

investment company. On April 2, 2001, applicant made a liquidating distribution to its shareholders based on net asset value. Expenses of \$8,500 incurred in connection with the liquidation were paid by applicant's investment adviser, Skye Investment Advisers LLC.

*Filing Date:* The application was filed on April 4, 2001.

*Applicant's Address:* 985 University Avenue, Suite 26, Los Gatos, CA 95032.

**Kemper Bond Enhanced Securities Trust, Series 1 and Subsequent Series**  
[File No. 811-4382]

*Summary:* Applicant, a unit investment trust, seeks an order declaring that it has ceased to be an investment company. On September 8, 1999, applicant made a final liquidating distribution to its shareholders based on net asset value. Applicant incurred no expenses in connection with the liquidation.

*Filing Date:* The application was filed on March 30, 2001.

*Applicant's Address:* 250 North Rock Road, Suite 150, Wichita, KA 67206-224.

**IGAM Group Funds**  
[File No. 811-9493]

*Summary:* Applicant seeks an order declaring that it has ceased to be an investment company. On February 15, 2001, applicant made a liquidating distribution to its shareholders based on net asset value. Applicant incurred no expenses in connection with the liquidation.

*Filing Date:* The application was filed on March 27, 2001.

*Applicant's Address:* 24 Salt Pond Road, South Kingstown Office Park, Suite A5, Wakefield, RI 02879.

**Income Opportunities Fund 2000, Inc.**  
[File No. 811-7240]

*Summary:* Applicant, a closed-end investment company, seeks an order declaring that it has ceased to be an investment company. On December 27, 2000, applicant made a liquidating distribution to its shareholders based on net asset value. As of April 6, 2001, applicant still had 20 shareholders who have not redeemed their shares. The Bank of New York is holding any unclaimed funds, which will escheat to each shareholder's state of residence after the applicable holding period. Expenses of \$35,133 incurred in connection with the liquidation were paid by applicant.

*Filing Dates:* The application was filed on February 23, 2001, and amended on April 18, 2001,

*Applicant's Address:* Merrill Lynch Investment Managers, LLP, 800 Scudders Mill Road, Plainsboro, NJ 08536.

**State Farm Balanced Fund, Inc.**  
[File No. 811-1520]

**State Farm Interim Fund, Inc.**  
[File No. 811-2726]

**State Farm Municipal Bond Fund, Inc.**  
[File No. 811-2727]

*Summary:* Each applicant seeks an order declaring that it has ceased to be an investment company. On April 1, 2001, each applicant transferred its assets to a corresponding series of State Farm Associates' Funds Trust based on net asset value. Expenses of \$66,928, \$7,878, and \$25,025, respectively, incurred in connection with the reorganizations were paid by each applicant.

*Filing Dates:* The applications were filed on April 6, 2001, and amended on April 25, 2001.

*Applicant's Address:* Three State Farm Plaza, Bloomington, IL 61710-0001.

**Composite Deferred Series, Inc.**  
[File No. 811-4962]

*Summary:* Applicant seeks an order declaring that it has ceased to be an investment company. On April 21, 2000, Applicant distributed all of its shares at net asset value to its sole shareholder in connection with Applicant's liquidation. Total expenses of approximately \$4,000.00 were incurred in connection with the liquidation and were paid by WM Advisors, Inc.

*Filing Date:* The application was filed on February 1, 2001.

*Applicant's Address:* John T. West, c/o WM Advisors, Inc., 1201 Third Avenue, Suite 1400, Seattle, WA 98101.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Margaret H. McFarland,**  
*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-44223; File No. SR-NASD-00-55]

**Self-Regulatory Organizations; Order Approving and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 2 and 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Delivery Requirement of a Margin Disclosure Statement to Non-Institutional Customers**

April 26, 2001.

**I. Introduction**

On September 5, 2000, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to require NASD member firms to deliver a margin disclosure statement to their non-institutional customers with margin accounts. On September 26, 2000, NASD Regulation submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change and Amendment No. 1 were published for comment in the **Federal Register** on October 23, 2000.<sup>4</sup> The Commission received eight comment letters with respect to the proposed rule change and Amendment No. 1.<sup>5</sup> On March 28, 2001,

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 clarified that if the equity in a customer's margin account falls below applicable requirements, an NASD member firm can force the sale of any of the securities in any of the customer's accounts held at the firm and such liquidations are not limited to the customer's margin account. Additionally, NASD Regulation deleted the phrase "under the law" from its original filing to clarify that maintenance margin requirements are requirements of self-regulatory organizations. See Letter from Alden S. Adkins, General Counsel and Senior Vice President, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated September 25, 2000.

<sup>4</sup> See Securities Exchange Act Release No. 43441 (October 12, 2000), 65 FR 63275 ("Notice").

