

Alden S. Adkins
General Counsel and
Senior Vice President

September 5, 2000

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-00-55**; Delivery of a Margin Disclosure Statement to Non-Institutional Customers

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Stephanie Dumont, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8176; e-mail Stephanie.Dumont@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Alden S. Adkins

Enclosures

File No. SR-NASD-00-55
Consists of 25 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to add new Rule 2341. The proposed rule change would require members to deliver to non-institutional customers, prior to or at the opening of a margin account, a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin. The proposed rule change also would require members to deliver the disclosure statement annually to all non-institutional customers with margin accounts.

Below is the text of the proposed rule change (all proposed rule language is new).

Rule 2341. Margin Disclosure Statement

(a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a non-institutional customer, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in writing or electronically, the following margin disclosure statement:

Your brokerage firm is furnishing this document to you to provide some basic facts about purchasing securities on margin, and to alert you to the risks involved with trading securities in a margin account. Before trading stocks in a margin account, you should carefully review the margin agreement provided by your firm. Consult your firm regarding any questions or concerns you may have with your margin accounts.

When you purchase securities, you may pay for the securities in full or you may borrow part of the purchase price from your brokerage firm. If you choose to borrow funds from your firm, you will open a margin account with the firm. The securities purchased are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities in your account, in order to maintain the required equity in the account.

It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- **You can lose more funds than you deposit in the margin account.** A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities in your account.
- **The firm can force the sale of securities in your account.** If the equity in your account falls below the maintenance margin requirements under the law, or the firm's higher "house" requirements, the firm can sell the securities in your account to cover the margin deficiency. You also will be responsible for any short fall in the account after such a sale.
- **The firm can sell your securities without contacting you.** Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities in their accounts to meet the call unless the firm has contacted them first. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without notice to the customer.
- **You are not entitled to choose which security in your margin account is liquidated or sold to meet a margin call.** Because the securities are collateral for the margin loan, the firm has the right to decide which security to sell in order to protect its interests.
- **The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.** These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause the member to liquidate or sell securities in your account.

- **You are not entitled to an extension of time on a margin call.** While an extension of time to meet margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension.

(b) Members shall, with a frequency of not less than once a calendar year, deliver individually, in writing or electronically, the disclosure statement described in paragraph (a) to all non-institutional customers with margin accounts.

(c) In lieu of providing the margin disclosure statement specified in paragraph (a), a member may provide to the customer an alternative disclosure statement, provided that the alternative disclosure statement shall be substantially similar to the disclosure statement specified in paragraph (a).

(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).

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on July 26, 2000, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on July 27, 2000. No other action by the NASD is necessary for the filing of the proposed rule change.

Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval. With respect to the annual delivery requirement, members would be required to provide the margin disclosure statement to each existing margin customer at the time the member is required to send the next annual statement to the customer (following the effective date of the rule change), but not to exceed 180 days following the effective date of the rule change.

(b) Questions regarding this rule filing may be directed to Stephanie M. Dumont, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8176.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

The recent growth in the level of customer margin account balances, coupled with the increase in customer inquiries and complaints to NASD Regulation and SEC staffs relating to the handling of margin accounts, has raised concerns as to whether investors understand the operation and risks associated with margin trading. NASD Regulation believes that investors' misconceptions about margin requirements, particularly with respect to maintenance margin, may cause investors to underestimate the risks of margin trading and to misunderstand the operation of and reasons for margin calls.

In this regard, a recent report issued by the General Accounting Office (“GAO”) noted that the SEC has determined from the customer complaints it has received that many investors who traded on-line did not understand margin requirements.¹ The lack of disclosures relating to when firms would sell securities in a margin account to cover margin loans was among the leading margin-related complaints that the SEC received.

The GAO Report also collected and summarized information from 12 on-line broker/dealers.² All of the on-line firms contacted did provide their customers the limited information currently required on margin trading.³ Some firms also provided additional information relating to margin, such as requirements for account opening, procedures for selling securities to cover account losses, or special requirements for volatile stocks. However, nearly half of the firms contacted automatically opened margin accounts for new customers without providing the customer information relating to the risks associated with margin trading. At three firms that automatically⁴ opened margin accounts, customers

¹ See *On-Line Trading, Better Investor Protection Information Needed*, Report to Congressional Requesters, GAO, General Government Division, 00-43 (May 2000) (the “GAO Report”). According to the GAO Report, between January 1998 and June 1999, 140 margin-related complaints concerning on-line trading firms were submitted to the SEC.

