Notice to Members

MAY 2004

SUGGESTED ROUTING

Legal & Compliance

Operations

Senior Management

KEY TOPICS

Day Trading

Margin Requirements

Regulation T

Rule 2520

GUIDANCE

Credit Extension/Day Trading Requirements

NASD Reminds Member Firms of Their Obligations to Adhere to Credit Extension Requirements and Day Trading Margin Rules

Executive Summary

On March 11, 2004, NASD announced a disciplinary action that resulted in a $10 million fine against three firms for improperly extending credit in violation of Federal Reserve Board Regulation T and, in numerous instances, allowing trades that avoided NASD Rule 2520's day trading margin requirements (NASD actions).[1] Day trading is the buying and selling, or selling short and buying to cover, the same security on the same day in a margin account. Firms should familiarize themselves with the facts surrounding the NASD actions and review their own procedures to ensure that strong safeguards are in place relative to compliance with Regulation T and Rule 2520. In this regard, firms should also review the full text of Regulation T and Rule 2520, as well as related materials, to ensure full compliance with all credit extension provisions and day trading margin rules.

Questions/Further Information

Questions concerning this *Notice* may be directed to Susan M. DeMando, Director, Financial Operations, Member Regulation Department, at (202) 728-8411.

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Regulation T Requirements

The principal purpose of the Federal Reserve Board's Regulation T (Reg T) is to regulate the extension of credit by brokers and dealers. It imposes, among other things, initial margin requirements and payment rules on certain securities transactions.

Reg T provides for a margin account and four special purpose accounts (special memorandum accounts, good faith accounts, broker-dealer credit accounts, and cash accounts) in which to record all financial relationships between a customer and the creditor.

Any transaction not specifically permitted in a special purpose account must be recorded in a margin account. When the transaction involves a purchase of an equity security, it may only be recorded in a cash or margin account. Which account is used depends on: (1) whether the equity qualifies as a "margin security," and (2) how the customer intends to pay for the purchase.[2] In addition, other factors require that certain transactions be conducted in a cash account. Importantly, Reg T authorizes a broker-dealer to purchase securities for a customer in a cash account, *only* if the customer has "sufficient funds" in the account or the creditor accepts in good faith the customer's agreement that he or she will promptly make "full cash payment" for the securities before selling them. If the customer plans to sell securities before making payment, the transaction must be recorded in a margin account.

If a trade is recorded in a cash account, the transaction must comply with Reg T Section 220.8. Trades recorded in a margin account must comply with Reg T Section 220.4. In addition to the Reg T requirements, a creditor must also comply with all applicable Federal Reserve Board (FRB) interpretations. As further discussed below, the transactions that were the subject of the NASD actions were conducted in customers' cash accounts and did not comply with the requirements of Reg T Section 220.8 and FRB interpretations.

NASD Actions

Respondents in the NASD actions permitted cash account customers to purchase and sell securities in a series of trades without requiring full cash payment for each purchase in violation of Reg T Section 220.8. Specifically, the firms allowed their customers to make purchase transactions based on proceeds due from unsettled trades. NASD further found that the respondents permitted day trading in cash accounts that, in many instances, would have required $25,000 minimum equity under NASD rules and should have occurred only in a margin account.

Reg T Section 220.8(a)(1) states that a broker-dealer may use a cash account to buy a security for a customer if:

(i) There are sufficient funds in the account; or

(ii) The creditor accepts in good faith the customer's agreement that the customer will promptly make full cash payment for the security or asset before selling it and does not contemplate selling it prior to making such payment….

FRB interpretations make clear that a customer who sells a security on trade date to pay for another security purchased on that day does not have "sufficient funds in the account" on trade date for purposes of Reg T Section 220.8(a)(1)(i).[3] Rather, a customer must make full payment for each separate purchase transaction in a cash account without regard to the unsettled proceeds of securities sold.[4] If a member firm plans to accept the unsettled proceeds of a securities sale as payment for securities purchased, the transaction must be conducted in a margin account, subject to the regulations affording protection to customers who trade in margin accounts.

Applicability to Clearing and Introducing Firms

The NASD Actions involved both clearing firm and introducing firm members. Clearing firms and introducing firms share responsibility for compliance with Reg T and FRB interpretations. In transactions involving a customer introduced to a clearing firm on a fully disclosed basis, the clearing firm has responsibility for Regulation T and FRB interpretation compliance as the clearing firm extends the credit. Additionally, because the introducing broker opens the customer account, it must observe the requirements of the cash account, even though it is not extending the credit.[5]

NASD Rule 2520

As described above, if a customer plans on selling securities before making full cash payment for them, the transactions must be recorded in a margin account. Transactions conducted in a margin account are subject to the requirements of NASD Rule 2520, as well as Reg T Section 220.4.[6] Rule 2520 focuses on maintenance margin requirements for positions carried overnight. The Rule also imposes initial margin requirements and, in some cases, special requirements.

To the extent a customer's trades would cause the customer to meet the definition of a "pattern day trader," such transactions must occur in a margin account and the creditor must comply with the Day Trading Margin Requirements contained in Rule 2520(f)(8)(B). The Rule defines "day trading" as buying and selling, or selling short and buying to cover, the same security on the same day in a margin account.

As of September 28, 2001, a pattern day trader is required to maintain minimum equity of $25,000 in his or her margin account to continue to engage in activities that would fall under the definition of day trading. If a firm permits transactions that should occur in a margin account to occur in a cash account, the transactions will most likely be inconsistent with the requirements applicable to cash accounts as discussed in this Notice. In addition, by permitting such transactions to occur in a cash account when it is not appropriate to do so, firms may be failing to impose on a customer the required $25,000 minimum equity requirement applicable to pattern day traders, as well as the "penalties" imposed when "excess" day-trading occurs.[7] Any firm that seeks to avoid application of the minimum equity and other requirements of Rule 2520(f)(8)(B) by shifting customer transactions to a cash account violates both Reg T and Rule 2520.

Endnotes

1 The firms subject to the NASD Actions were Ameritrade, Inc., Datek Online Financial Services LLC, and iClearing LLC. In settling these matters, the firms neither admitted nor denied the charges. See www.nasdr.com/news/pr2004/release_04_014.html.

2 In addressing certain credit extension and day-trading margin issues, this Notice focuses on the purchase and sale of equity securities.

3 See Fed. Res. Staff Op., 2 Federal Reserve Regulatory Services, Part 5-616.14 (Feb. 18, 1999). See also Fed. Res. Staff Op., Federal Reserve Regulatory Services, 5-616.15 (Jan. 6, 2000).

4 *See* Board of Governors of the Federal Reserve, Notice of Proposed Rule Making, 60 Federal Register 33763, 33767 (June 29, 1995) ("Customers are required to pay for all purchases in full without netting sale proceeds from securities purchased and sold on the same day…").

5 See Fed. Res. Staff Op., 2 Federal Reserve Regulatory Services, Part 5-615.971 (April 19, 1991).

6 Where the clearing firm is designated to the New York Stock Exchange, the transactions would be subject to NYSE Rule 431 and Reg T Section 220.4.

7 Customers whose transactions exceed their day-trading buying power are subject to special margin calls and restrictions on their account activity until such special margin calls are satisfied.