<sup>5</sup> See letter from Bill Singer, Attorney, Singer Frumento LLP, to Jonathan G. Katz, Secretary, Commission, dated October 26, 2000 ("Singer Letter"); letter from J. Scott Colesanti, Senior Compliance Attorney, Edward D. Jones & Co., Inc. to Jonathan G. Katz, Secretary, Commission, dated November 10, 2000 ("Edward Jones Letter"); letter from Professor Barbara Black and Adjunct Professor Jill Gross, Co-Directors, Securities Arbitration Clinic, John Jay Legal Services, Inc., Pace University School of Law, to Jonathan G. Katz, Secretary, dated November 8, 2000 ("John Jay Letter"); letter from

NASD Regulation filed Amendment No. 2 to the proposed rule change responding to the comments.<sup>6</sup> On April 11, 2001, NASD Regulation filed a technical Amendment No. 3 to the proposed rule change.<sup>7</sup> In this notice and order, the Commission is approving the proposed rule change and Amendment No. 1, and approving Amendment Nos. 2 and 3 on an accelerated basis. The Commission is also seeking comment from interested persons on Amendment Nos. 2 and 3.

## II. Description of the Proposal

As described in the proposed rule change and Amendment No. 1, the NASD, through NASD Regulation, proposes to add a new NASD Rule 2341 to require NASD member firms to deliver to their non-institutional customers,<sup>8</sup> prior to or at the opening of

a margin account, a specified disclosure statement discussing the operation of margin accounts and the risks associated with trading on margin.<sup>9</sup> NASD Regulation also proposes to require NASD member firms to deliver a disclosure statement to their non-institutional customers with margin accounts on an annual basis.<sup>10</sup> NASD Regulation proposes the following proposed rule text amendments in response to the comment letters submitted to the Commission regarding the proposed rule change and Amendment No. 1. The amended rule is as follows:

Proposed new language is *italicized*.  
Proposed deletions are in [brackets].

\* \* \* \* \*

### Rule 2341. Margin Disclosure Statement

(a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a non-institutional customer, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in writing or electronically, *and in a separate document*, the following margin disclosure statement:

Your brokerage firm is furnishing this document to you to provide some basic facts about purchasing securities on margin, and to alert you to the risks involved with trading securities in a margin account. Before trading stocks in a margin account, you should carefully review the margin agreement provided by your firm. Consult your firm regarding any questions or concerns you may have with your margin accounts.

When you purchase securities, you may pay for the securities in full or you may borrow part of the purchase price from your brokerage firm. If you choose to borrow funds from your firm, you

will open a margin account with the firm. The securities purchased are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities *or other assets* in any of your accounts held with the member, in order to maintain the required equity in the account.

It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

- *You can lose more funds than you deposit in the margin account.* A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities *or assets* in your account(s).

- *The firm can force the sale of securities or other assets in your account(s).* If the equity in your account falls below the maintenance margin requirements or the firm's higher "house" requirements, the firm can sell the securities *or other assets* in any of your accounts held at the firm to cover the margin deficiency. You also will be responsible for any short fall in the account after such a sale.

- *The firm can sell your securities or other assets without contacting you.* Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities *or other assets* in their accounts to meet the call unless the firm has contact them first. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without the notice to the customer.

- *You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.* Because the securities are collateral for the margin loan, the firm has the right to decide which security to sell in order to protect its interests.

- *The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.* These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause

Christopher R. Franke, Chairman, Self-Regulation and Supervisory Practices Committee, Securities Industry Association ("SIA"), to Margaret H. McFarland, Deputy Secretary, dated November 13, 2000 ("SIA Self-Regulation Committee Letter"); letter from W. Hardy Callcott, Senior Vice President and General Counsel, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, dated November 14, 2000 ("Charles Schwab Letter"); letter from Albert Tylka, Vice President, A.G. Edwards & Sons, Inc., to Margaret H. McFarland, Deputy Secretary, dated November 17, 2000 ("A.G. Edwards Letter"); letter from George Ruth, Chairman of the Rules and Regulations Committee, Credit Division, SIA, to Jonathan G. Katz, Secretary, dated November 21, 2000 ("SIA Credit Division Letter"); and letter from Jeffrey S. Alexander, Vice President and Senior Counsel, Office of the General Counsel, Merrill Lynch, to Jonathan G. Katz, Secretary, dated November 22, 2000 ("Merrill Lynch Letter").

<sup>6</sup> In Amendment No. 2, NASD Regulation responded to the comment letters submitted on the proposed rule change and Amendment No. 1, and incorporated several recommendations from the comment letters into the proposed rule text. The comments concerned the following: the need for flexibility with respect to the type of disclosure statement that NASD member firms would be required to provide to their customers; the burden and costs of sending a separate document; the expense and need for the requirement that the disclosure statement be delivered annually; the need for clarification of the delivery requirement and method; and the need for disclosure of the fact that any of the customers' assets, in addition to securities, carried by a broker-dealer firm on behalf of such customers may be liquidated to satisfy a margin call. See Letter from Jeffrey S. Holik, Vice President and Acting General Counsel, NASD Regulation, to Jack Drogin, Assistant Director, Division, Commission, dated March 27, 2001 ("Amendment No. 2").

