will not be deemed to be promoting day-trading activities solely by engaging in certain enumerated activities.

## **Issues Raised in Comment Letters**

### Application of the Rule

As noted above, the subject proposal would only apply to firms that promote a day-trading strategy. The discussion accompanying Amendment Number 1 clarifies that solicitations by individual brokers, alone, would not necessarily cause a firm to be considered to be promoting a day-trading strategy for purposes of the rules. This commentary also notes that if a principal or officer of the firm is aware that brokers in the firm are soliciting customers for day trading, then the firm will be deemed to be promoting day trading. SIA contends that knowing the strategies employed by representatives is a good supervisory practice and should not trigger application of the day-trading rules to the entire firm. SIA argues that, alternatively, the commentary accompanying the proposal should state that a number of representatives would need to be individually soliciting customers to day trade in order for these solicitations to cause the firm itself to be considered to be promoting a day-trading strategy. NASD Regulation, however, continues to believe that when an officer or a principal has knowledge of brokers soliciting accounts for day trading,<sup>4</sup> the firm will be deemed to be promoting day trading and thus subject to the day-trading rules.

Further, even if a firm is promoting day-trading activities, the proposal would not require the firm to make appropriateness determinations for customers who sign agreements stating that the customers do not intend to day trade. However, the proposal does not permit a member to rely on these agreements if the member knows that the customers intend to use the accounts for day trading. SIA believes that the proposal unfairly assigns a firm the responsibility for customers’

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<sup>3</sup> In 1999, the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate (“Subcommittee”) conducted a comprehensive investigation into day-trading activities. The Subcommittee held three day-trading hearings and conducted an eight-month investigation of the day-trading industry. On March 17, 2000, the SEC received a comment letter in response to the publication of Amendment Number 1 from Senators Collins, Levin and Durbin (Senator Collins is the Chairman of the Subcommittee and Senator Levin is the Ranking Minority Member. Senator Durbin is also a member of this Subcommittee). The Senators’ letter is based on the findings and evidence gathered by the Subcommittee.

<sup>4</sup> Firms must maintain a system to supervise the activities of each registered representative that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with NASD Rules. *See* NASD Rule 3010(a).

changing their minds. SIA contends that since firms maintain records of customers' trades, it can be argued that firms always have actual knowledge. In Amendment Number 1, NASD Regulation stated that on balance, this provision is appropriate and not overly burdensome. NASD Regulation continues to believe that it is proper to hold a firm accountable for facts known to the firm.

On the other hand, NASAA is concerned that the proposal could be read narrowly so as to not cover certain firms promoting day-trading activities. The proposed rule language states that firms would not be deemed to be promoting day-trading strategies *solely* by engaging in certain specified activities. NASAA recommends that NASD Regulation clarify that these activities may still be considered part of a plan to promote day trading when combined with other acts. NASD Regulation believes that the current proposed rule language addresses NASAA's concerns. Rule 2360(g) states that firms will not be deemed to be promoting day-trading activities *solely* by engaging in one of the listed activities. Accordingly, the activities specified in Rule 2360(g) may be considered part of a plan to promote day-trading activities when combined with other acts.<sup>5</sup>

Finally, All-Tech believes that it is hypocritical to impose the additional regulatory requirements on day-trading firms and not other firms that facilitate online trading. In formulating the proposed day-trading rules, NASD Regulation has consistently concluded that day-trading strategies present unique investor protection concerns that do not necessarily translate to other forms of trading.<sup>6</sup> This view is supported by the 1999 findings of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate Subcommittee.<sup>7</sup> The Subcommittee found that

Day trading firms provide a fundamentally different service than traditional brokerage houses and even on-line brokerage firms, such as E\*Trade and Charles Schwab. Neither discount on-line brokerage firms nor traditional full-service firms offer customers direct electronic access to the stock market, as do day trading firms. Online brokerage firms generally do not offer immediate stock order execution to their customers. Rather, online brokerage firms generally refer customer orders to other entities – such as market makers – for execution. The other basic difference between day trading firms and on-line firms is that day trading firms generally promote active trading by their

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<sup>5</sup> Further, NASAA argues that the proposal should apply to both new and existing customers, and that members should be required to obtain the customer's signature on the disclosure statement. These issues were addressed in response to prior comment letters, and NASD Regulation has not been provided any new arguments that would support a change in position.

<sup>6</sup> See, e.g., NTM 99-32.

<sup>7</sup> See *supra* note 3.

customers and, in most instances, cater primarily to persons seeking to trade for a living.<sup>8</sup>

Accordingly, NASD Regulation does not believe there is any reason to change its position.

#### Disclosure Statement

Under the proposal, members promoting day-trading strategies for non-institutional customers need to furnish the risk disclosure statement to customers. The disclosure statement lists several factors that a customer should consider before engaging in day trading, including that the customer should be prepared to lose all of the funds that he or she uses for day trading, and that day trading on margin may result in losses beyond the initial investment. As noted above, NASD Regulation has modified the disclosure statement in response to prior comment letters.