² These firms represented less than 10 percent of the total estimated number of firms that offer on-line trading. However, they accounted for about 90 percent of the on-line trading volume during early 1999.

³ Rule 10b-16 under the Securities Exchange Act of 1934 (“SEC Rule 10b-16”) requires that broker/dealers that extend credit to customers to finance securities transactions furnish, in writing, specified information regarding the terms of the loan. These disclosures must be made on both an initial and periodic basis. For instance, at the time a customer opens a margin account, a broker/dealer must provide the customer with a written statement disclosing, among other things, the annual rate of interest, the method of computing interest, and what other credit charges may be imposed.

⁴ Those firms that provided clear indications of the type of account to be opened offered their customers the option on the web site to choose either a cash or margin account, or both. However,

would find out about their account type only if they read and understood their account agreements, which SEC staff indicated were written in legal language and may be difficult for investors to understand. Three of the 12 on-line broker/dealers contacted did take “extra measures” to ensure that their customers understood that stocks could be sold to cover outstanding loans in a margin account. These firms included information on their web sites that explained that accounts could be liquidated in fast-moving markets before the customary period.

The GAO Report concluded that better investor protection information, including information relating to margin requirements, was needed on web sites of some on-line broker/dealers. In this regard, the GAO Report recommended that the SEC ensure that broker/dealers with on-line trading systems include accurate and complete information on their web sites regarding, among other things, margin requirements.

Specific Areas of Concern

Based on customer complaints and inquiries it has received, NASD Regulation identified several areas associated with margin trading that may have generated confusion and misunderstanding between customers and members. These include:

Margin Calls - Notification. Some investors hold the mistaken belief that their broker/dealer must contact them for a margin call to be valid, and that their broker/dealer cannot liquidate securities in their account to meet the call unless a specified number of days have passed and/or the broker/dealer has contacted the customer. There are no such restrictions in Regulation T of the Board of Governors

those firms that automatically opened margin accounts only offered new customers a choice with respect to account ownership, such as joint or individual account.

of the Federal Reserve System or NASD Rule 2520. Moreover, securities that have been purchased on margin by a customer are collateral for the margin loan and are, therefore, subject to the security claim of the broker/dealer until the customer fully pays for the securities. Thus, if a broker/dealer believes that the collateral for the margin loan is at risk, the broker/dealer is entitled to take any steps necessary to protect its financial interests, including immediate liquidation without notice to the customer. Some broker/dealers will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a broker/dealer has contacted a customer and provided a specific date by which the customer can meet a margin call, the broker/dealer can still take necessary steps to protect its financial interests, including immediate liquidation, without further notice to the customer.

Extensions of time on margin calls. Some investors believe they are automatically entitled to an extension of time to meet margin calls. While an extension of time to meet *initial* margin requirements may be available to the customer under certain conditions, it is only granted if the clearing firm chooses to request an extension from its Designated Examining Authority; the customer does not have a right to an automatic extension.

In addition, some investors believe that when a *maintenance* margin call has been issued that they are entitled to one or more extensions of time to meet the call; however, there is no mechanism for extending maintenance margin calls. If the customer fails to meet a maintenance margin call, the broker/dealer can, under certain circumstances, take a charge to its net capital in lieu of collecting the call, but the broker/dealer is not required to do so, and the customer has no right to demand it.

Right to dictate which security is liquidated. Some investors believe that they have the right to control which securities are liquidated to meet a maintenance margin call if there is more than one

security in the account. There is no provision in the margin rules that gives the customer the right to control liquidation decisions. As discussed above, because the securities are collateral for the margin loan, the broker/dealer has the right to control the disposition of the collateral in order to protect its interests. In this regard, the broker/dealer may choose which securities in the margin account to liquidate, and this selection need not relate to factors associated with the individual customer. For example, the broker/dealer may choose a particular security in a customer's account to liquidate based on a high concentration of the security held by customers firm-wide.

Members raising their maintenance margin requirements. Some members have increased their "house" maintenance margin requirements as a result of concerns about the volatility and extreme price run-ups on certain stocks and the risks to their customers and the member's own potential exposure to losses from margin defaults. These changes in policy often take effect immediately and will result in the issuance of a maintenance margin call. A customer's failure to satisfy the call will usually cause the member to liquidate a portion of the customer's account.