<sup>7</sup> In Amendment No. 3, NASD Regulation provided a technical amendment to the proposed rule language clarifying that the annual margin disclosure statement may be delivered within or as part of other account documentation, and is not required to be provided in a separate document. See Letter from Jeffrey S. Holik, Vice President and Acting General Counsel, NASD Regulation, to Jack Drogin, Assistant Director, Division, Commission, dated April 10, 2001 ("Amendment No. 3").

<sup>8</sup> The term "non-institutional customer" would mean a customer that does not qualify as an "institutional account" under NASD Rule 3110(c)(4). NASD Rule 3110(c)(4) defines "institutional account" to mean the account of: (1)

A bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing similar functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

<sup>9</sup> NASD's 2300 series of rules covers *Transactions with Customers*.

<sup>10</sup> This annual disclosure statement may be the mandated margin disclosure statement as specified in proposed NASD Rule 2341(a), the abbreviated disclosure specified in proposed NASD Rule 2341(b), or an alternate disclosure that is "substantially similar" to the two other disclosure statements. In addition, the annual disclosure statement may be delivered within or as part of other account documentation, and is not required to be provided in a separate document. See Amendment No. 2, *supra* note 6 and Amendment No. 3, *supra* note 7.

the member to liquidate or sell securities in your account(s).

- *You are not entitled to an extension of time on a margin call.* While an extension of time to meet margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension.

(b) Members shall, with a frequency of not less than once a calendar year, deliver individually, in writing or electronically, the disclosure statement described in paragraph (a) *or the following bolded disclosures* to all non-institutional customers with margin accounts:

*Securities purchased on margin are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities or other assets in any of your accounts held with the member, in order to maintain the required equity in the account. It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:*

- *You can lose more funds than you deposit in the margin account.*
- *The firm can force the sale of securities or other assets in your account(s).*
- *The firm can sell your securities or other assets without contacting you.*
- *You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.*
- *The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.*
- *You are not entitled to an extension of time on a margin call.*

*The annual disclosure statement required pursuant to this paragraph (b) may be delivered within or as part of other account documentation, and is not required to be provided in a separate document.*

(c) In lieu of providing the [margin] disclosures [statement] specified in paragraphs (a) *and* (b), a member may provide to the customer an alternative disclosure statement, provided that the alternative disclosures [statement] shall be substantially similar to the disclosures [statement] specified in paragraphs (a) *and* (b).

(d) For purposes of this Rule, the term "non-institutional customer" means a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

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#### A. Background

The recent growth in the level of customer margin account balances, coupled with the increase in customer inquiries and complaints to NASD Regulation and SEC staffs relating to the handling of margin accounts, has raised concerns as to whether investors understand the operation and risks associated with margin trading. NASD Regulation believes that investors' misconceptions about margin requirements, particularly with respect to maintenance margin, may cause them to underestimate the risks of margin trading and misunderstand the operation of and reasons for margin calls.

In this regard, a May 2000 General Accounting Office ("GAO") report ("GAO Report") noted that the SEC determined from the customer complaints it received that many investors who traded on-line did not understand margin requirements.<sup>11</sup> The GAO Report indicated that the lack of disclosures relating to when firms would sell securities in a margin account to cover margin loans was among the leading margin-related complaints that the SEC received.

In addition, the GAO Report collected and summarized information from 12 on-line broker-dealers.<sup>12</sup> All of the on-line firms contacted did provide their customers with the limited information required by Rule 10b-16 under the Act.<sup>13</sup> Some firms also provided additional information relating to margin, such as requirements for account opening, procedures for selling securities to cover account losses, or special requirements for volatile stocks. Nearly half of the firms contacted, however, automatically opened margin accounts for new customers without providing the customer with information relating to the risks associated with margin trading. At three

<sup>11</sup> See *On-Line Trading, Better Investor Protection Information Needed*, Report to Congressional Requesters, GAO, GGD-00-43 (May 2000). Between January 1998 and June 1999, 140 margin-related complaints concerning on-line trading firms were submitted to the SEC.

<sup>12</sup> While these firms represented less than 10 percent of the total estimated number of firms that offer on-line trading, they accounted for about 90 percent of the on-line trading volume during early 1999.

