

# Notice to Members

JUNE 2002

## SUGGESTED ROUTING

Legal & Compliance  
Operations  
Registration  
Senior Management

## KEY TOPICS

Day-Trading Risk Disclosure  
Statements  
Margin Disclosure  
Statements

## INFORMATIONAL

### Margin Disclosure and Day-Trading Risk Disclosure Statements

NASD Adopts Amendments Regarding the Posting  
of Margin Disclosure and Day-Trading Risk Disclosure  
Statements on Web Sites—Effective Date: July 1, 2002

#### Executive Summary

NASD has adopted amendments to require the posting of certain investor disclosure statements on members' Web sites. Specifically, NASD has amended (1) NASD Rule 2341 (Margin Disclosure Statement) to require members that permit customers to open accounts online or to engage in transactions in securities online to post the margin disclosure statement on their Web sites and (2) NASD Rule 2361 (Day-Trading Risk Disclosure Statement) to require members that promote a day-trading strategy to post the day-trading risk disclosure statement on their Web sites. The rule change became effective immediately upon filing with the Securities and Exchange Commission (SEC) on May 29, 2002 and will become operative on July 1, 2002. Attachment A contains the text of the amendments.

#### Questions/Further Information

Questions regarding this *Notice to Members* may be directed to Grace Yeh, Assistant General Counsel, at (202) 728-6939.

#### Discussion

##### Background

NASD Rules 2341 and 2361 were developed to provide investors with additional and specific risk disclosures concerning margin and day trading, respectively. Rule 2341, which was adopted in April 2001,<sup>1</sup> is designed to provide investors with information concerning the operation and risks associated with margin trading. NASD believed that investors' misconceptions about margin requirements, particularly with respect to maintenance margin, could cause investors to underestimate the risks of margin trading and to misunderstand the operation of and reasons for margin calls. Accordingly, NASD adopted Rule 2341 requiring members to deliver

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to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin. Each member is required to deliver the margin disclosure statement to the customer prior to or at the opening of a margin account. Rule 2341 also requires that the margin disclosure statement, or an abbreviated version of the statement as set forth in the Rule, be provided to margin customers annually.

Rule 2361, which was adopted in July 2000,<sup>2</sup> is designed to provide investors with information concerning unique risks arising from day-trading activities. Rule 2361 requires firms promoting a day-trading strategy to provide their non-institutional customers with a day-trading risk disclosure statement prior to opening an account. The day-trading risk disclosure statement discusses 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.

Both Rules further permit member firms to develop an alternative disclosure statement substantially similar to the ones provided in the Rules. In the case of Rule 2361, the alternate day-trading risk disclosure statement must be filed with, and approved by, the NASD Advertising Regulation Department.

#### **Posting of Disclosure Statements on Web Sites**

While Rules 2341 and 2361 required that the disclosure statements be delivered individually to each covered customer, either in writing or electronically, the Rules did not require firms to post the

statements on their Web sites. Rather, in developing Rules 2341 and 2361, NASD focused on ensuring that each individual investor received the required risk disclosure statements. NASD believed that mandating individual delivery of the risk disclosure statements would be the most effective means of ensuring that customers received the required disclosures.

In 2001, following the adoption of Rule 2341 and Rule 2361, the General Accounting Office (GAO) issued a report that discusses, among other things, actions taken by securities industry regulators to address online trading issues.<sup>3</sup> The 2001 GAO Report recognized that Rules 2341 and 2361 require broker/dealers to furnish investors with certain key investor protection disclosures. It also noted that the margin disclosure statement required under Rule 2341 provides substantial information that is very helpful to investors to understand the risks of trading on margin. The GAO expressed concern, however, that while customers covered by Rules 2341 and 2361 were receiving the margin and day-trading risk disclosure statements, additional benefits could be achieved if the disclosures also were provided online, noting that many investors who trade online may prefer to review information in that medium and that a Web site posting also would make the information available to other online investors who are thinking about engaging in the activities covered by the disclosure statements. In this regard, the 2001 GAO Report recommended that the SEC take steps to ensure broker/dealers disclose additional information on their Web sites regarding, among other things, margin requirements and trading risks.<sup>4</sup>

While many firms posted the margin and day-trading risk disclosure statements

on their Web sites on a voluntary basis, NASD believed that the investing public could further benefit from the information contained in the statements if additional online and day-trading firms were to post them on their Web sites. Accordingly, NASD has amended Rules 2341 and 2361 to address the GAO's recommendations and enable a broader array of persons to review the information regarding margin requirements and day-trading risks contained in the mandated disclosure statements.

