

ACTION REQUESTED BY
FEBRUARY 12, 2001

Member Facilitation Of Lending Between Customers

NASD Regulation
Requests Comment On
Member Facilitation Of
Lending Between
Customers; **Comment
Period Expires
February 12, 2001**

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.

- Individual Investor
- Legal & Compliance
- Registered Representatives
- Senior Management

KEY TOPICS

- Lending Arrangements
- Margin

Executive Summary

NASD Regulation, Inc. (NASD RegulationSM) requests comment from National Association of Securities Dealers, Inc. (NASD[®]) members, investors, and other interested parties on whether member facilitation of lending between customers should be substantially restricted or prohibited. As an alternative, NASD Regulation also is soliciting comment on whether specific risk disclosures should be provided to customers participating in these types of lending activities.

Included with this *Notice* is Attachment A—specific questions on which NASD Regulation requests comments from members and interested parties.

Request For Comment

NASD Regulation is soliciting comment on whether members should be prohibited or restricted from arranging for or facilitating the lending of funds between customers, and/or whether specific disclosure to customers participating in such loans should be required. NASD Regulation encourages all members, investors and interested parties to submit comments. For your convenience, we have provided a checklist (see Attachment A) so that in a minimum amount of time you can provide NASD Regulation with your general comments.

Comments must be received by **February 12, 2001**. Members and interested parties can submit their comments using the following methods:

- mailing in the checklist (Attachment A)
- mailing in written comments
- e-mailing written comments to: pubcom@nasd.com
- submitting comments online at the NASDR Web Site (www.nasdr.com)

If you decide to send comments using both the checklist and one of the other methods listed above, please let us know.

The checklist and/or written comments should be mailed to:

*Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500*

The only comments that will be considered are those submitted in writing, either via e-mail, regular mail, or the NASDR Web Site.

Before becoming effective, the NASD Regulation Board of Directors must adopt, and the Securities and Exchange Commission (SEC) must approve, any rule change. The NASD Board of Governors also may review the rule change.

Questions/Further Information

As noted, written comments should be submitted to Joan C. Conley. Questions concerning the substance of this Notice may be directed to Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8176.

Background

Certain firms may arrange for and/or facilitate loans between customers that are used to finance securities trading and/or meet margin requirements. Customers borrowing funds may incur additional finance charges when credit is arranged by the member, and customers lending funds may face additional, and perhaps undisclosed, credit risks when they extend credit to other customers. NASD Regulation believes that questions arise regarding investor protection and disclosure practices when members become involved in the extension of credit between customers. In addition, such lending activities can result in a conflict of interest between the customer and the member, particularly when such lending activities allow customers to continue to trade when they would not otherwise be in a financial position to do so, thereby generating more commission income to the member.

Such inter-customer lending practices have raised concerns, particularly in the area of day trading.¹ Specifically, certain members that facilitate lending between day traders may arrange for the loans by identifying those day traders that have outstanding margin calls

and matching those individuals with customers that have excess equity. Alternatively, a member may have one customer who is the primary lender to the member's other customers.

The member may facilitate the lending activity by journaling the funds and interest payments between the two customer accounts, often pursuant to Letters of Authorization (LOA) and other preexisting agreements signed by the customers. Customers that agree to certain types of LOAs may give authority to the member to journal funds in and out of the customers' accounts as frequently as needed in order to facilitate these types of lending activities. Customers may be unaware of the extent of lending activity resulting from LOAs, and in some cases, there may be minimal or no disclosure provided to customers of the credit or other risks associated with such lending activities. Absent the receipt of these loans, many of the customers would be unable to continue to trade.

The Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the U.S. Senate (Subcommittee) issued a Staff Memorandum (Memorandum) on day trading, which described the Subcommittee's investigation and findings relating to day trading.² The Memorandum cited several examples of day-trading firms that allowed, or even encouraged, customers to trade beyond their means by arranging loans for customers to satisfy margin calls. The Memorandum indicated that in many instances, the borrowing customer paid an "exorbitant fee" to the lending customer

for the use of the funds. In addition, customers loaned money to other customers without any information regarding the borrower's creditworthiness, and in some instances, without knowing the borrowing customer's name.