<sup>13</sup> Rule 10b-16 under the Act requires broker-dealers that extend credit to customers to finance securities transactions to furnish, in writing, specified information regarding the terms of the loan. These disclosures must be made on both an initial and periodic basis. For example, at the time a customer opens a margin account, the broker-dealer must provide the customer with a written statement disclosing, among other things, the annual rate of interest, the method of computing interest, and what other credit charges may be imposed. 17 CFR 240.10b-16.

of the firms that automatically<sup>14</sup> opened margin accounts, customers would find out about their account type only if they read and understood their account agreements. Three of the 12 on-line broker-dealers contacted did take "extra measures" to assure that their customers understood that stocks could be sold to cover outstanding loans in a margin account. These firms included information on their web sites that explained that accounts could be liquidated in fast-moving markets before the customary period.

The GAO Report concluded that better investor protection information, including information relating to margin requirements, was needed on web sites of some on-line broker-dealers. In this regard, the GAO Report recommended that the SEC ensure that broker-dealers with on-line trading systems include accurate and complete information on their web sites regarding, among other things, margin requirements.

#### B. Specific Areas of Concern

Based on customer complaints and the inquiries it has received, NASD Regulation identified several areas associated with margin trading that may have generated confusion and misunderstanding between customers and NASD member firms. According to NASD Regulation, these areas include:

*Margin Calls—Notification.* Some investors hold the mistaken belief that their broker-dealer must contact them for a margin call to be valid, and that their broker-dealer cannot liquidate securities or other assets in their accounts to meet the call unless a specified number of days have passed and/or the broker-dealer has contacted the customer. There are no such restrictions in Regulation T<sup>15</sup> promulgated by the Board of Governors of the Federal Reserve System or NASD Rule 2520.<sup>16</sup> Moreover, securities that have been purchased on margin by a customer and securities and other assets held in any other accounts with the firm by a customer are collateral for the margin loan and are, therefore, subject to the security claim of the broker-dealer until the customer fully pays for the securities. Thus, if a broker-dealer believes that the collateral for the margin loan is at risk, the broker-dealer

<sup>14</sup> Those firms that provide clear indications of the type of account to be opened offered their customers the option on the web site to choose either a cash or margin account, or both. However, those firms that automatically opened margin accounts only offered new customers a choice with respect to account ownership, such as a joint or individual account.

<sup>15</sup> 12 CFR 220 *et seq.*

<sup>16</sup> NASD Rule 2520 governs margin requirements.

is entitled to take any steps necessary to protect its financial interests, including immediate liquidation without notice to the customer. Some broker-dealers will attempt to notify their customers of margin calls, but they are not required to do so. Even if a broker-dealer has contacted a customer and provided a specific date by which the customer can meet a margin call; however, the broker-dealer can still take necessary steps to protect its financial interests, including immediate liquidation, without further notice to the customer.

*Extension of time on margin calls.* Some investors believe they are automatically entitled to an extension of time to meet margin calls. While an extension of time to meet initial margin requirements may be available to the customer under certain conditions, it is only granted if the clearing firm chooses to request an extension from its Designated Examining Authority—the customer does not have a right to an automatic extension.

In addition, some investors believe that when a maintenance margin call has been issued they are entitled to one or more extensions of time to meet the call, however, there is no mechanism for extending maintenance margin calls. If the customer fails to meet a maintenance margin call, the broker-dealer can, under certain circumstances, take a charge to its net capital in lieu of collecting the call, but the broker-dealer is not required to do so, and the customer has no right to demand it.

*Right to dictate which security or other asset is liquidated.* Some investors believe that they have the right to control which securities or other assets are liquidated to meet a maintenance margin call if there is more than one security or asset in the NASD customer's accounts.<sup>17</sup> There is no provision in the margin rules that gives the customers the right to control liquidation decisions. As discussed above, because the securities and other assets in any of the customers's accounts are collateral for the margin loan, the broker-dealer has the right to control the disposition of the collateral in order to protect its interests. In this regard, the broker-dealer may choose which securities or other assets in the margin account, or any other account held by the NASD member firm on behalf of the customer, to liquidate, and this selection need not relate to factors associated with the individual customer.<sup>18</sup> For example, the broker-dealer may choose a particular security or asset in customer's account to

liquidate based on a high concentration of the security held by customers firm-wide.

*NASD members raising their maintenance margin requirements.* Some NASD member firms have increased their "house" maintenance margin requirements (*i.e.*, requirements above those required by law) as a result of concerns about the volatility and extreme price run-ups on certain stocks, the risks to their customers, and the NASD members's own potential exposure to losses from margin defaults. These changes in policy often take effect immediately and may result in the issuance of maintenance margin call. A customer's failure to satisfy the call will usually cause the NASD member firm to liquidate a portion of the customers's account.

Some investors believe that an NASD member firm must provide thirty days written notice before implementing this type of change. While Rule 10b-16 under the Act requires members to disclose to customers the credit terms (interest rates and methods of calculating interest) for margin transactions and requires advance written notice of such changes, it does not require advance notice of the amount of margin required.

