January 13, 2000

Katherine A. England, Esq.
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-00-03** - Margin Requirements for Day-Trading Customers

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed is the above-numbered rule filing. Also enclosed is a 3-l/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
Sr. Vice President
and General Counsel

Enclosures

File No. SR-NASD-00-03
Consists of 30 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. <u>Text of Proposed Rule Change</u>

(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 amend NASD Rule 2520 to impose overall more stringent margin requirements for day-trading customers. The proposed rule change would:

(1) Revise the definition of "pattern day trader" to include any customer who (a) the firm knows or has a reasonable basis to believe will engage in pattern day trading, or (b) day trades four or more times in five business days, unless his or her day-trading activities do not exceed 6% of his or her total trading activity for that time period. A day trader would be able to shed the day trader classification if he or she did not day trade for a ninety (90) day period;

(2) Require minimum equity of $25,000 to be in an account on any day in which the customer day trades. Funds deposited into a day trader’s account to meet the minimum equity requirement would have to remain in the account for a minimum of two business days following the close of business on any day the deposit was required;

(3) Permit day-trading buying power of up to four times maintenance margin excess;

(4) Impose a day-trading margin call on any customer who exceeds his or her day-trading buying power and limit the customer to two times maintenance margin excess based on daily total trading commitment until the call is met. If the call is not met by the fifth business day, the day trader would be limited to trading on a cash available basis for 90 days or until the call is met;

(5) Prohibit the use of cross-guarantees to meet day-trading minimum equity requirements or day-trading margin calls; and

(6) Revise the current interpretation that requires the sale and repurchase on the same day of a position held from the previous day to be treated as a day trade. Instead, the sale of the position would be treated as a liquidation of the existing position and the subsequent repurchase as the establishment of a new position not subject to the rules affecting day trades.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

2520. Margin Requirements

(a) Definitions No change.

(b) Initial Margin

For the purpose of effecting new securities transactions and commitments, the customer shall be required to deposit margin in cash and/or securities in the account which shall be at least the greater of:

(1) through (3) No change.

(4) equity of at least $2,000 except that cash need not be deposited in excess of the cost of any security purchased (this equity and cost of purchase provision shall not apply to "when distributed" securities in a cash account). <u>The minimum equity requirement for a "pattern day trader" is $25,000 pursuant to paragraph (f)(8)(B)(iv)a. of this Rule.</u>

Withdrawals of cash or securities may be made from any account which has a debit balance, "short" position or commitments, provided it is in compliance with Regulation T of the Board of Governors of the Federal Reserve System and after such withdrawal the equity in the account is at least the greater of $2,000 ($25,000 in the case of a "pattern day trader") or an amount sufficient to meet the maintenance margin requirements of this [paragraph] Rule.

(c) through (f)(8)(A)(iii) No change.

(f)(8)(B) **Day[-] Trading**

(i) The term "day[-] trading" means the purchasing and selling or the selling and purchasing of the same security on the same day in a margin account except for:

a. a long security position held overnight and sold the next day prior to any new purchase of the same security, or

b. a short security position held overnight and purchased the next day prior to any new sale of the same security.

(ii) [A "day- trader" is any customer whose trading shows a pattern of day- trading.] The term "pattern day trader" means any customer who executes four or more day trades within five business days. However, if the number of day trades is 6% or less of total trades for the five business day period, the customer will not be considered a pattern day trader and the special requirements under paragraph (f)(8)(B)(iv) of this Rule will not apply. In the event that the organization at which a customer seeks to open an account knows or has a reasonable basis to believe that the customer will engage in pattern day trading, then the special requirements under paragraph (f)(8)(B)(iv) of this Rule will apply. If a pattern day trader does not day trade for a 90 day period, the customer will no longer be considered a pattern day trader.

(iii) The term "day-trading buying power" means the equity in a customer's account at the close of business of the previous day, less any maintenance margin requirement as prescribed in paragraph (c) of this Rule, multiplied by four for equity securities.

