

February 12, 2001

Joan C. Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, NW  
Washington, DC 20006-1500

Filed electronically

Re: NASD Notice to Members 0106- Member Facilitation of Lending Between Customers

Dear Ms. Conley:

Please accept this comment letter on behalf of the North American Securities Administrators Association<sup>1</sup> (NASAA) regarding the practice of firm facilitation of lending between their customers. We appreciate the opportunity to comment on such an important topic. NASAA agrees with the NASDR's statement that firm facilitation of credit between customers raises questions of investor protection and disclosure practices.

With the tremendous increase in households trading in the stock markets, making sure investors receive adequate disclosure regarding loans they extend or obtain is important in protecting such investors against unforeseen risks and expenses. To promote investor protection and ensure that such lending practices at issue are governed by internal controls, NASAA believes NASD members, (members), or any firm that arranges or facilitates such lending of funds between customers, must ascribe to certain checks and balances.

As discussed in the NASD Notice to Members 01-06, lending between customers has been a particular concern when reviewing the activities of day trading firms. NASAA has raised this issue as an area of concern in the recent past by testifying at the Hearing on Day Trading on February 25, 2000 before the Permanent Subcommittee of Investigations of the Senate Governmental Affairs Committee regarding findings by the state of Washington based on field examinations of all day trading firms believed to have branches in Washington state. The most common questionable lending practice the

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<sup>1</sup> NASAA is the association of the 66 state, provincial and territorial securities regulatory agencies of the United States, Canada and Mexico. NASAA serves as a forum for state regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

Washington examination found was that of facilitation of loans between customers by firms, questioning whether customer authorization of such loans was obtained prior to funds being transferred between customer accounts.<sup>2</sup> The above results and other findings regarding lending practices at day trading firms shows that day trading firm facilitation of customer lending fueled many of the problems customers faced as day traders. Had it not been so simple for customers to be able to borrow funds and keep trading, many of them would not have been in a position to incur such heavy monetary losses. Therefore, NASAA believes day trading firms should be prohibited from arranging or facilitating customer lending of funds.

NASAA does not necessarily believe that other non-day trading firms need be prohibited from arranging or facilitating the lending of funds between customers and other lenders. However, there are two areas concerning lending by such firms that NASAA believes are lacking oversight and internal controls. One is the disclosure by the firm that is given to both the customer that lends the funds as well as the borrowing customer. The second area of concern is firms' practices in determining whether inter-customer lending is appropriate for their specific customers.

In an effort to protect both the lending customers and the borrowers, there must be better disclosure to both parties by the firms. In many cases neither the lending customer nor the borrowing customer is aware of the identity of the other party in such a lending situation, much less the terms of the loan. For example, as mentioned by the NASD Notice to Members 01-06, in the Memorandum (Memorandum) on Day Trading by The Staff of The Permanent Subcommittee on Investigations, (Staff), the Staff found in studying one day trading firm, in some cases the customers did not know the credit worthiness nor the names of borrowers. Many times lending customers were totally unaware that such lending was occurring out of their account. In fact, in many cases the borrowers were located in different branches of the firm.<sup>3</sup>

Lending and borrowing customers must receive full disclosure of the credit terms and risks of the proposed loans. NASAA recommends that as a model the NASD go beyond the scope of the disclosure requirements of SEC Rule 15c2-5 by requiring, under all circumstances, full disclosure of the borrowing customer's credit history and financial condition to lending customers. These additional requirements would help the lending customer be able to decide whether to loan their funds to borrowers and understand the risks associated with such loans. Also, with full disclosure of the credit terms, borrowers would better understand the extra monetary impact such a loan would have on them, especially if they are going to trade on margin. NASAA continues to believe if borrowers cannot meet their own financial obligations, they should evaluate carefully whether trading on margin is an appropriate strategy to follow.

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<sup>2</sup> Testimony of Deborah Bortner, NASAA president-elect and Director of Securities at the Washington State Department of Financial Institutions, page 5.

<sup>3</sup> See Staff Memorandum of Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate, "Day Trading: Everyone Gambles but the House", February 24, 2000, page 40.

The second area that NASAA believes needs oversight concerns firms' determination of whether inter-customer lending is appropriate for their specific customers. NASAA shares the NASDR's concern over the possible conflict of interest that can exist between the customer and the firm. This conflict is especially true if facilitation of a loan by the firm allows a customer to keep trading on borrowed money that generates extra commission for the firm.

In line with SEC Rule 15c2-5, NASAA recommends firms be required to make sure customer lending activities are appropriate for them before lending to them occurs. By obtaining information on a customer's financial condition, a firm could determine how suitable a loan is for a customer. At times a firm's suitability determination may be more objective than a customer's decision to keep trading on borrowed money.

These suitability determinations by the firm would help protect the lending and the borrowing customers as well as the firm. In the Memorandum the Staff found that one day trading firm's customers often failed to pay back margin loans on their due dates. In such cases, the firm would insert another due date on the loan and add interest to the amount due.<sup>4</sup> With the above-mentioned internal controls, borrowers would perhaps be better protected because, in certain cases, they would be prevented from trading on margin with other people's money and thus not be susceptible to such high interest rates. Lending customers would be protected from making loans that may not be repaid on time. Lastly, firms would be protected from conflict of interest issues if adequate suitability checks were run before loans were facilitated.

In conclusion, NASAA appreciates the NASDR's attention to the area of firm facilitation of customer lending. NASAA believes there must always be disclosure of the terms of the loan to the borrower as well as disclosure of the credit history and financial condition of the borrower to the lending customer. Firms must also put in place requirements similar to SEC Rule 15c2-5 to review the suitability of loans to customers based on the customer's financial condition. These practices would serve to increase protection of the growing number of investors and solve conflict of interest issues that arise for firms.

NASAA appreciates the opportunity to provide guidance and comments in this area. If we can be of further assistance, please contact me directly at 360-902-8797 or contact Katy Davé, Associate Counsel at NASAA. Thank you.

Sincerely,



Deborah Bortner  
NASAA President  
Director of Securities, Washington State Department of Financial Institutions

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<sup>4</sup> *Id* at 93.