NASD Notice to Members 98-102

Calculating Margin For Day-Trading And Cross-Guaranteed Accounts

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Executive Summary

Federal Reserve Board Regulation T governs the extension of credit to customers by broker/dealers. Among the provisions of Regulation T are requirements governing the initial margin requirements for certain securities transactions. In addition, National Association of Securities Dealers, Inc. (NASD®) Rule 2520 requires NASD members to impose additional margin requirements on customer accounts.[1] The purpose of this *Notice* is to communicate the opinion of the NASD on the margin requirements under Regulation T and Rule 2520 for day-trading and cross-guaranteed accounts with the expectation that members will calculate margin for such accounts in a manner that is consistent with Regulation T and Rule 2520.

The NASD believes that some members are calculating margin for day-traders and cross-guaranteed accounts in a manner that is not consistent with the requirements of Regulation T and Rule 2520. Accordingly, members are advised to review their margin calculation practices to ensure that they conform to the requirements of these rules. Adherence to the margin requirements is in the best interest of the investing public and serves to protect the financial security of members that extend credit.

Finally, the NASD believes that some members may be failing to take certain account-related charges when computing their net capital pursuant to Securities and Exchange Commission (SEC) Rule 15c3-1. These charges include those specified in Rule 2520(f)(4) for certain guaranteed accounts. Members should review the requirements of SEC Rule 15c3-1 and Rule 2520 to determine whether they are in compliance with these rules.

Members should be aware that the NASD believes compliance with the margin and net capital requirements is of paramount importance and intends to examine member firms for compliance with these rules.

Questions concerning this *Notice* may be directed to Samuel Luque, Associate Director, Member Regulation, NASD Regulation, Inc. (NASD Regulation℠), at (202) 728-8472, or Susan DeMando, Regional Compliance Supervisor, Member Regulation, NASD Regulation, at (202) 728-8411.

Discussion

This *Notice* addresses some of the most frequently asked questions regarding the application of Regulation T and Rule 2520 to day-trading and cross-guaranteed accounts. In addition, this *Notice* addresses only common scenarios and questions relating to marginable equity securities and is not meant to be a complete discussion of the application of Regulation T and Rule 2520 to all possible trading strategies utilized by day-trading and/or cross-guaranteed accounts.

In order to clarify member understanding of the requirements relating to day-trading and cross-guaranteed accounts, highlighted below in plain English are some of the fundamental requirements and provisions of these rules.

General

• Members must perform two separate margin calculations for each account each day; one for Regulation T and one for Rule 2520. The calculations should be performed at the end of each trade date; intra-day calculations are not permitted. Members must comply with the requirements of both rules at all times.

• "Day-trading" means buying and selling the same security on the same day. A "day-trader" is any customer whose trading shows a pattern of day-trading (see Rule 2520(f)(8)(B)). (See also the Securities Industry Association's *Credit Division Manual's* definition of "day-trading" as "selling first and then repurchasing" the same security on the same day.)

• Day-trades should occur only in margin accounts. Day-trading in a cash account may amount to free riding (*i.e.*, purchasing a security and then selling it without having paid for the purchase).

• Regulation T requires initial margin of 50 percent for new purchases and 150 percent for short sales (of which 100 percent can come from the proceeds of the short sale, with the customer depositing the remaining 50 percent). (See Regulation T, Sections 220.12(a) and (c)(1).)

• Rule 2520 requires maintenance margin of 25 percent of the current market value for all long positions, and $5 per share or 30 percent of the current market value, whichever amount is greater, of each stock "short" in the account selling at $5 per share or above (see Rule 2520(c)(1) and (c)(3)). *If a customer's account is both "long" and "short" the same security, Rule 2520(e)(1) requires five percent maintenance margin of the current market value of the long security. The short position must be marked to the market.*

• If two accounts are cross-guaranteed and one is long the same security that the other is short the same number of securities, the maintenance margin requirement on the combined positions is five percent. This five percent maintenance margin requirement in no way eliminates the requirement to comply with the initial margin requirements of Regulation T on the original purchase and short sale.