Whenever day[-] trading occurs in a customer's margin account the special maintenance margin required for the day trades in equity securities [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.] 25% of the cost of all the day trades made during the day. For non-equity securities, the special maintenance margin shall be as required pursuant to the other provisions of this Rule. Alternatively, when two or more day trades occur on the same day in the same customer's account, the margin required may be computed utilizing the highest (dollar amount) open position during that day. To utilize the highest open position computation method, a record showing the "time and tick" of each trade must be maintained to document the sequence in which each day trade was completed.

(iv) Special Requirements for Pattern Day Traders

a. Minimum Equity Requirement for Pattern Day Traders - The minimum equity required for the accounts of customers deemed to be pattern day traders shall be $25,000. This minimum equity must be deposited in the account before such customer may continue day trading and must be maintained in the customer's account at all times.

b. Pattern day traders cannot trade in excess of their day-trading buying power as defined in paragraph (f)(8)(B)(iii) above. In the event a pattern day trader exceeds its day-trading buying power, which creates a special maintenance margin deficiency, the following actions will be taken by the member:

<u>1. The account will be margined based on the cost of all the day trades made during the day,</u>

<u>2. The customer's day-trading buying power will be limited to the equity in the customer's account at the close of business of the previous day, less the maintenance margin required in paragraph (c) of this Rule, multiplied by two for equity securities, and</u>

<u>3. "time and tick" (i.e., calculating margin using each trade in the sequence that it is executed, using the highest open position during the day) may not be used.</u>

<u>c. Pattern day traders who fail to meet their special maintenance margin calls as required within five business days from the date the margin deficiency occurs will be permitted to execute transactions only on a cash available basis for 90 days or until the special maintenance margin call is met.</u>

<u>d. Pattern day traders are restricted from using the guaranteed account provision pursuant to paragraph (f)(4) of this Rule for meeting the requirements of paragraph (f)(8)(B).</u>

<u>e. Funds deposited into a day trader's account to meet the minimum equity or maintenance margin requirements of paragraph (f)(8)(B) of this Rule cannot be withdrawn for a minimum of two business days following the close of business on the day of deposit.</u>

(C) When the equity in a customer's account, after giving consideration to the other provisions of this [paragraph (c)] <u>Rule</u>, is not sufficient to meet the requirements of [subparagraph (i) or (ii) hereof] <u>paragraph (f)(8)(A) or (B)</u>, additional cash or securities must be received into the account to meet any deficiency within [seven] five business days of the trade date.

In addition, on the sixth business day only, members are required to deduct from Net Capital the amount of unmet maintenance margin calls pursuant to SEC Rule 15c3-1.

(f)(9) and (f)(10) No change.

* * *

(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 December 8, 1999, which authorized the filing of the rule change with the SEC in order to remain procedurally consistent with the New York Stock Exchange ("NYSE") on this issue. In authorizing this filing, the NASD Regulation Board asked that the staff request that the Commission solicit comment specifically on certain aspects of the proposal and authorized the establishment of a task force to consider these issues. 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 December 9, 1999. 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.

(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

Introduction

Day-trading margin requirements have come under close scrutiny, as day-trading activities have become more prevalent. The 431 Committee[1] has been meeting frequently over the last few months to consider responses to the various problem areas that have been identified. These proposed rule changes are based on recommendations from this Committee and will more appropriately protect the safety and soundness of member firms and ensure the overall financial well-being of the securities markets.

---

[1] After the Board of Governors of the Federal Reserve System extensively amended Regulation T, an informal ad hoc committee (the "431 Committee") was formed to consider changes to the NYSE’s and NASD’s margin rules (NYSE Rule 431 and NASD Rule 2520, respectively). The 431 Committee also was formed to ensure that the NYSE’s and NASD’s margin rules were consistent in order to prevent confusion and to avoid conferring advantages on members that are required to comply with one rule and not the other. The 431 Committee is composed of NYSE staff, attorneys from the NYSE’s outside counsel, NASD staff, Federal Reserve staff, and representatives from several clearing firms and broker/dealers.