Consistent with the general recommendations raised in the GAO Reports, NASD has amended (1) Rule 2341 to require member firms that permit customers to open accounts online or to engage in transactions in securities online to post the margin disclosure statement on their Web sites and (2) Rule 2361 to require member firms that promote a day-trading strategy, directly or indirectly, to post the day-trading risk disclosure statement on their Web sites. The firms will be required to post the statements specified in Rules 2341 or 2361, as applicable, or the alternate statements permitted by the Rules. The disclosure statements must be displayed on the Web site in a "clear and conspicuous manner," or in a clearly identified location that is readily accessible to investors. While compliance with the "clear and conspicuous" standard will be based on the facts and circumstances surrounding each member's Web site, NASD's primary concern is that firms not post the disclosure statements in a remote place on their Web sites, where investors or potential investors will be unlikely to locate them.

Importantly, the amendments do not affect a member firm's existing requirements under Rules 2341 and 2361 to deliver individually to each customer

covered by the Rules, either in writing or electronically, the disclosure statements mandated under the Rules. In addition, while NASD is not at this time requiring online firms that do not promote a day-trading strategy as defined in Rule 2361 to post the day-trading risk disclosure statement in addition to the margin disclosure statement on their Web sites, NASD encourages all online firms to do so. NASD believes that online traders may benefit from the information provided in the day-trading risk disclosure statement regardless of whether the online firm whose Web site the trader is visiting or using promotes a day-trading strategy.

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## ENDNOTES

- 1 See Exchange Act Release No. 44223 (April 26, 2001).
- 2 See Exchange Act Release No. 43021 (July 10, 2000).
- 3 See *OnLine Trading, Investor Protections Have Improved but Continued Attention is Needed*, Report to Congressional Requesters, GAO, 01-858 (July 2001) (the "2001 GAO Report"). The 2001 GAO Report is a follow-up to a GAO report issued in 2000 (*On-Line Trading, Better Investor Protection Information Needed on Brokers' Web Sites*, Report to Congressional Requesters, GAO, General Government Division, 00-43 (May 2000) (the "2000 GAO Report")) that examined how online broker/dealers addressed investor protection issues.
- 4 Similarly, noting that the SEC has determined from customer complaints it has received that many investors who traded online did not understand margin requirements and may not understand the risks they are taking or the rules and procedures for trading, the 2000 GAO Report also recommended that the SEC ensure that broker/dealers with online trading systems include certain investor protection information on their Web sites.

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## ATTACHMENT A

New language is underlined; deletions are in brackets.

### 2341. Margin Disclosure Statement

(a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a non-institutional customer, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in writing or electronically, and in a separate document, the [following] margin disclosure statement[:.] specified in this paragraph (a). In addition, any member that permits non-institutional customers either to open accounts on-line or to engage in transactions in securities on-line must post such margin disclosure statement on the member's Web site in a clear and conspicuous manner.

#### **Margin Disclosure Statement**

Your brokerage firm is furnishing this document to you to provide some basic facts about purchasing securities on margin, and to alert you to the risks involved with trading securities in a margin account. Before trading stocks in a margin account, you should carefully review the margin agreement provided by your firm. Consult your firm regarding any questions or concerns you may have with your margin accounts.

When you purchase securities, you may pay for the securities in full or you may borrow part of the purchase price from your brokerage firm. If you choose to borrow funds from your firm, you will open a margin account with the firm. The securities purchased are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities or other assets in any of your accounts held with the member, in order to maintain the required equity in the account.

It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- ***You can lose more funds than you deposit in the margin account.***

A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities or assets in your account(s).

- ***The firm can force the sale of securities or other assets in your account(s).*** If the equity in your account falls below the maintenance margin requirements, or the firm's higher "house" requirements, the firm can sell the securities or other assets in any of your account held at the firm to cover the margin deficiency. You also will be responsible for any short fall in the account after such a sale.

- ***The firm can sell your securities or other assets without contacting you.*** Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities or other assets in their accounts to meet the call unless the firm has contacted them first. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without notice to the customer.

- ***You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.*** Because the securities are collateral for the margin loan, the firm has the right to decide which security to sell in order to protect its interests.

- ***The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.*** These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause the member to liquidate or sell securities in your account(s).

- ***You are not entitled to an extension of time on a margin call.*** While an extension of time to meet margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension.

(b) No Change.

(c) In lieu of providing the disclosures specified in paragraphs (a) and (b), a member may provide to the customer and, to the extent required under paragraph (a) post on its Web site, an alternative disclosure statement, provided that the alternative disclosures shall be substantially similar to the disclosures specified in paragraphs (a) and (b).

(d) No Change

### **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[:] specified in this paragraph (a). In addition, any member that is promoting a day-trading strategy, directly or indirectly, must post such disclosure statement on the member's Web site in a clear and conspicuous manner.

#### **Day-Trading Risk 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 involves aggressive trading, and generally you will pay commissions on each trade. The total daily commissions that you pay on your trades will add to your losses or significantly reduce your earnings. For instance, assuming that a trade costs \$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 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, and post on its Web site, 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 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) No Change.

(d) No Change.