The Senators suggest additional modifications to the disclosure statement that NASD Regulation believes would improve the statement. The Senators, after reviewing evidence gathered by the Subcommittee, stated in their comment that: "possessing 'adequate risk capital' is the single most determinative factor in the success or failure of the average day trader . . . [and] under current market conditions, \$50,000 of risk capital is a 'limiting minimum' below which day traders significantly impair their chances of success." These conclusions are the basis for the Senators' recommendations.

The disclosure statement warns customers that day trading is generally not appropriate for someone of limited resources. The Senators recommend that the risk disclosure statement further warn customers that those who have less than \$50,000 in risk capital are not likely to succeed as day traders. In Amendment Number 2, NASD Regulation is proposing to supplement the current disclosure statement with an additional warning to highlight the significant resources generally needed to day trade.

The disclosure statement also warns customers that commissions may add to losses or significantly reduce earnings. The Senators recommend that the disclosure statement warn customers that there is substantial evidence that most day traders will need to generate at least \$100,000 per year just to cover commission costs and trading fees. (At the firms that the Subcommittee staff examined, the average customer commission is \$16 per trade, and the average customer executes about 29 trades per day. The Subcommittee staff extrapolated this information to conclude that the average day trader must generate annual trading profits of \$111,360 to cover commission expenses). In Amendment Number 2, NASD Regulation is proposing to include such

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<sup>8</sup> Staff Memorandum, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *Day Trading: Everyone Gambles But The House* (Feb. 24, 2000).

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a mathematical example in the disclosure statement to highlight the need to generate substantial earnings to cover costs.

Finally, NASAA recommends changing the section of the proposed disclosure statement captioned "Day trading requires knowledge of a firm's operations." In Amendment Number 1, NASD Regulation replaced language proposed by NASD Regulation with language recommended in a comment letter. NASAA believes that the original language proposed by NASD Regulation should be retained. The original language states that: "You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures." NASAA notes that although the language included in Amendment Number 1 provides important risk disclosures, it does not replace the need for customers to understand their own firm's execution systems and evaluate the potential problems for themselves. NASD Regulation agrees. In Amendment Number 2, NASD Regulation is proposing to include the language originally proposed by NASD Regulation as well as the language proposed in Amendment Number 1.

#### Appropriateness Determination

The Senators suggest establishing a "rebuttable presumption" that if an investor has less than \$50,000 risk capital, day trading is not appropriate for the customer. This presumption could be rebutted by other factors that the firm concludes outweigh the inadequate risk capital. The Senators further suggest that where firms determine that day trading is an appropriate strategy for customers who do not possess \$50,000, the firm would be required to prepare and maintain a record setting forth the reasons that it deemed day trading to be appropriate. NASD Regulation believes that while the \$50,000 threshold may make sense for many investors, this figure is arguably too low for very active day traders and too high for less active day traders. Further, imposing such a presumption may encourage individuals to misrepresent the value of their assets. NASD Regulation also notes that the current proposal requires a firm to document the basis on which it approves an account for a day-trading strategy. NASD Regulation does not believe that the proposal should incorporate the presumption.

NASAA is recommending that the proposal incorporate some additional recordkeeping requirements included under the NASD options rules. However, many of these recordkeeping requirements are duplicative of obligations already imposed on firms. Further, earlier this year, in drafting Amendment Number 1, NASD Regulation considered, and decided against, expressly incorporating these additional recordkeeping requirements into the day-trading proposal. NASD Regulation believes that there is no reason to change its position.

#### Sources of Customer Funds

The Senators suggest modifying the proposal to require broker/dealers that are promoting day-trading strategies to inquire whether parties opening accounts are planning on trading for

others, and if so, require firms to determine if parties need to be registered as investment advisers. NASD Regulation believes that it would be difficult, if not impossible, for firms to determine whether customers need to register as investment advisers. However, NASD Regulation feels that customers should be informed of potential registration requirements (both investment adviser and broker/dealer). In Amendment Number 2, NASD Regulation is proposing to include such a warning in the risk disclosure statement.

NASAA is recommending that the proposal be amended to require firms to obtain information on the sources of customer funds invested. NASAA is recommending this change because of the prevalence of day traders using borrowed money to fund their accounts. NASD Regulation is considering a separate regulatory response to address the concerns raised in the NASAA letter.

### **Amended Rule Language**

As noted above, the Association is herein revising the proposed rule language. Below is the text of proposed new Rules 2360 and 2361, as filed with the Commission and as modified by Amendment Number 1 and Amendment Number 2. Proposed additions under Amendment Number 2 are underlined; proposed deletions under Amendment Number 2 are in brackets.

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### **Rule 2360. Approval Procedures for Day-Trading Accounts**

(a) No member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer, unless, prior to opening the account, the member has furnished to the customer the risk disclosure statement set forth in Rule 2361 and has:

- (1) approved the customer's account for a day-trading strategy in accordance with the procedures set forth in paragraph (b) and prepared a record setting forth the basis on which the member has approved the customer's account; or
- (2) received from the customer a written agreement that the customer does not intend to use the account for the purpose of engaging in a day-trading strategy, except that the member may not rely on such agreement if the member knows that the customer intends to use the account for the purpose of engaging in a day-trading strategy.

