

## NEW MARGIN REQUIREMENTS FOR DAY TRADING

The regulation of securities credit as it applies to day trading will change substantially in August and September of this year as a result of amendments to the credit rules of the New York Stock Exchange, Inc. (the “NYSE”) and the National Association of Securities Dealers, Inc. (the “NASD”). The effect will be to reduce available leverage for “pattern day traders”, as defined in the new rules. Set forth below is a description of the current requirements under Regulation T (“Reg T”) and the NYSE and NASD rules, and a description of the new changes that will go into effect.

*Regulation T.* Credit regulation under Reg T provides relatively liberal treatment of day trading. Reg T contemplates two main types of brokerage accounts for most institutional customers. First, there is a margin account, which is governed by Section 4 of Reg T and in which a broker is permitted to extend credit against collateral consisting of margin securities or exempted securities. For example, long positions in margin stocks are entitled to 50% credit in a margin account, so that a long position in a margin stock having a market value of \$10,000 would be entitled to \$5,000 credit and the customer would have to supply the balance of the money from its own funds.

In a margin account, all transactions on the same day are combined to determine whether additional margin is required. Additional margin is required on any day when the day’s transactions create or increase a margin deficiency in the account and the amount of additional margin required equals the amount of the margin deficiency so created or increased.<sup>1</sup> That is to say, the collateral required to be in the account is calculated at the end of each trading day and buys and sells of a given security during the day are effectively netted. The net increase or decrease in the security position (long or short) at the end of the day forms the basis for the calculation of margin deficit (which, depending on other activity in the account that day, would require a deposit) or margin excess (which, depending on other activity in the account that day, would permit a withdrawal of cash or collateral from the margin account).

The second type of account is a cash account. That account, which is governed by Section 8 of Reg T, cannot support margin indebtedness. To prevent an abusive practice known as “free-riding”,<sup>2</sup> Reg T provides for a 90-day freeze on the use of a cash account if a customer buys securities in a cash account and then sells the securities without first depositing in the cash

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<sup>1</sup> Reg T, Section 3(c)(1).

<sup>2</sup> The term “free riding” as used with respect to cash accounts under Reg T is not to be confused with a different practice by the same name in the rules of the NASD dealing with the allocation of “hot” issues.

account sufficient cash to pay for the securities purchased (Section 8(c)). As a result, day trading in a cash account is impractical.

Reg T applies to brokers, not to customers. Nonetheless, Regulation X (“Reg X”) applies to borrowers. Section 3(b) of Reg X provides that “[a]ny borrower who willfully causes credit to be extended in contravention of Regulations T and U . . . must conform to the margin regulation that applies to the lender.” As a result, a borrower that willfully accepts credit in excess of what Reg T allows violates Reg X.

*Self-regulatory organization rules.* The U.S. brokers with which institutional investors typically deal are subject to rules of the NYSE and of the NASD governing securities credit. As currently in effect, initial margin requirements under Reg T and under the NYSE securities credit rule, NYSE Rule 431, and the NASD securities credit rule, NASD Rule 2520, are calculated only at the end of each day. Accordingly, a day trader who does not have any positions in his or her account at the end of the day would not incur a Reg T initial margin nor a standard maintenance margin requirement, assuming no losses in the account for that day’s trading. Rules 431 and 2520 generally require a customer to deposit margin of the greater of \$2,000 or the cost of securities in the account.

Although a day trader may end the day with no positions in his or her account, and therefore no Reg T deposit requirement, the day trader’s clearing firm is at risk during the day in connection with trades in the account. To address this risk, both the NYSE and the NASD 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.<sup>3</sup> To further regulate day trading margin, both the

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<sup>3</sup> The NYSE and the NASD currently have a deposit requirement for day trading that does little to address the actual intra-day risk incurred by a clearing firm in connection with customer day trading. Currently, both the NYSE and the NASD 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. Under the current NYSE and NASD rules, a broker must cause a customer who meets the definition of “day trader” and has liquidated a day trading position to deposit in his or her account by the settlement date the margin that would have been required under Reg T (i.e., the 50 percent initial margin requirement) had the customer not liquidated the position during the trading day. If a customer day trades but does not meet the definition of a “day trader”, the current NYSE and NASD rules require the broker to collect from the customer 25 percent of the position held during the day. Under current requirements, this payment is due only at settlement, after the clearing firm has already incurred the potential risk of the customer’s settlement default. If a customer’s day trading results in a day trading margin call, the customer has seven business days after the trade date (not the customary five business days for other margin calls) to meet the call by depositing cash or securities in the account. Since day traders typically end the day “flat” (i.e., they do not typically carry positions overnight) and their day trading “margin” deposit therefore does not secure a margin loan, the customer does not have to leave the margin deposit in the account and may withdraw the deposit on the day after it is made. In addition, the broker does not have to limit future trading on the part of a customer that fails to make the requisite margin call, which is quite unlike the 90-day freeze a broker has to put on a customer that day trades in a cash account without first depositing money to cover his or her transactions.