Some investors believe that a member must provide thirty days written notice before implementing this type of change. While SEC Rule 10b-16 requires members to disclose to customers the credit terms (interest rates and methods of calculating interest) for margin transactions and requires advance written notice of such changes, it does not require advance notice of the amount of margin required.

Proposed Requirements

Although NASD Regulation recognizes that some members are providing disclosures to customers relating to margin, the content of these disclosures is not consistent from firm to firm and may

not always be in a form that is understandable to investors. As such, NASD Regulation is proposing new Rule 2341 that would require members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin.⁵ Members would be required to deliver the disclosure statement, in writing or electronically, to customers individually,⁶ prior to or at the opening of a margin account. The proposed rule change also would require members to deliver the disclosure statement annually to all non-institutional customers with margin accounts. Members would be required to provide the disclosure statement to existing margin customers at the time the member is required to send the next annual statement to the customer (following the effective date of the rule change), but not to exceed 180 days following the effective date of the rule change.

The margin disclosure statement: (1) describes the operation of a margin account; (2) emphasizes that customers should carefully review their margin agreements; and (3) clarifies some of the risks associated with margin trading, including that the customer can lose more funds than initially deposited, the firm can force the sale of the securities in the customer's account without notice to the

⁵ The term “non-institutional customer” would mean 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 similar functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

⁶ Members would be required to deliver the disclosure statement to each customer individually. For example, a member firm posting the disclosure statement on its web site would not fulfill the proposed delivery requirements.

customer, the firm can dictate which security is selected for liquidation and the customer is not entitled to an extension of time on a margin call.

Members would be permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated statement and incorporates all of the relevant concepts. Under the proposed rule, disclosure at or prior to the opening of the account must be made in a separate document, even if a member chooses to deliver the disclosures as part of or within the margin agreement or other opening account documentation. However, with respect to the annual disclosure requirement, members would be permitted to provide the disclosures within other documentation, such as the customer account statement.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that the proposed rule change will provide margin customers a better understanding of the operation of a margin account and the risks associated with margin trading.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.⁷ However, several NASD Regulation standing and District committees raised several issues that deserve further opportunity for comment. As such, the NASD requests that the SEC, in its Release giving notice of filing of this proposed rule change, specifically solicit comment on the following issues: (1) whether the proposed methods of delivery of the margin disclosure statement for both the initial and the annual disclosure requirements are appropriate; (2) whether providing only the "bulleted" information in the margin disclosure statement would be appropriate for fulfilling the annual disclosure requirement; and (3) whether requiring that members deliver the annual margin disclosure statement at the time the member is required to deliver the next annual statement to the customer, but not to exceed 180 days following the effective date of the proposed rule, is an appropriate amount of time for the first delivery of the statement to all existing margin customers.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

⁷ This proposed rule change was not published for comment by the NASD through its Notice to Members process.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____
Alden S. Adkins
Senior Vice President and General Counsel

Date: September 5, 2000

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-00-55)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Delivery of a Margin Disclosure Statement to Non-Institutional Customers

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to add new Rule 2341 of the National Association of Securities Dealers, Inc. (“NASD” or “Association”), to require members to deliver to non-institutional customers, prior to or at the opening of a margin account, a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin. The proposed rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

change also would require members to deliver the disclosure statement to all non-institutional customers with margin accounts on an annual basis. Below is the text of the proposed rule change (all proposed rule language is new).

Rule 2341. Margin Disclosure Statement

(a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a non-institutional customer, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in writing or electronically, the following margin disclosure statement:

Your brokerage firm is furnishing this document to you to provide some basic facts about purchasing securities on margin, and to alert you to the risks involved with trading securities in a margin account. Before trading stocks in a margin account, you should carefully review the margin agreement provided by your firm. Consult your firm regarding any questions or concerns you may have with your margin accounts.

When you purchase securities, you may pay for the securities in full or you may borrow part of the purchase price from your brokerage firm. If you choose to borrow funds from your firm, you will open a margin account with the firm. The securities purchased are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities in your account, in order to maintain the required equity in the account.

