INFORMATIONAL

Day-Trading Margin

SEC Approves Proposed Rule Change Relating To Day-Trading Margin Requirements

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

KEY TOPICS

- Rule 2520
- Margin
- Day Trading

Executive Summary

On February 27, 2001, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2520 relating to margin requirements for day traders (the "amendments").[1] The amendments become effective on September 28, 2001 and are substantially similar to amendments by the New York Stock Exchange (NYSE) to its margin rules.[2]

The text of the amendments and *Federal Register* version of the SEC Approval Order are attached (see Attachments A & B). For a detailed description of the amendments, as well as specific examples of certain margin calculations under the amendments, members should review the attached SEC Approval Order (see Attachment B).

Questions concerning this *Notice* may be directed to Susan DeMando, Director, Financial Operations, Member Regulation, NASD Regulation, Inc. (NASD Regulation), at (202) 728-8411, or Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

Because Regulation T initial margin requirements and NASD/NYSE standard maintenance margin requirements[3] are calculated only at the end of each day, a day trader who has no positions in his or her account at the end of the day would not incur a Regulation T initial margin nor a standard maintenance margin requirement, assuming no losses in the account from that day's trading. Current NASD/NYSE initial margin provisions, however, generally require a customer to deposit margin of at least $2,000, unless in excess of the cost of the security.

Although the day trader may end the day with no position, the day trader's clearing firm is at risk during the day if credit is extended. To address this risk, the NASD and NYSE require day traders to demonstrate that they have the ability to meet the initial margin requirements for at least their largest open position during the day. Specifically, under current margin requirements, a customer who meets the definition of day trader under the rule must deposit in his or her account the margin that would have been required under Regulation T (*i.e.*, the 50 percent initial margin requirement) if the customer had not liquidated the position during the trading day. If the customer day trades, but is not considered a "day trader," the customer is still required to post 25 percent of the position held during the day.[4] Currently, this payment is due after the risk has been incurred. Therefore, the funds are not available during the trading day when the clearing firm is at risk.

Currently, if a customer's day trading results in a day-trading margin call, the customer has seven days to meet the call by depositing cash or securities in the account. Because day traders typically end the day flat and this day-trading "margin" deposit is not securing a margin loan, the customer is not required to leave the margin deposit in the account and may withdraw the deposit the day after the deposit is made. If the customer fails to meet a day-trading margin call, no specific action to the customer account is required to be taken by the firm. There are no securities to liquidate, as there would be for an existing position, because day traders typically end the day flat.

Description Of Amendments

The amendments address the deficiencies that have been identified with existing rules relating to day-trading margin activities. Specifically, the amendments provide for the following changes to current margin requirements:

(1) Definition of "pattern day trader." Under the amendments, "pattern day traders" are defined as those customers who day trade four or more times in five business days. If day-trading activities do not exceed six percent of the customer's total trading activity for the five-day period, the clearing firm is not required to designate such accounts as pattern day traders. The six percent threshold is designed to allow clearing firms to exclude from the definition of pattern day trader those customers whose day-trading activities comprise a small percentage of their overall trading activities.

In addition, if the firm knows or has a reasonable basis to believe that the customer is a pattern day trader (for example, if the firm provided training to the customer on day trading in anticipation of the customer opening an account), the customer must be designated as a pattern day trader immediately, instead of delaying such determination for five business days.

(2) Minimum equity requirement. The amendments require that a pattern day trader have deposited in his or her account minimum equity of $25,000 on any day in which the customer day trades. The required minimum equity must be in the account prior to any day-trading activities; however, firms are not required under the rule to monitor the minimum equity requirements on an intra-day basis. The minimum equity requirement 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) Day-trading buying power. The amendments limit day-trading buying power to four times the day trader's maintenance margin excess. This calculation is based on the customer's account position as of the close of business of the previous day.