Although Rule 15c2-5 of the Securities Exchange Act of 1934 (Exchange Act) generally would not apply to the types of lending activities described above, NASD Regulation is considering whether the requirements of Rule 15c2-5 may provide a model for an NASD proposal in this area. Rule 15c2-5 generally requires that before any purchase, loan, or other related element of an applicable transaction is entered into, the broker/dealer deliver to the customer a written statement setting forth the exact nature and extent of the following:

- the customer's obligations under the particular loan arrangement, including among other things, the specific charges that the customer will incur under such loan in each period during which the loan may continue or be extended;
- the risks and disadvantages that the customer will incur in the entire transaction, including the loan arrangement; and
- all commissions, discounts, and other remuneration received and to be received in connection with the entire transaction including the loan arrangement, by the broker/dealer, by any person controlling, controlled by, or under common control with the broker/dealer, and by any other person participating in the transaction.

Rule 15c2-5 also requires that under certain circumstances, the broker/dealer obtain from the customer information concerning his/her financial situation and needs, and that the broker/dealer reasonably determine that the entire transaction, including the loan arrangement, is suitable for the customer. In such instances, Rule 15c2-5 also would require the broker/dealer to retain in its files a written statement setting forth the basis upon which it made such determination.

Endnotes

1 Another related area of concern involves lending to customers by associated persons to meet Regulation T and NASD margin requirements. Because the definition of “creditor” under Regulation T extends to associated persons of broker/dealers, associated persons generally should not make loans to customers unless they separately comply with the provisions of Regulation T.

2 See Staff Memorandum of Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate, “Day Trading: Everyone Gambles but the House,” (February 24, 2000).

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ATTACHMENT A**Request For Comment Checklist**

The following list of questions provides a quick and easy means to comment on some of the issues described in the *Notice*. This list of questions does not cover all of the issues contained in the *Notice*; therefore, we encourage members and other interested parties to review the entire *Notice* and to comment separately, as necessary.

Instructions

Comments must be received by **February 12, 2001**. Members and interested parties can submit their comments using the following methods:

- mailing in this checklist
- e-mailing written comments to pubcom@nasd.com
- mailing in written comments
- submitting comments online at the NASDR Web Site (www.nasdr.com)

The checklist and/or written comments should be mailed to:

*Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500*

Member Facilitation Of Lending Between Customers

1. Should members be prohibited from arranging for or facilitating the lending of funds between customers and other lenders?
☐ Yes ☐ No ☐ See my attached written comments
2. If such lending activities were not prohibited, are there limitations or restrictions that should be imposed on specific types of loans, such as loans that are used to meet a margin call or minimum equity requirements?
☐ Yes ☐ No ☐ See my attached written comments
3.
 - a. Do customers who borrow funds from other customers receive adequate disclosure of the credit terms associated with the loans?
☐ Yes ☐ No ☐ See my attached written comments
 - b. Do the persons or entities making the loans receive adequate disclosure of the credit terms and risks of the loans?
☐ Yes ☐ No ☐ See my attached written comments
 - c. Should members be required to provide disclosures to both parties to the loan regarding the terms and risks involved in such lending activities? For example, should disclosure requirements similar to that of SEC Rule 15c2-5 apply to these types of lending activities?
☐ Yes ☐ No ☐ See my attached written comments
 - d. Should members be required to make a determination that inter-customer lending activities are appropriate for customers similar to that of SEC Rule 15c2-5?
☐ Yes ☐ No ☐ See my attached written comments
4. Are there other approaches to addressing the concerns associated with such lending practices? For example, what types of additional supervisory mechanisms or requirements should be in place to monitor and/or approve these types of loans?
☐ Yes ☐ No ☐ See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

☐ An NASD Member

☐ An Investor

☐ A Registered Representative

☐ Other: _____