It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- **You can lose more funds than you deposit in the margin account.** A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities in your account.
- **The firm can force the sale of securities in your account.** If the equity in your account falls below the maintenance margin requirements under the law, or the firm's higher "house" requirements, the firm can sell the securities in your account to cover the margin deficiency. You also will be responsible for any short fall in the account after such a sale.
- **The firm can sell your securities without contacting you.** Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities in their accounts to meet the call unless the firm has contacted them first. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without notice to the customer.
- **You are not entitled to choose which security in your margin account is liquidated or sold to meet a margin call.** Because the securities are collateral for the margin loan, the firm has the right to decide which security to sell in order to protect its interests.
- **The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.** These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause the member to liquidate or sell securities in your account.
- **You are not entitled to an extension of time on a margin call.** While an extension of time to meet margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension.

(b) Members shall, with a frequency of not less than once a calendar year, deliver individually, in writing or electronically, the disclosure statement described in paragraph (a) to all non-institutional customers with margin accounts.

(c) In lieu of providing the margin disclosure statement specified in paragraph (a), a member may provide to the customer an alternative disclosure statement, provided that the alternative disclosure statement shall be substantially similar to the disclosure statement specified in paragraph (a).

(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).

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below.

NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

The recent growth in the level of customer margin account balances, coupled with the increase in customer inquiries and complaints to NASD Regulation and SEC staffs relating to the handling of margin accounts, has raised concerns as to whether investors understand the operation and risks associated with margin trading. NASD Regulation believes that investors' misconceptions about margin requirements, particularly with respect to maintenance margin, may cause investors to underestimate the risks of margin trading and to misunderstand the operation of and reasons for margin calls.

In this regard, a recent report issued by the General Accounting Office (“GAO”) noted that the SEC has determined from the customer complaints it has received that many investors who traded on-line did not understand margin requirements.³ The lack of disclosures relating to when firms would sell securities in a margin account to cover margin loans was among the leading margin-related complaints that the SEC received.

The GAO Report also collected and summarized information from 12 on-line broker/dealers.⁴ All of the on-line firms contacted did provide their customers the limited information currently required on margin trading.⁵ Some firms also provided additional information relating to margin, such as requirements for account opening, procedures for selling securities to cover account losses, or special requirements for volatile stocks. However, nearly half of the firms contacted automatically opened margin accounts for new customers without providing the customer information relating to the risks associated with margin trading. At three firms that automatically⁶ opened margin accounts, customers

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⁴ These firms represented less than 10 percent of the total estimated number of firms that offer on-line trading. However, they accounted for about 90 percent of the on-line trading volume during early 1999.

⁵ Rule 10b-16 under the Securities Exchange Act of 1934 (“SEC Rule 10b-16”) requires that broker/dealers that extend credit to customers to finance securities transactions furnish, in writing, specified information regarding the terms of the loan. These disclosures must be made on both an initial and periodic basis. For instance, at the time a customer opens a margin account, a broker/dealer must provide the customer with a written statement disclosing, among other things, the annual rate of interest, the method of computing interest, and what other credit charges may be imposed.

⁶ Those firms that provided clear indications of the type of account to be opened offered their customers the option on the web site to choose either a cash or margin account, or both. However,

would find out about their account type only if they read and understood their account agreements, which SEC staff indicated were written in legal language and may be difficult for investors to understand. Three of the 12 on-line broker/dealers contacted did take “extra measures” to ensure that their customers understood that stocks could be sold to cover outstanding loans in a margin account. These firms included information on their web sites that explained that accounts could be liquidated in fast-moving markets before the customary period.

The GAO Report concluded that better investor protection information, including information relating to margin requirements, was needed on web sites of some on-line broker/dealers. In this regard, the GAO Report recommended that the SEC ensure that broker/dealers with on-line trading systems include accurate and complete information on their web sites regarding, among other things, margin requirements.

Specific Areas of Concern

Based on customer complaints and inquiries it has received, NASD Regulation identified several areas associated with margin trading that may have generated confusion and misunderstanding between customers and members. These include:

Margin Calls - Notification. Some investors hold the mistaken belief that their broker/dealer must contact them for a margin call to be valid, and that their broker/dealer cannot liquidate securities in their account to meet the call unless a specified number of days have passed and/or the broker/dealer has contacted the customer. There are no such restrictions in Regulation T of the Board of Governors

those firms that automatically opened margin accounts only offered new customers a choice with respect to account ownership, such as joint or individual account.

of the Federal Reserve System or NASD Rule 2520. Moreover, securities that have been purchased on margin by a customer are collateral for the margin loan and are, therefore, subject to the security claim of the broker/dealer until the customer fully pays for the securities. Thus, if a broker/dealer believes that the collateral for the margin loan is at risk, the broker/dealer is entitled to take any steps necessary to protect its financial interests, including immediate liquidation without notice to the customer. Some broker/dealers will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a broker/dealer has contacted a customer and provided a specific date by which the customer can meet a margin call, the broker/dealer can still take necessary steps to protect its financial interests, including immediate liquidation, without further notice to the customer.