• When calculating Regulation T margin, cross guarantees have *no* effect (see Regulation T, Section 3(d)). Therefore, members must apply Regulation T to each account separately, notwithstanding the fact that Rule 2520 permits certain special maintenance margin treatment for transactions in cross-guaranteed accounts.

• Rule 2520(f)(4) permits cross guarantees for maintenance margin purposes so that the amount of maintenance margin excess in one account may be used to offset a maintenance margin deficit in the other cross-guaranteed account. In any given situation, the account with the maintenance margin excess is considered the guaranteeing account and the account with the maintenance margin deficit is considered the guaranteed account.

• The fact that Regulation T margin is calculated at the end of the business day only does not mean that broker/dealers can disregard intraday risk. Reliance on the proceeds of anticipated sales to pay for purchases exposes the broker/dealer to risk.

Regulation T

• Margin is required for each long or short securities position unless an exception or special provision is available (see Regulation T, Section 4(b)). The required margin is set forth in Section 12 (the Supplement).

• Regulation T margin is calculated at the end of the business day. All transactions on the same day are combined to determine the Regulation T requirement. Therefore, Regulation T does not distinguish between day-trading and other forms of trading (see Regulation T, Section 4(c)(1)).

• A Regulation T margin requirement may be satisfied by a transfer from the Special Memorandum Account (SMA), or by a deposit of cash, margin securities, or exempted securities, in any combination (see Regulation T, Section 4(c)(2)).

• Regulation T treats a short sale "against the box" as a long sale (see Regulation T, Section 4(b)(2)). As a result, there is no Regulation T requirement on the transaction; however, Rule 2520(e)(1) imposes a five percent margin requirement on the market value of the long position and requires the short position to be marked to the market.

• A sale cannot be treated as a short sale "against the box," nor can it be treated as a long sale, if the account making the sale is not long the same number of shares of the same security, even if another cross-guaranteeing account is long the security. Because cross guarantees have no effect under Regulation T, the fact that another cross-guaranteeing account is long the security is meaningless for Regulation T purposes and the sale must be regarded as a short sale subject to a margin requirement of 150 percent (see Regulation T, Section 12(c)(1)).

• Regulation T has no margin requirements for day-trading *per se.* Regulation T margin is calculated on the position in the account at the end of the day. Therefore, if a day-trader engages in numerous day-trades throughout the day, but ends the day with no securities position, Regulation T requires margin equal to the net loss in the account at the end of the day. A Regulation T call must be issued for the entire amount of the loss. The call may be met by a deposit of cash or securities (margin or exempted), a transfer from SMA, or any combination (see Regulation T, Section 4(c)(2)).

Rule 2520

• While often thought of as a "maintenance" margin rule, Rule 2520 also contains initial margin requirements (see paragraph (b)). Initial margin is always the greater of the amount specified in Regulation T or the maintenance margin specified in paragraph (c). This requirement applies to both non day-traders (see paragraph (B)) and day-traders (see paragraph (f)(8)(B)).

• Rule 2520 was created to work in tandem with Regulation T. Therefore, because Regulation T calculations are made only at the end of the day, Rule 2520 maintenance margin calculations must be made only at the end of the day.

Although firms may calculate margin intra-day for risk assessment and risk avoidance purposes, and may impose margin calls based on such intra-day calculations, members may not grant additional buying power[2] to a customer on the basis of such intra-day calculations. Buying power may only be based on the preceding day's end-of-the-day margin calculations.

• A maintenance margin call may be satisfied by a deposit of cash, margin securities, or exempted securities, in any combination. A maintenance margin call *may not* be satisfied by a transfer from the SMA.

• Rule 2520(f)(4) permits special margin treatment for transactions in cross-guaranteed accounts if certain conditions are met. Since Regulation T does not recognize cross guarantees, nothing in Rule 2520 is intended to grant guaranteed accounts any benefit that would circumvent the provisions of Regulation T.

• Day-trading is recognized by Rule 2520 through the definitions of "day-trading," "day-trader" and the margin requirements specified in Rule 2520 (f)(8)(B). The paragraph states:

> Whenever day-trading occurs in a customer's margin account the margin 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.

Questions And Answers Relating To The Calculation Of Initial And Maintenance Margin On Day-Trading And Cross-Guaranteed Accounts

For the purpose of the illustrations contained in this *Notice*, the examples assume: 1) that the securities discussed are marginable equity securities; 2) that unless otherwise noted the maintenance margin requirement on short transactions is 30 percent of the current market value of the security; 3) the customer intends to meet his/her requirement with a deposit of cash; and 4) that each of the customers has a history of day-trading, whether or not the trades in a specific example are day-trades.

1.

Q. *Customer A and Customer B cross guarantee each other's accounts. Customer A buys $1,000,000 of securities on Day 1 and is long the securities at the end of the day. Customer B sells short $1,000,000 of* ***different*** *securities on Day 1 and is short the securities at the end of the day. What are the Regulation T and maintenance margin requirements for each customer?*

A. Since Regulation T does not acknowledge the existence of the cross guarantee, Regulation T would require Customer A to put up margin of 50 percent or $500,000 in payment for the securities purchased in Customer A's account (see Regulation T, Section 220.12(a)). Regulation T would require Customer B to put up margin of 150 percent or $1,500,000 in payment for the securities sold short in Customer B's account, of which $1,000,000 could come from the proceeds of the short sale (see Regulation T, Section 220.12(c)(1)).

Rule 2520 requires maintenance margin for Customer A of $250,000 (25 percent of the market value long) and maintenance margin for Customer B of $300,000 (30 percent of the market value short). (See Rule 2520, paragraphs (c)(1) and (c)(3) respectively.)

2.

Q. *Considering the facts in Question 1 again, would the answer be different if the securities bought by Customer A and sold short by Customer B were the* same *securities,* i.e., *because of the cross guarantee the accounts were fully hedged?*

A. Again, since Regulation T does not acknowledge the existence of the cross guarantee, Regulation T would require Customer A to put up margin of 50 percent or $500,000 in payment for the securities purchased in Customer A's account (see Regulation T, Section 220.12(a)). Regulation T would require Customer B to put up margin of 150 percent or $1,500,000 in payment for the securities sold short in Customer B's account, of which $1,000,000 could come from the proceeds of the short sale (see Regulation T, Section 220.12(c)(1)).

Rule 2520 (e)(1) permits maintenance margin of five percent of the current market value of the long securities for "Offsetting 'Long' and 'Short' Positions" where the same security is carried long and short *for the same customer*. Given the existence of the cross guarantee, Rule 2520(f)(4) allows any account guaranteed by another account to be consolidated with the other account, and the margin to be maintained may be determined on the net positions on both accounts. In this case, since Customer A and Customer B are long and short the same securities, and since they cross guarantee each other's accounts, they may utilize the five percent maintenance margin requirement outlined in paragraph (e)(1) on the offsetting positions. Therefore, the required maintenance margin for the combined position would be $50,000.

3.

Q. *On Day 1, Customer C purchases $400,000 of securities. The Regulation T margin required is $200,000. The customer deposits $250,000 cash in the account and, as a result, has received a margin loan of $150,000 from the broker/dealer to complete the transaction. What is the customer's Regulation T buying power for Day 2? What is the customer's day-trading buying power for Day 2?*

A. Going into Day 2, Customer C has Regulation T buying power of $100,000 because the previous day's Regulation T excess of $50,000 would provide $100,000 in buying power. Thus, if Customer C purchases securities on Day 2 that he does not sell on Day 2, he can make such purchases up to $100,000 without incurring a Regulation T call. Buying power is calculated as follows: ($250,000 - ($400,000 x 50%)) x 2 = $100,000.

Going into Day 2, the customer has day-trading buying power of $300,000 because the maintenance margin excess of $150,000 provides day-trading buying power of $300,000. If Customer C purchases securities on Day 2 which he subsequently sells on Day 2, *i.e.*, he engages in day-trading, he can make such purchases up to $300,000 without incurring a day-trading call. This is calculated as follows: ($250,000 - ($400,000 x 25%)) x 2 = $300,000.

The above answer presumes Customer C did not incur a loss on the day-trades (*i.e.*, made a profit or broke even). If Customer C were to buy $300,000 of securities and sell them the same day for $280,000, he would have a Regulation T call for $20,000, or 100 percent of the loss. Regulation T requires additional margin when a transaction creates or increases a margin deficiency in an amount equal to the deficiency created or increased (see Regulation T, Section 220.4(c)(1)).

4.

Q. *Customer D makes one purchase for $2,000,000 in the morning of Day 1 and then sells the securities at a profit in the afternoon of Day 1 for the same account ending the day with no securities position. What is the customer's margin requirement?*

A. Regulation T margin is calculated on the end of the day position. Because the customer has no securities position at the end of the day, and did not incur a loss, there is no Regulation T requirement. However, there is a required day-trading maintenance margin requirement of $1,000,000. The margin call would be classified as a Rule 2520 Call (not a Regulation T call) since it is Rule 2520 (b) that sets the margin for the trade.

5.

Q. *On Day 1, Customer E buys 100 ABCD at $88 in an existing margin account that has no SMA, and deposits $4,400, which is the Regulation T requirement, into the account. She carries the position over into Day 2. On Day 2, she sells 100 ABCD at $89 at 11 a.m. What is impact of the sale on the customer's Regulation T buying power or day-trading buying power for the remainder of Day 2?*

A. Going into Day 2, the customer has zero Regulation T buying power since she deposited the exact amount of the Regulation T requirement into her account on Day 1, *i.e.*, $8,800 x 50% = $4,400. Per Regulation T, Section 220.4(c)(1), buying power for Day 2 is based on the status of the account at the end of Day 1. Intra-day sales on Day 2 cannot be used to increase Regulation T buying power for Day 2. Therefore, Customer E's Regulation T buying power for Day 2 remains at zero, irrespective of the sale on Day 2.

Going into Day 2, the customer has day-trading buying power of $4,400. If Customer E chooses to purchases securities on Day 2 that she subsequently sells on Day 2, *i.e.*, she engages in day-trading, she can make such purchases up to $4,400 without incurring a day-trading call. This is calculated as follows: ($4,400 - ($8,800 x 25%)) x 2 = $4,400. The customer's day-trading buying power is set at $4,400 for Day 2. It can not be adjusted by intra-day activity.

6.

Q. *On Day 1, Customer F has an account containing equity securities with a market value of $100,000, a* *debit balance of $70,000, equity of $30,000, and maintenance margin excess of $5,000. On Day 2, the customer purchases $100,000 in equity securities and later in the same day sells them for $105,000. What is the Regulation T requirement for Day 2?*

A. Regulation T margin is calculated on the end of the day position. Since the customer has no securities position at the end of Day 2 resulting from Day 2 transactions and earned a profit on the sale, there is no Regulation T requirement for Day 2.

However, there is a Rule 2520 requirement. Going into Day 2, the customer may use the maintenance margin excess carried over from Day 1 to day-trade additional securities. Customer F has a maintenance margin excess of $5,000 ($30,000 - ($100,000 x 25%)). She could use this excess to day-trade $10,000 ($5,000 x 2) in equity securities on Day 2 without having to deposit any additional margin as long as she incurs no loss (*i.e.*, she makes a profit or breaks even) on the Day 2 day-trades. Taking the above into account, the customer should receive a Rule 2520 day-trading margin call of $45,000 representing half of the purchase price not covered by the day-trading buying power.

Endnotes

[1]Several years ago, the NASD amended Rule 2520 to make it substantially the same as New York Stock Exchange (NYSE) Rule 431, including paragraph numbering. Thus, for example, paragraph 2520(f)(4) is the same as NYSE Rule 431(f)(4). The NASD has also customized Rule 2520 in a few places in recognition of certain differences between the NASD and NYSE in rules, jurisdiction, and market structure. Members should be familiar with the requirements of either NASD Rule 2520 or NYSE Rule 431, depending upon which one applies to them.

[2]Buying power - either Regulation T or day-trading - represents the dollar value of securities that can be purchased with a given amount of Regulation T or maintenance margin excess respectively (usually twice the amount of the excess).