Current Day-Trading Margin Requirements

Because Regulation T initial margin requirements and NASD/NYSE standard maintenance margin requirements[2] are calculated only at the end of each day, a day trader who has no positions in his or her account at the end of the day would not incur a Regulation T initial margin nor a standard maintenance margin requirement, assuming no losses in the account. Current NASD/NYSE initial margin provisions, however, generally require a customer to deposit margin of at least $2,000, unless in excess of the cost of the security.

Although the day trader may end the day with no position, the day trader and the firm, if credit is extended, are at risk during the day. To address this risk, the NASD and NYSE require day traders to demonstrate that they have the ability to meet the initial margin requirements for at least their largest open position during the day. Specifically, a customer who meets the definition of day trader under the rule must deposit in his or her account, the margin that would have been required under Regulation T (i.e., the 50 percent initial margin requirement) if the customer had not liquidated the position during the trading day. If the customer day trades, but is not considered a "day trader," the customer is still required to post 25% of the largest open position during the day.

Currently, if a customer's day trading results in a day-trading margin call, the customer has seven days to meet the call by depositing additional cash or securities. Because day traders typically end the day flat and this day-trading "margin" deposit is not securing a margin loan, the customer is not required to leave the margin deposit in the account and may withdraw the deposit the day after the deposit is made. If the customer fails to meet a day-trading margin call, no

---

[2] NASD Rule 2520 and NYSE Rule 431, the margin provisions for the NASD and the NYSE, respectively, are substantially similar.

specific action to the customer account is required to be taken by the firm. There are no securities to liquidate, as there would be for an existing position, because day traders typically end the day flat.

Proposed Rule Change

The proposed rule change would address the perceived deficiencies that have been identified with existing rules relating to day-trading margin activities. Specifically, the proposed rule change would:

(1) Change the definition of “pattern day trader” to cover only true day traders. Day-trading margin requirements should be imposed only on true day traders, not just incidental or occasional day traders. The current definition sweeps too broadly when it includes customers, such as institutions and other large individual accounts, that have a high volume of trading activity and that occasionally day trade, not as a strategy, but because of a specific investment decision or in reaction to events. Accordingly, day traders would be defined as those customers who day trade four or more times in five business days, unless their day-trading activities do not exceed 6% of their total trading activity for that period. In addition, if the firm knows or has a reasonable basis to believe that the customer is a pattern day trader, for example, if the firm provided training to the customer on day trading in anticipation of the customer opening an account, the customer must be designated as a pattern day trader immediately, instead of delaying such determination for five business days. A pattern day trader would be able to shed the day trader classification if he or she did not day trade for a 90 day period.

(2) Minimum equity requirement. The current minimum equity requirements of $2,000 do not sufficiently prevent day traders from continuing to generate losses in their accounts, without any additional deposit of funds. Accordingly, a day trader would be required to have

minimum equity in his or her account of $25,000 on any day in which the customer day trades. This minimum equity must remain in the account for at least two subsequent business days following the close of business on any day the deposit was required. A minimum requirement of $25,000 would more appropriately address the additional risks inherent in leveraged day-trading activities and would better ensure that customers cover any loss incurred in the account from the previous day prior to day trading.

(3) Permit day-trading buying power of up to four times the day trader's maintenance margin excess. Current day-trading margin calls represent illusory liabilities. The funds used to meet a call are deposited after the day-trading risk has already been incurred and need only remain in the account overnight. Accordingly, day-trading buying power would not be permitted to exceed four times the day trader's maintenance margin excess. This calculation would be based on equity maintained in the account prior to each day's trading and, at the firm's option, could be based on either the largest open position at any given time during the day, or on the customer's total trading commitment during the day. By limiting a customer's day-trading buying power to four times maintenance margin excess, which must be in the account prior to any day trading, intra-day risks to firms of customer day trading would be more appropriately addressed.

