March 10, 2000

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609
(filed electronically in Word format: rule-comments@sec.gov)

RE: File No. SR-NASD-00-03

Dear Mr. Katz:

The North American Securities Administrators Association (NASAA)[1] appreciates the opportunity to comment on the proposed rule change by the National Association of Securities Dealers, Inc. (NASD) to amend NASD Rule 2520 relating to margin requirements for day-trading customers.

Background
Day trading has been a concern of state securities regulators for several years. In 1998, the Colorado Securities Commissioner raised concerns about day-trading firms in his state and imposed restrictions on their operations. Massachusetts, Wisconsin, Indiana and Texas followed by bringing enforcement actions after examining day-trading firms in their states.

Because of ongoing concerns, in December 1998, the NASAA Board of Directors formed a Day-Trading Project Group to conduct research about the industry, prepare a report of its findings and make recommendations. The Project Group worked for seven months gathering information, analyzing issues and studying trading records with the assistance of a consultant. The result of that effort was the "NASAA Day-Trading Project Group Report," (hereafter known as the "Report") dated August 9, 1999.[2]

The NASAA report, the first of its kind, catalogued problems regulators found in the day-trading industry, including misleading marketing, lax supervision and questionable loan schemes. The Report did not suggest major restrictions on day trading, but called on the firms to do a better job of screening potential customers and disclosing the substantial risks of day trading.

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots protection and efficient capital formation.
[2] Report of the Day Trading Project Group, "Findings and Recommendations," August 9, 1999 is available at the NASAA web site: www.nasaa.org.

The report identified two areas of investor protection concern for state regulators with respect to margin lending: (1) the circumvention of the margin regulatory structure and (2) potential violations of SEC Rule 15c2-5.

Circumvention of the Margin Regulatory Structure
The Report found that the day-trading firms' promotion and arranging of loans among customers to meet margin calls had the effect of circumventing and undermining the margin regulatory structure. The margin rules limit the leverage customers may utilize, or, to state it another way, the rules require customers to commit a certain amount of their <u>own</u> funds in order to effect transactions. When day trading firms arrange for affiliates or customers to meet margin call for other customers, the firms are defeating the purpose of the margin requirements.[3]

Violations of SEC Rule 12b2-5
The Report highlighted day-trading firms that may be violating SEC Rule15c2-5[4] by facilitating loans outside of the margin arrangements that are subject to Regulation T.[5] The NASAA project group interpreted this rule to apply to "inter-customer" lending, which would lead to the conclusion that some day-trading firms had engaged in violations of the rule's disclosure and suitability requirements.[6]

Finally, the Report concluded by supporting the NASD adoption of an explicit rule prohibiting the conduct exposed by the findings. The Report also stated that these "lending arrangements invite precisely the types of misconduct that have been observed, including forgeries, unauthorized transfers of customers' funds, and maintenance of accounts for which day-trading is unsuitable."[7]

It is in that light that NASAA strongly endorses the NASD proposed rule revisions that enhance Margin Rule 2520 to manage the new risks posed by customers who engage in day-trading strategies. The original rule did not contemplate the scope of modern "day-trading." The proposed revisions would bring the rule up-to-date and create an effective method for regulators and firms to ensure that customers use margin prudently.

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[3] Ibid at 26.
[4] Rule 15c2-5 of the Securities and Exchange Act of 1934 pertains to Disclosure and Other Requirements When Extending or Arranging Credit in Certain Transactions.
[5] NASAA Report at 27.
[6] NASAA Report at 28.
[7] Ibid at 46.

Proposed Rulemaking

NASAA commends the NASD for putting forth this rule revision in light of their recent joint statement with the New York Stock Exchange expressing alarm over the continuing growth of customer margin balances and concerns that "in the event of a severe market contraction, some investors may not be in a position to sustain the leveraging and will be required to liquidate their positions under unfavorable market conditions."[8] The relevance of this statement is even more pronounced in a day-trading environment where the frequent trading of some of the most volatile equities compounds the risks of margin leveraging.

Addressing the proposed rule revision, NASAA supports:

The requirement that a firm immediately impose the $25,000 minimum equity requirement if the firm "knows or has a reasonable basis to believe" that a customer will engage in pattern day-trading.

It has long been held that there is an acknowledged industry standard that places an affirmative duty upon the brokerage firm entering into an account agreement with the client to assess the clients suitability prior to recommending or executing the first transaction. It is incumbent upon the brokerage firm to determine whether the client fits the definition of a day-trader. This determination should not be overly burdensome, especially for firms which promote a day-trading strategy. As the comments to the proposed rule indicate, if a firm engages in training a new customer in day-trading techniques, it would be presumed to have a reasonable basis to believe the new client will be a pattern day-trader.

The increase of the initial minimum equity required for the opening of a margin account from the current $2,000 to the proposed $25,000 and the continual maintenance of this higher equity amount for the period of time that the account is being used for day-trading.

Day-trading as a strategy involves executing numerous transactions daily in sometimes volatile equities. The higher minimum equity requirements would protect the day-traders and their firms from risks accruing from the "overleveraging" of an account. This is a prudent step towards ensuring that customers have sufficient equity in their accounts *before* they begin to trade. Encouraging properly capitalized accounts should reduce the frequency of margin calls, increase the chances of these calls being met independently by day-traders (instead of by the firm or other clients) and provide a "cushion' in the event of any market corrections that reduces the equity in an account.

[8] "Joint Statement by NYSE and NASD On the Continuing Growth in Investor Margin Debt," February 24, 2000 at 1.

The provision in the revised rule imposing a margin call if the day-trading buying power is exceeded and requiring those subjected to this call to deposit funds that will remain in their account for two-days.

NASAA further supports the restriction of day-trading activity to only two times the margin maintenance excess until this call is met. NASAA also supports the ninety-day "cash-only" restriction that would be placed on the account if the call is not met within five business days. This is another example of the prudent placing of regulatory "speed bumps" in the road to ensure compliance with reasonable margin risk levels and to enforce penalties for trading in an account which has little or no equity.

The provision in the rule prohibiting day-traders from meeting the day-trading requirements through the use of cross-guarantees.

Customers must be responsible for meeting their margin requirements independently and not through a labyrinth of relationships established by the firm. NASAA questions whether investor protection interests are maintained when the firm who may be aggressively recommending an investment or strategy is the same firm who may also be arranging for guarantee of the account in the event of a margin call. The NASAA Report included many instances where questionable practices were employed to "assist" clients who were unable to meet their margin obligations independently. If clients cannot meet their own financial obligations, they should evaluate carefully whether trading on margin is an appropriate strategy to follow.

Conclusion

NASAA applauds the proposed amendments to the NASD's margin rule that protect the interests of the markets, brokerage firms and investors who use margin without curtailing the legitimate use of leverage as an investment strategy.

NASAA appreciates the opportunity, presently, as well as in the future, to provide guidance and comments in this area of great investor protection concern and importance. If I can be of further assistance, please contact me directly at (317) 232-6690. Thank you.

Sincerely,

Bradley W. Skolnik
NASAA President
Indiana Securities Commissioner