(b) In order to approve a customer's account for a day-trading strategy, a member shall have reasonable grounds for believing that the day-trading strategy is appropriate for the customer.

In making this determination, the member shall exercise reasonable diligence to ascertain the essential facts relative to the customer, including:

- (1) Investment objectives;
- (2) Investment and trading experience and knowledge (e.g., number of years, size, frequency and type of transactions);
- (3) Financial situation, including: estimated annual income from all sources, estimated net worth (exclusive of family residence), and estimated liquid net worth (cash, securities, other);
- (4) Tax status;
- (5) Employment status (name of employer, self-employed or retired);
- (6) Marital status; number of dependents; and
- (7) Age.

(c) If a member that is promoting a day-trading strategy opens an account for a non-institutional customer in reliance on a written agreement from the customer pursuant to paragraph (a)(2) and, following the opening of the account, knows that the customer is using the account for a day-trading strategy, then the member shall be required to approve the customer's account for a day-trading strategy in accordance with paragraph (a)(1) as soon as practicable, but in no event later than 10 days following the date that such member knows that the customer is using the account for such a strategy.

(d) Any record or written statement prepared or obtained by a member pursuant to this rule shall be preserved in accordance with Rule 3110(a).

(e) For purposes of this rule, the term "day-trading strategy" means 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.

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

(g) A firm will not be deemed to be "promoting a day-trading strategy" for purposes of this rule solely by its engaging in the following activities:



- (1) Promoting efficient execution services or lower execution costs based on multiple trades;
- (2) Providing general investment research or advertising the high quality or prompt availability of such general research; and
- (3) Having a Web site that provides general financial information or news or that allows the multiple entry of intra-day purchases and sales of the same securities.

### **Rule 2361. Day-Trading Risk Disclosure Statement**

(a) Except as provided in paragraph (b), no member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer unless, prior to opening the account, the member has furnished to each customer, individually, in writing or electronically, the following disclosure statement:

You should consider the following points before engaging in a day-trading strategy. For purposes of this notice, a “day-trading strategy” means 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.

**Day trading can be extremely risky.** Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day-trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses. Further, certain evidence indicates that an investment of less than \$50,000 will significantly impair the ability of a day trader to make a profit. Of course, an investment of \$50,000 or more will in no way guarantee success.

**Be cautious of claims of large profits from day trading.** You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead to large and immediate financial losses.

**Day trading requires knowledge of securities markets.** Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.

**Day trading requires knowledge of a firm's operations.** You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures. Under certain market conditions, you may find it difficult or impossible to liquidate a position quickly at a reasonable price. This can occur, for example, when the market for a stock suddenly drops, or if trading is halted due to recent news events or unusual trading activity. The more volatile a stock is, the greater the likelihood that problems may be encountered in executing a transaction. In addition to normal market risks, you may experience losses due to system failures.

**Day trading will generate substantial commissions, even if the per trade cost is low.** [Day trading may result in your paying large commissions]. Day trading involves [may require you to trade your account] aggressive[ly] trading, and generally you will [may] pay commissions on each trade. The total daily commissions that you pay on your trades will [may] add to your losses or significantly reduce your earnings. For instance, assuming that a trade cost \$16 and an average of 29 transactions are conducted per day, an investor would need to generate an annual profit of \$111,360 just to cover commission expenses.

**Day trading on margin or short selling may result in losses beyond your initial investment.** When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day-trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

**Potential Registration Requirements.** Persons providing investment advice for others or managing the securities accounts for others may need to register as either an "Investment Advisor" under the Investment Advisors Act of 1940 or as a "Broker" or "Dealer" under the Securities Exchange Act of 1934. Such activities may also trigger state registration requirements.

(b) In lieu of providing the disclosure statement specified in paragraph (a), a member that is promoting a day-trading strategy may provide to the customer, individually, in writing or electronically, prior to opening the account, an alternative disclosure statement, provided that:

- (1) The alternative disclosure statement shall be substantially similar to the disclosure statement specified in paragraph (a); and
- (2) The alternative disclosure statement shall be filed with the Association's Advertising Department (Department) for review at least 10 days prior to use (or

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such shorter period as the Department may allow in particular circumstances) for approval and, if changes are recommended by the Association, shall be withheld from use until any changes specified by the Association have been made or, if expressly disapproved, until the alternative disclosure statement has been refiled for, and has received, Association approval. The member must provide with each filing the anticipated date of first use.

(c) For purposes of this rule, the term “day-trading strategy” shall have the meaning provided in Rule 2360(e).

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

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In conclusion, NASD Regulation believes that the proposed rules on day trading fairly balance two public interests: protecting investors and ensuring that excessive regulatory burdens are not placed on member firms. Accordingly, NASD Regulation continues to believe that the proposal is an appropriate and reasonable resolution of the issues.

NASD REGULATION, INC.

BY: \_\_\_\_\_

Joan Conley

Senior Vice President and Corporate Secretary