(4) Impose a day-trading margin call if day-trading buying power is exceeded. In the event a day-trading customer exceeds his or her day-trading buying power limitations, additional restrictions would be imposed on the day trader that would more adequately protect the firm from the additional risk and help prevent a recurrence of such prohibited conduct. Members would be required to issue a day-trading margin call to day traders that exceed their day-trading buying power. Customers would have five business days to deposit funds to meet this day-trading

margin call. The day-trading account would be restricted to day-trading buying power of two times maintenance margin excess based on the customer's daily total trading commitment until the call is met. Funds used to meet a day-trading margin call would be required to remain in the account for two business days. If the day-trading margin call is not met by the fifth business day, the account would be further restricted to trading only on a cash available basis for 90 days or until the call is met.

(5) Prohibit cross-guaranteeing of day-trading accounts. Day traders would not be able to meet the day-trading margin requirements through the use of cross-guarantees. Each day-trading account would be required to meet the applicable requirements independently, using only the financial resources available in the account. Accordingly, day traders would be prohibited from using cross-guarantees to meet the minimum equity requirements or to meet day-trading margin calls.

(6) Revise the current interpretation that requires the sale and repurchase on the same day of a position held from the previous day to be treated as a day trade. The proposed rule change would treat the sale of an existing position as a liquidation and the subsequent repurchase as the establishment of a new position not subject to the rules affecting day trades. Similarly, if a short position is carried overnight, the purchase to close the short position and subsequent new sale would not be considered a day trade.

(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. The

NASD believes that the proposed rule change will more appropriately address the perceived deficiencies that have been identified with existing rules relating to day-trading margin activities, will promote the safety and soundness of member firms, and will further investor protection.

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 not solicited. The NASD received, however, a petition to the NASD Board dated December 2, 1999, from Steven H. Levine, Special Credit Counselor to the Electronic Traders Association ("ETA"). The petition requested that the NASD make certain modifications to its proposed rule change. In general, the petition supported the increase in the minimum equity requirement from $2,000 to $25,000 and the increase in day-trading buying power from two times to four times maintenance margin excess. It also supported the use of "time and tick" as part of the proposed rule and raised no objection to the five business day requirement for day traders to meet the day-trading margin call.

The petition opposed the proposed definition of a pattern day trader and indicated that for almost 65 years, a general standard of three day trades in a 12 month period resulting in a person being deemed a day trader has worked. It also noted that many of the NYSE's largest carrying clearing firms only allow one or two day trades as an indication of a day trading pattern.

The petition disagreed with the proposed requirement that funds deposited to meet day-trading margin calls must remain in the account for two full business days. It noted that such a rule will increase the day trader's ability to further day trade with the deposited funds for additional days, will expose the lender to needless risk, and will needlessly penalize the customer for the use of funds, including the use of their own funds.

In addition, the petition opposed the restriction on the use of cross guarantees to meet day-trading margin requirements on the basis that it constituted discrimination against the day trader margin investor and violates his or her constitutional right to trade and to enter into agreements with others.

The NASD believes that the proposed rule change is appropriate to address the additional risks inherent in leveraged day-trading activities. The proposed rule change will provide greater financial stability to a day trader's account and will provide a more accurate indicator of the financial means and resources of each individual day-trading customer than is provided under current rules.