Extensions of time on margin calls. Some investors believe they are automatically entitled to an extension of time to meet margin calls. While an extension of time to meet *initial* margin requirements may be available to the customer under certain conditions, it is only granted if the clearing firm chooses to request an extension from its Designated Examining Authority; the customer does not have a right to an automatic extension.

In addition, some investors believe that when a *maintenance* margin call has been issued that they are entitled to one or more extensions of time to meet the call; however, there is no mechanism for extending maintenance margin calls. If the customer fails to meet a maintenance margin call, the broker/dealer can, under certain circumstances, take a charge to its net capital in lieu of collecting the call, but the broker/dealer is not required to do so, and the customer has no right to demand it.

Right to dictate which security is liquidated. Some investors believe that they have the right to control which securities are liquidated to meet a maintenance margin call if there is more than one

security in the account. There is no provision in the margin rules that gives the customer the right to control liquidation decisions. As discussed above, because the securities are collateral for the margin loan, the broker/dealer has the right to control the disposition of the collateral in order to protect its interests. In this regard, the broker/dealer may choose which securities in the margin account to liquidate, and this selection need not relate to factors associated with the individual customer. For example, the broker/dealer may choose a particular security in a customer's account to liquidate based on a high concentration of the security held by customers firm-wide.

Members raising their maintenance margin requirements. Some members have increased their "house" maintenance margin requirements as a result of concerns about the volatility and extreme price run-ups on certain stocks and the risks to their customers and the member's own potential exposure to losses from margin defaults. These changes in policy often take effect immediately and will result in the issuance of a maintenance margin call. A customer's failure to satisfy the call will usually cause the member to liquidate a portion of the customer's account.

Some investors believe that a member must provide thirty days written notice before implementing this type of change. While SEC Rule 10b-16 requires members to disclose to customers the credit terms (interest rates and methods of calculating interest) for margin transactions and requires advance written notice of such changes, it does not require advance notice of the amount of margin required.

Proposed Requirements

Although NASD Regulation recognizes that some members are providing disclosures to customers relating to margin, the content of these disclosures is not consistent from firm to firm and may

not always be in a form that is understandable to investors. As such, NASD Regulation is proposing new Rule 2341 that would require members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin.⁷ Members would be required to deliver the disclosure statement, in writing or electronically, to customers individually,⁸ prior to or at the opening of a margin account. The proposed rule change also would require members to deliver the disclosure statement annually to all non-institutional customers with margin accounts. Members would be required to provide the disclosure statement to existing margin customers at the time the member is required to send the next annual statement to the customer (following the effective date of the rule change), but not to exceed 180 days following the effective date of the rule change.

The margin disclosure statement: (1) describes the operation of a margin account; (2) emphasizes that customers should carefully review their margin agreements; and (3) clarifies some of the risks associated with margin trading, including that the customer can lose more funds than initially deposited, the firm can force the sale of the securities in the customer's account without notice to the

⁷ The term “non-institutional customer” would mean 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 similar functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

⁸ Members would be required to deliver the disclosure statement to each customer individually. For example, a member firm posting the disclosure statement on its web site would not fulfill the proposed delivery requirements.

customer, the firm can dictate which security is selected for liquidation and the customer is not entitled to an extension of time on a margin call.

Members would be permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated statement and incorporates all of the relevant concepts. Under the proposed rule, disclosure at or prior to the opening of the account must be made in a separate document, even if a member chooses to deliver the disclosures as part of or within the margin agreement or other opening account documentation. However, with respect to the annual disclosure requirement, members would be permitted to provide the disclosures within other documentation, such as the customer account statement.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that the proposed rule change will provide margin customers a better understanding of the operation of a margin account and the risks associated with margin trading.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and

copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary