

Special NASD Notice to Members 99-32

NASD Regulation Requests Comment On Proposed Rules Regarding Approval Procedures For Day-Trading Accounts, Including Appropriateness Determinations, And Disclosure Of Risks Of Day-Trading Activities; **Comment Period Expires May 31, 1999**

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☒ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☒ Registered Representatives
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☒ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

NASD Regulation, Inc. (NASD Regulation®) is requesting comment from members and other interested parties on proposed rules that would require a firm that has recommended a day-trading strategy to an individual to approve the individual's account for day trading. As part of the account approval process, the firm would be required to determine that the strategy is appropriate for the customer and to provide a disclosure statement to the customer discussing the risks of day trading.

A companion *Special Notice to Members* issued today, *Special Notice to Members 99-33*, discusses current margin requirements and steps that firms are taking to increase maintenance margin requirements for certain volatile stocks. *Special Notice to Members 99-33* also solicits comment on the use of margin during volatile market conditions, as well as the use of margin by individuals engaging in day-trading activities.

Questions concerning this *Special Notice* may be directed to Patrice M. Gliniecki, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8014.

Discussion

The increased popularity of day trading by individuals poses unique investor protection concerns. Individuals engaging in day-trading activities often trade their accounts aggressively, hoping to profit from intra-day price movements in securities. However, the ability to engage effectively in day trading requires not only sufficient capital, but also a sophisticated understanding of securities markets and trading techniques. Even sophisticated investors engaging in day-trading activities should be aware that the risk of loss of capital can be very high. For persons

without this sophistication, the risk of loss can be even higher.

To address these concerns, NASD Regulation is soliciting comment on two proposed rules that would clarify and enhance the responsibilities of members that recommend day trading to individuals. The text of the proposed rules follows this *Special Notice*.

Proposed Approval Procedures For Day-Trading Accounts

The proposed rules would require a member that has recommended an "intra-day trading strategy" to a customer who is a natural person to approve that customer's account for day trading prior to effecting an initial day-trading transaction for the customer. The proposed rules would define an "intra-day trading strategy" as "an overall trading strategy characterized by the regular transmission by a customer of multiple intra-day electronic orders to effect both purchase and sale transactions in the same security or securities." The account approval would be required to be in a written document, which would be subject to the National Association of Securities Dealers, Inc. (NASD® or Association) general recordkeeping requirements.

To approve a customer's account for day trading, the member would be required to determine that an intra-day trading strategy is appropriate for the customer. In making this determination, the member would be required to "exercise diligence to ascertain the essential facts relative to the customer." This would expressly include a review of the customer's financial situation, investment experience, and investment objectives. For purposes of the proposed rules, day trading generally would not be appropriate for someone of limited resources and investment or trading experience, and low risk tolerance.

Proposed Risk Disclosure Statement

The proposed account approval procedures also would require the member, prior to effecting an initial day-trading transaction, to provide a disclosure statement to the customer discussing the unique risks posed by this activity. The disclosure statement would include several points 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 proposed rules also would allow a firm to develop an alternative risk disclosure statement, provided that the alternative statement was substantially similar to the mandated disclosure statement and was filed with, and approved by, the NASD's Advertising Department.

The proposed rules do not define the term "recommendation" in the context of day-trading activities. In general, a member would be recommending a day-trading strategy for purposes of the proposed rules if it affirmatively promoted day trading through advertising, training seminars, or direct outreach programs, and an individual engaged in day trading in response to these solicitations. The fact that customers of a firm generally were engaged in day trading would reinforce a determination that the firm had promoted itself in this way. However, merely providing general investment research or having a Web site that allows the multiple entry of intra-day purchases and sales of the same securities would not constitute a recommendation under the proposal.

Alternative Approaches

NASD Regulation is interested in receiving views as to alternative approaches to addressing the investor protection concerns raised by individuals engaging in day-trading activities. For example, the proposal could be revised to apply to a broader range of firms. In particular, the proposed requirements could apply to any firm that promotes day trading in any manner, rather than be limited to those firms that have "recommended" an intra-day trading strategy to an individual.

In addition, the proposal could be revised to reach additional categories of customers, such as any customer that indicates an intent to engage in day-trading activities. The scope of the proposal also could be restricted to reach only those persons that a firm individually solicits to engage in a day-trading strategy. Moreover, an alternative to the proposal would be to require that risk disclosure statements be provided to every individual who opens an on-line trading account.

