INFORMATIONAL

Day-Trading Rules

SEC Approves Day-Trading Rules; **Effective Date: October 16, 2000**

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
- Registered Representatives
- Senior Management
- Trading & Market Making

KEY TOPICS

- Day Trading
- Risk Disclosure

Executive Summary

On July 10, 2000, the Securities and Exchange Commission (SEC) approved rule changes proposed by the National Association of Securities Dealers, Inc. (NASD®) that require a 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. The firm will further be required to either: (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 will be required to make a threshold determination that day trading is appropriate for the customer.

The new rules are included with this *Notice* (see Attachment A). These rules become effective on October 16, 2000. The day-trading rules will not apply to an existing customer unless the customer opens a new account at a firm that is promoting a day-trading strategy.

Questions/Further Information

Questions regarding this *Notice* may be directed to Eric Moss, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation℠), at (202) 728-8982.

Day-Trading Rules

In general, day traders seek to profit from very small movements in the price of a security. Such a strategy often requires aggressive trading of a brokerage account. As a result, day trading generally requires a significant amount of capital, a sophisticated understanding of securities markets and trading techniques, and high risk tolerance. Even experienced day traders with in-depth knowledge of the securities markets may suffer severe and unexpected financial losses.

To address investor protection concerns arising from day-trading activities, the NASD is amending its rules to include new Rule 2360 and 2361. As noted above, these rules will require a 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.[1] The firm will further be required to either:

(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.

A firm will not be permitted to rely on the written agreement from the customer if the firm knows that the customer intends to use the account for day trading. In addition, if a customer signs the written agreement stating that he/she does not intend to use the account for day-trading purposes, but the firm later discovers that the customer is using the account for day-trading activities, then the firm will be required to approve the customer's account for day trading in accordance with the rule as soon as practicable, but in no event later than 10 days from the date of discovery.

Account Approval Requirement

As part of the account approval process, the firm will be required to make a threshold determination that day trading is appropriate for the customer. In making this determination, the firm will be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her: investment objectives; investment and trading experience and knowledge; financial situation; tax status; employment status; marital status and number of dependents; and age. The firm also will be required to prepare a record setting forth the basis on which the firm has approved the customer's account. Any record or written statement prepared or obtained by the firm pursuant to the rule change will have to be preserved in accordance with NASD Rule 3110(a).

The day-trading rules define "day-trading strategy" to mean "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." The NASD believes that this definition includes those instances where an individual regularly transmits one or more purchase and sale (*i.e.*, "round-trip") transactions in a single day. In addition, although as a practical matter, day trading typically requires electronic delivery of orders, the definition of "day-trading strategy" includes orders transmitted by non-electronic means, such as by telephone.

Risk Disclosure Requirement

The day-trading rules require a firm that is promoting a day-trading strategy to deliver a disclosure statement to the customer discussing the unique risks posed by day trading. The day-trading rules require firms to deliver the disclosure statement to each customer individually, by mail or electronic means, prior to the opening of the account. This approach protects against a firm posting the disclosure statement in a remote place on its Web site and claiming that it was delivered to all customers in such a manner. The day-trading rules do not require customers to sign the disclosure statement. The NASD believes that it is sufficient for firms to have written procedures in place for delivery of the document and to be able to identify those procedures to any examiners.

The disclosure statement includes 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. The disclosure statement is set forth in Rule 2361(a) in Attachment A. The firm will be permitted to develop an alternative risk disclosure statement, provided that the alternative statement is substantially similar to the mandated statement and is filed with, and approved by, NASD Regulation's Advertising Department.

For more information about the filing process and related fees, please contact the Advertising Regulation Department at 9509 Key West Avenue, Rockville, MD 20850, telephone (240) 386-4500.

Members That Promote Day Trading

A member will be subject to the day-trading rules if it affirmatively promotes day-trading activities or strategies through advertising, training seminars, or direct outreach programs. For instance, a firm generally will be subject to the new rules if its advertisements address the benefits of day trading, rapid-fire trading, or momentum trading, or encourages persons to trade or profit like a professional trader. A firm also will be subject to the new rules if it promotes its day-trading services through a third party. Moreover, the fact that many of a firm's customers are engaging in a day-trading strategy will be relevant in determining whether a firm has promoted itself in this way.[2]

The day-trading rules only will be triggered by firms' general promotional efforts or by firm-sponsored promotional efforts. The day-trading rules clarify that a member will not be deemed to be promoting a day-trading strategy for purposes of the rule solely by engaging in the following actions:

(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; or

(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.

However, firms may not promote day trading through individuals in an effort to circumvent the rules. In addition, 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.

Endnotes

[1]For purpose of the day-trading rules, the term “non-institutional customer” means a customer that 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 like functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

[2]The new rules do not define the term “promoting a day-trading strategy.” However, firms may submit their advertisements to NASD Regulation’s Advertising Department for review and guidance on whether the content of the advertisement constitutes such activity for purposes of the new rules.

Attachment A

Text Of New Rules

(Note: All language is new.)

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 and 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 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, 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) 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).