Because the petition and other verbal comments provided by members to the NASD Regulation staff[3] have raised issues that deserve further opportunity for comment, 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 that have been raised by the petition and other interested parties: (1) Is the requirement that a firm "knows or has a reasonable basis to believe" that a customer will engage in pattern day trading too difficult to apply in practice? At what level within the firm would this "knowledge" requirement apply? (2) Does the 6% minimum requirement within the definition of a "pattern day trader" appropriately address trading by institutional accounts or would a different standard, including a possible blanket

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

exemption for institutional accounts, be more appropriate? (3) Is the requirement that funds remain in the account for two business days appropriate? (4) Should a customer be provided an opportunity (e.g., one business day) to meet a day-trading margin call prior to imposing the two times maintenance margin excess requirements based on the customer's daily total trading commitment? (5) Would it be more appropriate to immediately require a day trader that exceeds his or her day-trading buying power to trade on a cash available basis only until the day-trading margin call is met? (6) Should cross-guarantees for the use of meeting day-trading margin requirements be permitted? Would an alternative of limiting the use of cross-guarantees up to a certain multiple of the assets in an account or based on the funds available in an account be more appropriate?

As appropriate, the NASD can work with the Commission in identifying other specific issues on which to solicit comment.

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.

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

The provisions of the proposed rule change are consistent with proposed rule changes to NYSE Rule 431 that were recently filed with the SEC in SR-NYSE-99-47. NASD Regulation believes it is important that the NASD's and the NYSE's margin rules are consistent in order to avoid imposing confusing or inconsistent margin requirements on the securities industry.

9. <u>Exhibits</u>

1. Completed notice of proposed rule change for publication in the <u>Federal</u> <u>Register</u>.

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
Sr. Vice President and General Counsel

Date: January 13, 2000

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-00-03)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Margin Requirements for Day-trading 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 a rule change to amend NASD Rule 2520 to impose overall more stringent margin requirements for day-trading customers. The proposed rule change would:

(1) Revise the definition of "pattern day trader" to include any customer who (a) the firm knows or has a reasonable basis to believe will engage in pattern day trading, or (b) day trades four or more times in five business days, unless his or her day-trading activities do not exceed

---

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

6% of his or her total trading activity for that time period. A day trader would be able to shed the day trader classification if he or she did not day trade for a ninety (90) day period;

(2) Require minimum equity of $25,000 to be in an account on any day in which the customer day trades. Funds deposited into a day trader's account to meet the minimum equity requirement would have to remain in the account for a minimum of two business days following the close of business on any day the deposit was required;

(3) Permit day-trading buying power of up to four times maintenance margin excess;

(4) Impose a day-trading margin call on any customer who exceeds his or her day-trading buying power and limit the customer to two times maintenance margin excess based on daily total trading commitment until the call is met. If the call is not met by the fifth business day, the day trader would be limited to trading on a cash available basis for 90 days or until the call is met;

(5) Prohibit the use of cross-guarantees to meet day-trading minimum equity requirements or day-trading margin calls; and

(6) Revise the current interpretation that requires the sale and repurchase on the same day of a position held from the previous day to be treated as a day trade. Instead, the sale of the position would be treated as a liquidation of the existing position and the subsequent repurchase as the establishment of a new position not subject to the rules affecting day trades.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

2520. Margin Requirements

(a) Definitions No change.

(b) Initial Margin

For the purpose of effecting new securities transactions and commitments, the customer shall be required to deposit margin in cash and/or securities in the account which shall be at least the greater of:

(1) through (3) No change.

(4) equity of at least $2,000 except that cash need not be deposited in excess of the cost of any security purchased (this equity and cost of purchase provision shall not apply to "when distributed" securities in a cash account). The minimum equity requirement for a "pattern day trader" is $25,000 pursuant to paragraph (f)(8)(B)(iv)a. of this Rule.

Withdrawals of cash or securities may be made from any account which has a debit balance, "short" position or commitments, provided it is in compliance with Regulation T of the Board of Governors of the Federal Reserve System and after such withdrawal the equity in the account is at least the greater of $2,000 ($25,000 in the case of a "pattern day trader") or an amount sufficient to meet the maintenance margin requirements of this [paragraph] Rule.

(c) through (f)(8)(A)(iii) No change.

(f)(8)(B) **Day[-] Trading**

(i) The term "day[-] trading" means the purchasing and selling or the selling and purchasing of the same security on the same day in a margin account except for:

a. a long security position held overnight and sold the next day prior to any new purchase of the same security, or

b. a short security position held overnight and purchased the next day prior to any new sale of the same security.

(ii) [A "day- trader" is any customer whose trading shows a pattern of day- trading.] The term "pattern day trader" means any customer who executes four or more day trades within five business days. However, if the number of day trades is 6% or less of total trades for the five business day period, the customer will not be considered a pattern day trader and the special requirements under paragraph (f)(8)(B)(iv) of this Rule will not apply. In the event that the organization at which a customer seeks to open an account knows or has a reasonable basis to believe that the customer will engage in pattern day trading, then the special requirements under paragraph (f)(8)(B)(iv) of this Rule will apply. If a pattern day trader does not day trade for a 90 day period, the customer will no longer be considered a pattern day trader.

(iii) The term "day-trading buying power" means the equity in a customer's account at the close of business of the previous day, less any maintenance margin requirement as prescribed in paragraph (c) of this Rule, multiplied by four for equity securities.

Whenever day[-] trading occurs in a customer's margin account the special maintenance margin required for the day trades in equity securities [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.] 25% of the cost of all the day trades made during the day. For non-equity securities, the special maintenance margin shall be as required pursuant to the other provisions of this Rule. Alternatively, when two or more day trades occur on the same day in the same customer's account, the margin required may be computed utilizing the highest (dollar amount) open position during that day. To utilize the highest open position computation method, a record showing the "time and tick" of each trade must be maintained to document the sequence in which each day trade was completed.

(iv) Special Requirements for Pattern Day Traders

a. Minimum Equity Requirement for Pattern Day Traders - The minimum equity required for the accounts of customers deemed to be pattern day traders shall be $25,000. This minimum equity must be deposited in the account before such customer may continue day trading and must be maintained in the customer's account at all times.

b. Pattern day traders cannot trade in excess of their day-trading buying power as defined in paragraph (f)(8)(B)(iii) above. In the event a pattern day trader exceeds its day-trading buying power, which creates a special maintenance margin deficiency, the following actions will be taken by the member:

1. The account will be margined based on the cost of all the day trades made during the day,

2. The customer's day-trading buying power will be limited to the equity in the customer's account at the close of business of the previous day, less the maintenance margin required in paragraph (c) of this Rule, multiplied by two for equity securities, and

3. “time and tick” (i.e., calculating margin using each trade in the sequence that it is executed, using the highest open position during the day) may not be used.

c. Pattern day traders who fail to meet their special maintenance margin calls as required within five business days from the date the margin deficiency occurs will be permitted to execute transactions only on a cash available basis for 90 days or until the special maintenance margin call is met.

d. Pattern day traders are restricted from using the guaranteed account provision pursuant to paragraph (f)(4) of this Rule for meeting the requirements of paragraph (f)(8)(B).

e. Funds deposited into a day trader’s account to meet the minimum equity or maintenance margin requirements of paragraph (f)(8)(B) of this Rule cannot be withdrawn for a minimum of two business days following the close of business on the day of deposit.

(C) When the equity in a customer’s account, after giving consideration to the other provisions of this [paragraph (c)] Rule, is not sufficient to meet the requirements of [subparagraph (i) or (ii) hereof] paragraph (f)(8)(A) or (B), additional cash or securities must be received into the account to meet any deficiency within [seven] five business days of the trade date.

In addition, on the sixth business day only, members are required to deduct from Net Capital the amount of unmet maintenance margin calls pursuant to SEC Rule 15c3-1.

(f)(9) and (f)(10) No change.

* * *

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**

Introduction

Day-trading margin requirements have come under close scrutiny, as day-trading activities have become more prevalent. The 431 Committee[3] has been meeting frequently over the last few months to consider responses to the various problem areas that have been identified. These proposed rule changes are based on recommendations from this Committee and will more appropriately protect the safety and soundness of member firms and ensure the overall financial well-being of the securities markets.

[3] After the Board of Governors of the Federal Reserve System extensively amended Regulation T, an informal ad hoc committee (the "431 Committee") was formed to consider changes to the NYSE's and NASD's margin rules (NYSE Rule 431 and NASD Rule 2520, respectively). The 431 Committee also was formed to ensure that the NYSE's and NASD's margin rules were consistent in order to prevent confusion and to avoid conferring advantages on members that are required to comply with one rule and not the other. The 431 Committee is composed of NYSE staff, attorneys from the NYSE's outside counsel, NASD staff, Federal Reserve staff, and representatives from several clearing firms and broker/dealers.

Current Day-Trading Margin Requirements

Because Regulation T initial margin requirements and NASD/NYSE standard maintenance margin requirements[4] are calculated only at the end of each day, a day trader who has no positions in his or her account at the end of the day would not incur a Regulation T initial margin nor a standard maintenance margin requirement, assuming no losses in the account. Current NASD/NYSE initial margin provisions, however, generally require a customer to deposit margin of at least $2,000, unless in excess of the cost of the security.

Although the day trader may end the day with no position, the day trader and the firm, if credit is extended, are at risk during the day. To address this risk, the NASD and NYSE require day traders to demonstrate that they have the ability to meet the initial margin requirements for at least their largest open position during the day. Specifically, a customer who meets the definition of day trader under the rule must deposit in his or her account, the margin that would have been required under Regulation T (i.e., the 50 percent initial margin requirement) if the customer had not liquidated the position during the trading day. If the customer day trades, but is not considered a "day trader," the customer is still required to post 25% of the largest open position during the day.

Currently, if a customer’s day trading results in a day-trading margin call, the customer has seven days to meet the call by depositing additional cash or securities. Because day traders typically end the day flat and this day-trading "margin" deposit is not securing a margin loan, the customer is not required to leave the margin deposit in the account and may withdraw the deposit the day after the deposit is made. If the customer fails to meet a day-trading margin call, no specific action to the customer account is required to be taken by the firm. There are no securities to liquidate, as there would be for an existing position, because day traders typically end the day flat.

Proposed Rule Change

The proposed rule change would address the perceived deficiencies that have been identified with existing rules relating to day-trading margin activities. Specifically, the proposed rule change would:

(1) Change the definition of “pattern day trader” to cover only true day traders. Day-trading margin requirements should be imposed only on true day traders, not just incidental or occasional day traders. The current definition sweeps too broadly when it includes customers, such as institutions and other large individual accounts, that have a high volume of trading activity and that occasionally day trade, not as a strategy, but because of a specific investment decision or in reaction to events. Accordingly, day traders would be defined as those customers who day trade four or more times in five business days, unless their day-trading activities do not exceed 6% of their total trading activity for that period. In addition, if the firm knows or has a reasonable basis to believe that the customer is a pattern day trader, for example, if the firm provided training to the customer on day trading in anticipation of the customer opening an account, the customer must be designated as a pattern day trader immediately, instead of delaying such determination for five business days. A pattern day trader would be able to shed the day trader classification if he or she did not day trade for a 90 day period.

(2) Minimum equity requirement. The current minimum equity requirements of $2,000 do not sufficiently prevent day traders from continuing to generate losses in their accounts, without any additional deposit of funds. Accordingly, a day trader would be required to have

---

[4] NASD Rule 2520 and NYSE Rule 431, the margin provisions for the NASD and the NYSE, respectively,

minimum equity in his or her account of $25,000 on any day in which the customer day trades. This minimum equity must remain in the account for at least two subsequent business days following the close of business on any day the deposit was required. A minimum requirement of $25,000 would more appropriately address the additional risks inherent in leveraged day-trading activities and would better ensure that customers cover any loss incurred in the account from the previous day prior to day trading.