(4) Day-trading margin calls. Under the amendments, in the event a day-trading customer exceeds his or her day-trading buying power limitations, additional restrictions are imposed on the pattern day trader that more adequately protect the firm from the additional risk and help prevent a recurrence of such prohibited conduct. Members are required to issue a day-trading margin call to pattern day traders that exceed their day-trading buying power. Customers have five business days to deposit funds to meet this day-trading margin call. The day-trading account is restricted to day-trading buying power of two times maintenance margin excess based on the customer's daily total trading commitment, beginning on the trading day after the day-trading buying power is exceeded until the earlier of when the call is met or five business days. If the day-trading margin call is not met by the fifth business day, the account must be further restricted to trading only on a cash-available basis for 90 days or until the call is met.

(5) Two-day holding period requirement. The amendments require that funds used to meet the day-trading minimum equity requirement or to meet a day-trading margin call must remain in the customer's account for two business days following the close of business on any day when the deposit is required.

(6) Prohibition of the use of cross-guarantees. Under the amendments, pattern day traders are not permitted to meet day-trading margin requirements through the use of cross-guarantees. Each day-trading account is required to meet the applicable requirements independently, using only the financial resources available in the account. Accordingly, pattern day traders are prohibited from using cross-guarantees to meet the minimum equity requirements or to meet day-trading margin calls.

In addition, the amendments revise the current interpretation that requires the sale and repurchase on the same day of a position held from the previous day to be treated as a day trade. The amendments treat the sale of an existing position as a liquidation and the subsequent repurchase as the establishment of a new position not subject to the rules affecting day trades. Similarly, if a short position is carried overnight, the purchase to close the short position and subsequent new sale would not be considered a day trade.

For a more detailed description of the amendments, as well as specific examples of certain margin calculations under the amendments, members should review the attached SEC Approval Order.

Endnotes

1 *See* Securities Exchange Act Release No. 44009 (February 27, 2001), 66 FR 13608 (March 6, 2001) (File No. SR-NASD-00-03) ("SEC Approval Order").

2 The SEC issued a joint approval order for the NASD's and NYSE's proposed rule changes relating to day-trading margin requirements. The NYSE rule filing number is SR-NYSE-99-47.

3 NASD Rule 2520 and NYSE Rule 431, the margin provisions for the NASD and the NYSE, respectively, are substantially similar.

4 The firm has the option to calculate day-trading margin requirements based on either the largest open position at any given time during the day, or on the customer's total trading commitment during the day. If the firm chooses to base day-trading margin requirements on the customer's largest open position during the day, the firm must maintain "time and tick" records documenting the sequence in which each day trade is completed.

© 2001, National Association of Securities Dealers, Inc. (NASD). All rights reserved. Notices to Members attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

ATTACHMENT A

SR-NASD-00-03, Proposed Rule Language, as amended

Proposed new language is underlined; proposed deletions are in brackets.

2520. Margin Requirements

(a) Definitions No change.

(b) Initial Margin

For the purpose of effecting new securities transactions and commitments, the customer shall be required to deposit margin in cash and/or securities in the account which shall be at least the greater of:

(1) through (3) No change.

(4) equity of at least $2,000 except that cash need not be deposited in excess of the cost of any security purchased (this equity and cost of purchase provision shall not apply to "when distributed" securities in a cash account). The minimum equity requirement for a "pattern day trader" is $25,000 pursuant to paragraph (f)(8)(B)(iv)a. of this Rule.

Withdrawals of cash or securities may be made from any account which has a debit balance, "short" position or commitments, provided it is in compliance with Regulation T of the Board of Governors of the Federal Reserve System and after such withdrawal the equity in the account is at least the greater of $2,000 ($25,000 in the case of a "pattern day trader") or an amount sufficient to meet the maintenance margin requirements of this [paragraph] Rule.

(c) through (f)(8)(A)(iii) No change.

(f)(8)(B) **Day[-] Trading**

(i) The term "day[-] trading" means the purchasing and selling or the selling and purchasing of the same security on the same day in a margin account except for:

a. a long security position held overnight and sold the next day prior to any new purchase of the same security, or

b. a short security position held overnight and purchased the next day prior to any new sale of the same security.

(ii) [A "day- trader" is any customer whose trading shows a pattern of day- trading.] The term "pattern day trader" means any customer who executes four or more day trades within five business days. However, if the number of day trades is 6% or less of total trades for the five business day period, the customer will not be considered a pattern day trader and the special requirements under paragraph (f)(8)(B)(iv) of this Rule will not apply. In the event that the organization at which a customer seeks to open an account or to resume day trading knows or has a reasonable basis to believe that the customer will engage in pattern day trading, then the special requirements under paragraph (f)(8)(B)(iv) of this Rule will apply.

(iii) The term "day-trading buying power" means the equity in a customer's account at the close of business of the previous day, less any maintenance margin requirement as prescribed in paragraph (c) of this Rule, multiplied by four for equity securities.

Whenever day[-] trading occurs in a customer's margin account the special maintenance margin required for the day trades in equity securities [to be maintained] shall be [the margin on the "long" or "short" transaction, whichever occurred first, as required pursuant to the other provisions of this Rule. When day-trading occurs in the account of a "day-trader" the margin to be maintained shall be the margin on the "long" or "short" transaction, whichever occurred first, as required by Regulation T of the Board of Governors of the Federal Reserve System or as required pursuant to the other provisions of this Rule, whichever amount is greater.] 25% of the cost of all the day trades made during the day. For non-equity securities, the special maintenance margin shall be as required pursuant to the other provisions of this Rule. Alternatively, when two or more day trades occur on the same day in the same customer's account, the margin required may be computed utilizing the highest (dollar amount) open position during that day. To utilize the highest open position computation method, a record showing the "time and tick" of each trade must be maintained to document the sequence in which each day trade was completed.

(iv) Special Requirements for Pattern Day Traders

a. Minimum Equity Requirement for Pattern Day Traders - The minimum equity required for the accounts of customers deemed to be pattern day traders shall be $25,000. This minimum equity must be deposited in the account before such customer may continue day trading and must be maintained in the customer's account at all times.

b. Pattern day traders cannot trade in excess of their day-trading buying power as defined in paragraph (f)(8)(B)(iii) above. In the event a pattern day trader exceeds its day-trading buying power, which creates a special maintenance margin deficiency, the following actions will be taken by the member:

1. The account will be margined based on the cost of all the day trades made during the day,

2. The customer's day-trading buying power will be limited to the equity in the customer's account at the close of business of the previous day, less the maintenance margin required in paragraph (c) of this Rule, multiplied by two for equity securities, and

3. "time and tick" (*i.e.*, calculating margin using each trade in the sequence that it is executed, using the highest open position during the day) may not be used.

c. Pattern day traders who fail to meet their special maintenance margin calls as required within five business days from the date the margin deficiency occurs will be permitted to execute transactions only on a cash available basis for 90 days or until the special maintenance margin call is met.

d. Pattern day traders are restricted from using the guaranteed account provision pursuant to paragraph (f)(4) of this Rule for meeting the requirements of paragraph (f)(8)(B).

e. Funds deposited into a pattern day trader's account to meet the minimum equity or maintenance margin requirements of paragraph (f)(8)(B) of this Rule cannot be withdrawn for a minimum of two business days following the close of business on the day of deposit.

(C) When the equity in a customer's account, after giving consideration to the other provisions of this [paragraph (c)] Rule, is not sufficient to meet the requirements of [subparagraph (i) or (ii) hereof] paragraph (f)(8)(A) or (B), additional cash or securities must be received into the account to meet any deficiency within [seven] five business days of the trade date.

In addition, on the sixth business day only, members are required to deduct from Net Capital the amount of unmet maintenance margin calls pursuant to SEC Rule 15c3-1.

(f)(9) and (f)(10) No change.