### C. Description of Proposal

#### 1. Delivery Requirement

NASD Regulation believes that, although some NASD member firms are providing additional disclosures to customers relating to margin to address customers confusion, the content of these disclosures is not consistent from firm-to-firm and may not always be in a form that investors find clear and easy to understand.

Accordingly, the NASD is proposing to require all NASD member firms to deliver to each non-institutional customer individually, in hard copy or by electronic means, prior to or at the opening of a margin account, a disclosure statement that includes all of the information as specified in proposed NASD Rule 2341(a), or a substantially identical disclosure statement.<sup>19</sup> NASD member firms would also be required to deliver to each non-institutional customer individually, in hard copy or

by electronic means, a disclosure statement on an annual basis.<sup>20</sup>

The proposal, as amended, would require that disclosure at or prior to the opening to the margin account be made in a separate document.<sup>21</sup> NASD Regulation represents that the initial disclosure statement may be on a separate page of, or as a separate attachment to, the margin agreement or other opening account documentation. NASD member firms, however, would be permitted to provide the annual disclosure within other documentation, such as the customer account statement.<sup>22</sup>

Furthermore, NASD member firms would be required to provide the disclosure statement to existing margin customers at the time the NASD member firm is required to send the next annual statement to the customer (following the effective date of the proposed rule change, as amended), but not to exceed 180 days following the effective date of the proposed rule change, as amended.

#### 2. Content of Margin Disclosure Statement

The margin disclosure statement, as specified in proposed NASD Rule 2341(a), the abbreviated disclosure specified in proposed NASD Rule 2341(b), or an alternate disclosure that is "substantially similar" to the two versions provided by the proposal, as amended, should: (1) Describe the operation of a margin account; (2) emphasize that customers should carefully review their margin agreements; and (3) clarify some of the risks associated with margin trading, including among others, that the customer can lose more funds than initially deposited, the firm can force the sale of the securities or other assets in any of the customers's accounts held by the firm without notice the customer, the firm can dictate which securities or other assets in any of the customers's accounts may be selected for liquidation to meet a margin call, the firm may increase its "house" maintenance margin requirements at any time and is not required to provide the customer with advance written notice, and the customer is not entitled to an extension of time on a margin call.

#### 3. Effective Date of the Proposed Rule

NASD Regulation intends to announce the effective date of the proposed rule change, as amended, in a Notice to Members to be published no

<sup>19</sup> NASD member firms would be permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated disclosure statement and incorporates all of the relevant concepts. NASD Regulation represents that it will determine whether an alternative disclosure statement contains substantially identical information as required by the proposed NASD Rule 2341 during routine examinations of NASD member firms.

<sup>20</sup> See *supra* note 10.

<sup>21</sup> An NASD member firm would not satisfy the proposal's delivery requirement by posting the disclosure statement on its web site.

<sup>22</sup> See Amendment No. 3, *supra* note 7.

<sup>17</sup> See Amendment No. 1, *supra* note 3.

<sup>18</sup> *Id.*

later than 60 days following Commission approval of the proposed rule change. The effective date would be 30 days following publication of the Notice to Members announcing Commission approval of the proposed rule change.

### III. Summary of Comments

The Commission received eight comment letters in response to the proposal and Amendment No. 1.<sup>23</sup> While most commenters generally favored the concept of providing customers of NASD member firms with a disclosure of margin trading risks, they also suggested various modifications to the proposal. The comments submitted to the Commission are summarized by issue below.

#### A. Margin Disclosure Statement

Several commenters stated that the proposal needed to be more flexible and that a "one-size-fits-all" disclosure statement on margin trading is not appropriate for all firms.<sup>24</sup> Commenters indicated that firms should be permitted to develop a method of disclosure that is best suited to their individual business, so long as they provide the specific disclosure information required by the proposal. NASD Regulation responded to these concerns through the new proposed rule language in paragraph (c) of proposed NASD Rule 2341 providing that, in lieu of using the margin disclosure statement specified in the proposal, an NASD member firm may use an alternative disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated disclosure statement specified in the proposal.

One commenter indicated that the proposal should be directed only at customers who trade on-line, and not those being assisted by a registered representative.<sup>25</sup> The commenter stated that the proposal should address more directly the concerns of the GAO Report<sup>26</sup> that determined that on-line traders do not understand margin requirements. The commenter suggested that the disclosure statements would best serve on-line customers who do not have accounts with full-service firms that can provide appropriate education on margin trading. NASD Regulation responded that, although customer accounts of on-line brokerage firms were the focus of the GAO Report, margin-related complaints received by NASD

Regulation and the Commission have originated from customers of both on-line and full-service firms. Accordingly, NASD regulation believes that the misconceptions about the operation of a margin account and margin requirements are not limited to those investors who trade on-line, and that all investors would benefit significantly from the information provided in the proposed margin disclosure statement.

#### B. Separate Document

Several commenters opposed the requirement that the margin disclosure be made in a separate disclosure document, stating that such a requirement is unnecessary, duplicative, and economically burdensome.<sup>27</sup> These commenters also indicated that presenting the disclosure statement in a separate document could confuse customers by giving them the impression that it is more important than other disclosure requirements not presented in the same format, or by leading customers to believe it amends or voids their original agreements. In this regard, certain commenters indicated that such mistaken beliefs by customers could lead to costly legal challenges for NASD member firms.

In response, NASD Regulation indicated that it believes that the initial delivery of the margin disclosure statement should be in a separate document. NASD Regulation was concerned that the proposed disclosure may be hidden within other documentation and possibly overlooked by customers. With respect to the comment that a separate document may confuse customers, NASD Regulations responded that NASD member firms would be permitted to provide additional statements necessary to clarify the purpose of the disclosure document, including that the disclosures do not change or supersede the margin agreement in any way. With respect to the annual delivery requirement, NASD Regulation stated that the annual disclosure statement may be delivered within or as part of other account documentation.

One commenter, while supporting the proposed margin disclosure requirement, also indicated that customers should be educated about margin trading by their NASD member firms, and firm employees should be readily available to customers via dedicated telephone numbers and e-mail addresses posted on the firm's

Internet sites.<sup>28</sup> This commenter suggests that when communication fails, customers should document attempts to contact firms, and firms should be held liable for margin-related damages. As a general matter, NASD Regulation responded by agreeing that NASD member firms should be prepared to answer customer questions relating to margin, and that the proposed margin disclosure statement is not intended to replace NASD member firms' responsibilities to respond to customer inquiries.

#### C. Annual Delivery

Several commenters opposed the proposed requirement that the disclosure statement be delivered annually. The commenters indicated that it would present an undue burden and expense for firms and would be excessive, redundant, and counter-productive in light of the amount of documentation and disclosure statements already sent to customers.<sup>29</sup> One commenter stated that this firm already receives numerous complaints from its customers about the amount of paperwork being mailed to them.<sup>30</sup> Another commenter was concerned that repeated statements about the risks of margin trading would undermine legitimate products associated with central asset accounts.<sup>31</sup>

NASD Regulation continues to believe that providing customers with information about the operation of margin accounts at account opening and annually thereafter will be of significant value to customers in understanding the operation of a margin account. Given that the full margin disclosure statement would be provided to customers at account opening, however, NASD Regulations believes that providing an abbreviated version of the disclosures would be appropriate for the annual disclosure requirement, thereby addressing some of the commenters' concerns. Accordingly, NASD Regulation amended the proposed rule language to permit members, at their option, to provide an abbreviated version of the disclosures to comply with the annual disclosure requirement provided that, at a minimum, such version contains all of the "bulleted information" as specified in proposed NASD Rule 2341(b).

In addition, NASD Regulation amended the proposed rule language to clarify that the annual disclosure

<sup>23</sup> See *supra* note 5.

<sup>24</sup> See Singer Letter, SIA Self-Regulation Committee Letter, Merrill Lynch Letter and SIA Credit Division Letter, *supra* note 5.

<sup>25</sup> See Merrill Lynch Letter, *supra* note 5.

<sup>26</sup> See GAO Report, *supra* note 11.

<sup>27</sup> See SIA Self-Regulation Committee Letter, Merrill Lynch Letter, and A.G. Edwards Letter, *supra* note 5.

<sup>28</sup> See Singer Letter, *supra* note 5.

<sup>29</sup> See Charles Schwab Letter, SIA Credit Division Letter, and A.G. Edwards Letter, *supra* note 5.

<sup>30</sup> See Merrill Lynch Letter, *supra* note 5.

<sup>31</sup> See SIA Credit Division Letter, *supra* note 5.

statement required pursuant to proposed NASD Rule 2341(b) may be delivered within or as part of other account documentation, and is not required to be provided in a separate document.<sup>32</sup>

#### *D. Timing of Account Opening Delivery Requirement*

One commenter indicated that the proposal needed to clarify better when the initial disclosure statement should be delivered.<sup>33</sup> According to the commenter, the proposal directs that the initial disclosure statement be delivered when the margin account is opened; however, the proposal does not indicate what constitutes the opening of the account. The commenter questioned whether an account would be considered opened when the customer loan agreement is signed or when a loan is extended to the customer by the firm on margin. Another commenter requested clarification on whether "Personal Line of Credit" accounts would invoke the proposed margin disclosure requirements.<sup>34</sup> In order to address these comments, NASD Regulation clarified that, under the proposal, the margin disclosure statement is required to be sent at the time a margin account is opened, irrespective of whether a margin loan is extended. Also, if a "Personal Line of Credit" account is treated by the NASD member firm as an extension of credit via a margin account, NASD Regulation believes that the proposed disclosure requirement would apply.

#### *E. Other Comments*

One commenter indicated that the proposed delivery of the disclosure statement, "in writing or electronically," is confusing and suggests that the proposed rule confuses format with delivery.<sup>35</sup> To clarify, NASD Regulation indicated that the proposed disclosure statement may be sent "in writing," meaning that it may be delivered to the customer in a hard copy, paper format. The proposed disclosure statement also may be delivered "electronically," meaning that it may be delivered to the customer via an electronic delivery system (Internet, e-mail, etc.), provided that it is sent individually to the customer by such means.

Another commenter indicated that the proposed margin disclosure statements should be clarified to state that any asset held by the customer, not just securities,

can be liquidated.<sup>36</sup> The commenter believed that this clarification would be an important piece of information for the customer to understand. In addition, the commenter indicated that certain crucial language on the statement should be in boldface for better emphasis, and that disclosures using industry jargon, such as "equity," "house requirements" and "maintenance margin," should be avoided. NASD Regulation agreed that a clarification that any assets held by the firm on behalf of the customer, not just securities, can be liquidated, is appropriate to include in the proposed disclosure statement. Accordingly, NASD Regulation amended the proposed rule language to indicate that an NASD member firm can liquidate securities or other assets held in the customer's accounts. With respect to the comment regarding the use of industry jargon, NASD Regulation does not believe that the use of those terms in confusing within the context of the overall statement and indicated that it had endeavored to use a minimal amount of industry jargon in the proposed margin disclosure statement.

Finally, one commenter stated that each customer should be required to sign the disclosure statement to acknowledge receipt and understanding of it.<sup>37</sup> NASD Regulation believes that such a requirement would be overly burdensome for members to comply with, and would not significantly increase the informational value to the customer of the margin disclosure statement.

#### *F. Amendment to the Proposed Rule Language*

NASD Regulation amended proposed NASD Rule 2341(a), in Amendment No. 2, to clarify that the initial margin disclosure document must be delivered in a separate document.<sup>38</sup>

NASD Regulation also added the phrase "*or other assets*" throughout the text of proposed NASD Rule 2341 to clarify that assets other than securities held in the customer's account can be liquidated and sold by the NASD member firm to satisfy a margin call.<sup>39</sup>

Furthermore, NASD Regulation provided an abbreviated disclosure statement, as discussed above, in paragraph (b) of proposed NASD Rule 2341 that NASD member firms could use on an annual basis.<sup>40</sup>

In addition, NASD Regulation amended the proposed rule language, in Amendment No. 3, to clarify that the annual disclosure statement required pursuant to paragraph (b) of proposed NASD Rule 2341 need not be provided in a separate document.<sup>41</sup>

#### **IV. Discussion**

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act<sup>42</sup> and the rules and regulations thereunder applicable to a national securities association. In particular, the Commission finds the proposal to be consistent with the requirements of Section 15A(b)(6)<sup>43</sup> of the Act, because the proposal is 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.

As discussed above, based on the growing number of customer complaints and the GAO study, the Commission believes that many investors do not fully understand certain significant features of their margin accounts. The Commission believes that the proposed rule change will better inform investors by requiring NASD member firms to disclose to their non-institutional customers, in "plain English," the operations and the risks associated with margin trading. The Commission also believes that the proposal, as amended, will enhance customer protection by requiring that all NASD member firms provide identical or substantially identical information, and deliver the disclosures in a similar manner (*i.e.*, in the form of a hard copy or through electronic means) to their customers, pursuant to proposed NASD Rule 2341. The proposal's requirements will provide for uniform information consistent across all NASD member firms.

Specifically, the Commission finds that the mandated disclosure statement

<sup>36</sup> See John Jay Letter, *supra* note 5.

<sup>37</sup> *Id.*

<sup>38</sup> The proposed rule language is amended to clarify this requirement as follows:

(a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a non-institutional customer, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in writing or electronically, *and in a separate document*, the following margin disclosure statement:

<sup>39</sup> See Amendment No. 2, *supra* note 6.

<sup>40</sup> *Id.*

<sup>41</sup> The proposed rule language is amended to clarify this requirement as follows:

The annual disclosure statement required pursuant to this paragraph (b) may be delivered within or as part of other account documentation, and is not required to be provided in a separate document.

<sup>42</sup> In approving the proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>43</sup> 15 U.S.C. 78o-3(b)(6).

<sup>32</sup> See Amendment No. 3, *supra* note 7.

<sup>33</sup> See Edward Jones Letter, *supra* note 5.

<sup>34</sup> *Id.*

<sup>35</sup> See Merrill Lynch Letter, *supra* note 5.

is designed to alleviate customers' confusion and should help to alert them to some of the risks associated with margin trading, such as: (1) A customer could lose more funds than he/she deposits in a margin account; (2) an NASD member firm can force the sale of securities or other assets in any of the customer's accounts; (3) a customer does not have the right to dictate in which order those securities or other assets may be liquidated or sold to meet a margin call; (4) an NASD member firm may increase its "house" maintenance margin requirements at any time and is not required to provide its customer with advance written notice; and (5) an NASD customer is not entitled to an extension of time on a margin call.

The Commission also believes that NASD Regulation has responded adequately to commenters' concerns and suggestions by incorporating most of the recommendations into the proposal and explaining why it is not incorporating others. Among other things, in response to comments submitted on the published proposal, including Amendment No. 1, NASD Regulation clarified that: (1) Any asset held by the NASD member firm on behalf of the customer, not just securities, can be liquidated to satisfy a customer margin call; (2) the annual margin disclosure statement may be provided in an abbreviated form containing all the required information as specified in the proposed rule text; and (3) the annual disclosures may be delivered within or as part of other account documentation.

The Commission agrees that it was necessary for NASD Regulation to clarify that an NASD member firm may liquidate any securities or other assets held by such firm on behalf of the customer to meet a margin call. The Commission believes that this clarification will warn customers of the full extent of the risks of margin trading and ensure that such disclosure information is consistent with similar information provided in customers' margin agreements.

The Commission also believes that NASD Regulation's amendment to the proposed rule language to provide for an abbreviated version of the annual disclosure statement is appropriate because doing so allows NASD member firms flexibility as to the form of the annual disclosures, while still preserving the core disclosure information to investors.

Finally, the Commission believes that it is appropriate for NASD Regulation to require that, prior to or at the opening of a margin account, an NASD member firm must provide the disclosure

statement in a separate document so that customers do not overlook information that is critical to making an informed decision regarding whether to trade on margin. As a matter of general business practice, this document should be provided at the time the margin agreement is established. It may be more cost effective, however, for firms to provide the annual disclosure as part of other documentation.

Furthermore, although NASD Regulation determined not to require the signature of customers on the disclosure statement, the Commission notes that NASD member firms must have supervisory procedures reasonably designed to demonstrate that customers have received the margin risk disclosures, as well as to demonstrate compliance with Rules 15c2-5 and 10b-16 under the Act.<sup>44</sup>

The Commission notes that NASD Regulation will announce the operational date of the proposed rule change, as amended, in a Notice to Members to be published no later than 60 days following the date of approval by the Commission, and that the operational date will be 30 days following the date of publication of the Notice to Members announcing Commission approval. The Commission believes that requiring NASD member firms to implement the disclosure requirements pursuant to the proposed NASD Rule 2341, 30 days following the date of publication of the Notice to Members announcing Commission approval of the proposal, will provide NASD member firms with sufficient time to comply with the requirements of proposed NASD Rule 2341.

#### **V. Accelerated Approval of Amendment Nos. 2 and 3**

The Commission finds good cause for approving Amendment Nos. 2 and 3 prior to the thirtieth day after publication in the **Federal Register**. The Commission believes that NASD Regulation has responded adequately to commenters' concerns and suggestions by incorporating certain commenters' recommendations into the proposed rule language in Amendment No. 2, and by explaining why it was not incorporating others. Further, the Commission noted that Amendment No. 3 is a technical amendment providing clarifying language in the proposed rule text that the annual margin disclosure statement is not required to be provided in a separate document. Instead, the annual margin disclosure statement may be delivered within or as part of other customer account documentation. In

sum, the Commission believes that the substance of the proposed rule change was provided in the Notice and has been the subject of a full comment period. Accordingly, the Commission believes that there is good cause, consistent with Section 6(b)(5) and 19(b) of the Act,<sup>45</sup> to approve Amendment Nos. 2 and 3 to the proposal on an accelerated basis.

#### **VI. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 2 and 3, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington DC 20549-0609. 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 at the Commission's Public Reference Room. Copies of the filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-00-55 and should be submitted by May 23, 2001.

#### **VII. Conclusion**

The Commission believes that the proposed rule change, as amended, is consistent with the Act, and, particularly, with Section 15A.<sup>46</sup>

*It Is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act,<sup>47</sup> that the proposed rule change (File No. SR-NASD-00-55) is approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>48</sup>

**Jonathan G. Katz,**  
*Secretary.*

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<sup>45</sup> 15 U.S.C. 78f(b) and 78s(b).

<sup>46</sup> 15 U.S.C. 78o-3.

<sup>47</sup> 15 U.S.C. 78s(b)(2).

<sup>48</sup> 17 CFR 200.30-3(a)(12).

<sup>44</sup> 17 CFR 240.15c2-5; 240.10b-16.