(3) Permit day-trading buying power of up to four times the day trader's maintenance margin excess. Current day-trading margin calls represent illusory liabilities. The funds used to meet a call are deposited after the day-trading risk has already been incurred and need only remain in the account overnight. Accordingly, day-trading buying power would not be permitted to exceed four times the day trader's maintenance margin excess. This calculation would be based on equity maintained in the account prior to each day's trading and, at the firm's option, could be based on either the largest open position at any given time during the day, or on the customer's total trading commitment during the day. By limiting a customer's day-trading buying power to four times maintenance margin excess, which must be in the account prior to any day trading, intra-day risks to firms of customer day trading would be more appropriately addressed.

(4) Impose a day-trading margin call if day-trading buying power is exceeded. In the event a day-trading customer exceeds his or her day-trading buying power limitations, additional restrictions would be imposed on the day trader that would more adequately protect the firm from the additional risk and help prevent a recurrence of such prohibited conduct. Members would be required to issue a day-trading margin call to day traders that exceed their day-trading buying

---

are substantially similar.

power. Customers would have five business days to deposit funds to meet this day-trading margin call. The day-trading account would be restricted to day-trading buying power of two times maintenance margin excess based on the customer's daily total trading commitment until the call is met. Funds used to meet a day-trading margin call would be required to remain in the account for two business days. If the day-trading margin call is not met by the fifth business day, the account would be further restricted to trading only on a cash available basis for 90 days or until the call is met.

(5) Prohibit cross-guaranteeing of day-trading accounts. Day traders would not be able to meet the day-trading margin requirements through the use of cross-guarantees. Each day-trading account would be required to meet the applicable requirements independently, using only the financial resources available in the account. Accordingly, day traders would be prohibited from using cross-guarantees to meet the minimum equity requirements or to meet day-trading margin calls.

(6) Revise the current interpretation that requires the sale and repurchase on the same day of a position held from the previous day to be treated as a day trade. The proposed rule change would treat the sale of an existing position as a liquidation and the subsequent repurchase as the establishment of a new position not subject to the rules affecting day trades. Similarly, if a short position is carried overnight, the purchase to close the short position and subsequent new sale would not be considered a day trade.

(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. The NASD believes that the proposed rule change will more appropriately address the perceived deficiencies that have been identified with existing rules relating to day-trading margin activities, will promote the safety and soundness of member firms, and will further investor protection.

(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 not solicited. The NASD received, however, a petition to the NASD Board dated December 2, 1999, from Steven H. Levine, Special Credit Counselor to the Electronic Traders Association ("ETA"). The petition requested that the NASD make certain modifications to its proposed rule change. In general, the petition supported the increase in the minimum equity requirement from $2,000 to $25,000 and the increase in day-trading buying power from two times to four times maintenance margin excess. It also supported the use of "time and tick" as part of the proposed rule and raised no objection to the five business day requirement for day traders to meet the day-trading margin call.

The petition opposed the proposed definition of a pattern day trader and indicated that for almost 65 years, a general standard of three day trades in a 12 month period resulting in a person being deemed a day trader has worked. It also noted that many of the NYSE's largest carrying clearing firms only allow one or two day trades as an indication of a day trading pattern.

The petition disagreed with the proposed requirement that funds deposited to meet day-trading margin calls must remain in the account for two full business days. It noted that such a rule will increase the day trader's ability to further day trade with the deposited funds for additional days, will expose the lender to needless risk, and will needlessly penalize the customer for the use of funds, including the use of their own funds.

In addition, the petition opposed the restriction on the use of cross guarantees to meet day-trading margin requirements on the basis that it constituted discrimination against the day trader margin investor and violates his or her constitutional right to trade and to enter into agreements with others.

The NASD believes that the proposed rule change is appropriate to address the additional risks inherent in leveraged day-trading activities. The proposed rule change will provide greater financial stability to a day trader's account and will provide a more accurate indicator of the financial means and resources of each individual day-trading customer than is provided under current rules.

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