Request For Comment

NASD Regulation encourages members and other interested parties to comment on all aspects of the proposed rules. We also specifically solicit comment on the following issues:

1. Do the proposed rules target the appropriate activity given that they are directed at firms that recommend, through general advertisements, seminars, etc., day-trading strategies to individuals? To what extent are individuals engaging in day trading as a result of efforts by firms to promote this activity? By what other means are individuals being persuaded, or otherwise electing, to engage in day trading?

2. Should the proposed rules address a broader scope of firm activities? For example, should all firms that advertise or promote day trading in any manner be subject to the proposal, regardless of whether a particular individual engages in day trading in response to the firm's actions?

3. Should the proposed rules require that any representations as to the profitability of an intra-day trading strategy be reasonably based on actual prior historical results?

4. Should the proposed rules reach a broader range of individuals? For example, should any individual that expresses an intent to engage in day trading be covered by the rules?

5. Should the proposed rules (or similar rules) apply only to new customers? How should existing customers be treated?

6. Should the proposed rules set forth a definition of "recommendation"? If so, what types of activities should constitute a recommendation in the context of day trading?

7. Is the proposed definition of an "intra-day trading strategy" appropriate?

8. Should the proposed rules prescribe with greater specificity the actions that a firm needs to take in order to fulfill its obligations under the rules? Are there additional elements that a firm should consider in order to assess the appropriateness of a day-trading strategy for an individual? For example, should a member be required to determine the source of funds that an individual intends to use for day-trading activities?

9. Are there additional issues that should be addressed in the proposed risk disclosure statement? Should customers be required to sign or

otherwise acknowledge receipt of the risk disclosure statement? Should the proposed rules permit a firm to prepare its own disclosure statement regarding the risks of day trading?

10. Are there other alternative approaches that would achieve the regulatory goal of addressing the investor protection concerns raised by day trading?

Comments should be mailed to:

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1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com

Important Note: The only comments that will be considered are those submitted in writing or via e-mail.

Comments must be received by **May 31, 1999**. Before becoming effective, any rule change must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission.

Text Of Proposed Rules

Rule 2360. Approval Procedures for Intra-Day Trading Accounts

(a) No member that has recommended an intra-day trading strategy to a customer who is a natural person shall effect a transaction for or on behalf of such customer for this purpose, unless, prior to effecting the first of such transactions, the member has:

- (1) approved the customer's account for an intra-day trading strategy in accordance with the

procedures set forth in paragraph (b); and

- (2) provided the customer with a copy of the disclosure statement required by Rule 2361.

(b) In order to approve a customer's account for an intra-day trading strategy, a member shall determine that the intra-day trading strategy is appropriate for the customer. In making this determination, the member shall exercise diligence to ascertain the essential facts relative to the customer, including his or her financial situation, investment experience, and investment objectives.

(c) Each member subject to this rule shall make a record setting forth the basis on which the member approves the customer's account under paragraph (a) and shall preserve such record in accordance with Rule 3110(a).

(d) For purposes of this rule, the term "intra-day trading strategy" means an overall trading strategy characterized by the regular transmission by a customer of multiple intra-day electronic orders to effect both purchase and sale transactions in the same security or securities.

Rule 2361. Intra-Day Trading Strategy Disclosure Statement

(a) Except as provided in paragraph (b), no member that has recommended an intra-day trading strategy to a customer who is a natural person shall effect a transaction for or on behalf of such customer for this purpose, unless, prior to effecting the first of such transactions, the member has provided to the customer, in writing or electronically, the following disclosure statement:

You should consider the following points before engaging in day

trading activities. For purposes of this notice, "day trading" means the transmission by you of multiple intra-day electronic orders to effect both purchase and sale transactions in the same security or securities.

- **Day trading is extremely risky.** 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 for current income to meet your living expenses.

- **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. You should confirm that a firm has adequate systems capacity to permit customers to engage in day trading activities.

• **Day trading may result in your paying large commissions.** Day trading may require you to trade your account aggressively, and you may pay commissions on each trade. The total daily commissions that you pay on your trades may add to your losses or significantly reduce your earnings.

• **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.

(b) In lieu of providing the disclosure statement specified in paragraph (a), a member that has recommended an intra-day trading strategy to a customer who is a natural person may provide to the customer, in writing or electronically, prior to effecting the first of such transactions, 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 "intra-day trading strategy" means an overall trading strategy characterized by the regular transmission by a customer of multiple intra-day electronic orders to effect both purchase and sale transactions in the same security or securities.

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