NYSE and the NASD have filed amendments to their rules with the SEC to regulate “pattern day traders”<sup>4</sup> and the Commission recently approved both rule amendments.<sup>5</sup>

The amendment to NYSE Rule 431 takes effect on August 27, 2001<sup>6</sup> and the amendment to the NASD Rule 2520 takes effect on September 28, 2001.<sup>7</sup> On and after those dates, NYSE and NASD members will be subject to the new requirements.

The primary purpose of the new amendments is to require that certain levels of equity be deposited and maintained in day trading accounts, and that these levels be sufficient to support the risks associated with day trading activities. The effect of these rule amendments, which are essentially identical,<sup>8</sup> is summarized by the NASD as follows:<sup>9</sup>

- (1) *Definition of “pattern day trader”.* “Pattern day traders” are defined as those customers who day trade four or more times in five business days. If day trading activities do not exceed six percent of the customer’s total trading activity for the five-day period, the clearing firm is not required to designate such accounts as pattern day traders. The six percent threshold is designed to allow clearing firms to exclude from the definition of pattern day trader those customers whose day trading activities comprise a small percentage of their overall trading activities.

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<sup>4</sup> See Securities Exchange Act Release Nos. 42343 (January 14, 2001), available on the Internet at <http://www.sec.gov/rules/sro/ny9947n.htm> (proposed amendment to NYSE Rule 431), and 42418 (February 11, 2001), available on the Internet at <http://www.sec.gov/rules/sro/nd0003n.htm> (proposed amendment to NASD Rule 2520).

<sup>5</sup> Securities Exchange Act Release No. 44009 (February 27, 2001) (the “Approving Release”). The Approving Release is available as an attachment to NASD Notice to Members 01-26 (March 28, 2001), which is available on the Internet at <http://www.nasdr.com/pdf-text/0126ntm.txt>.

<sup>6</sup> See NYSE Information Memo 01-09 (April 2, 2001), available on the Internet at <http://www.nyse.com/regulation/regulation.html>.

<sup>7</sup> See NASD Notice to Members 01-26 (March 28, 2001).

<sup>8</sup> In the Approving Release, the SEC stated:

Although the NYSE and NASD proposals differ somewhat in their structure, they are fundamentally comparable in their substance.

*Id.*, in text following n.21.

<sup>9</sup> See NASD Notice to Members 01-26 (March 28, 2001).

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.

- (2) *Minimum equity requirement.* The amendments require that a pattern day trader have deposited in his or her account minimum equity of \$25,000 on any day in which the customer day trades. The required minimum equity must be in the account prior to any day trading activities; however, firms are not required under the rule to monitor the minimum equity requirements on an intra-day basis. The minimum equity requirement addresses the additional risks inherent in leveraged day trading activities and ensures that customers cover losses incurred in their accounts from the previous day before continuing to day trade.
- (3) *Day trading buying power.* The amendments limit day trading buying power to four times the day trader's maintenance margin excess. This calculation is based on the customer's account position as of the close of business on the previous day.
- (4) *Day trading margin calls.* Under the amendments, in the event a day trading customer exceeds his or her day trading buying power limitations, additional restrictions are imposed on the pattern day trader that more adequately protect the firm from the additional risk and help prevent a recurrence of such prohibited conduct. Members are required to issue a day trading margin call to pattern day traders that exceed their day trading buying power. Customers have five business days to deposit funds to meet this day trading margin call. The day trading account is restricted to day trading buying power of two times maintenance margin excess based on the customer's daily total trading commitment, beginning on the trading day after the day trading buying power is exceeded until the earlier of when the call is met or five business days. If the day trading margin call is not met by the fifth business day, the account must be further restricted to trading only on a cash-available basis for 90 days or until the call is met.
- (5) *Two-day holding period requirement.* The amendments require that funds used to meet the day trading minimum equity requirement or to meet a day trading margin call must remain in the customer's account for two business days following the close of business on any day when the deposit is required.

- (6) *Prohibition of the use of cross-guarantees.* Under the amendments, pattern day traders are not permitted to meet day trading margin requirements through the use of cross-guarantees. Each day trading account is required to meet the applicable requirements independently, using only the financial resources available in the account. Accordingly, pattern day traders are prohibited from using cross-guarantees to meet the minimum equity requirements or to meet day trading margin calls.

In addition, the amendments 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 amendments 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.