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CLIENT BULLETIN

MEMORANDUM

To: Our Clients

From: Trading Direct

Re: Rules affecting cash account trading

Date**:** September 14, 2004

To ensure full rule compliance and consistency with industry standards regarding daytrading rules in cash accounts and credit extension requirements, the following changes will become effective on or about October 15, 2004.

1. Accounts identified as having excessive liquidations are currently restricted and coded "FUNDS IN ADVANCE OF TRADING DUE TO EXCESSIVE LIQUIDATIONS". In the past only margin account liquidations were considered towards this restriction. Going forward, cash account liquidations will also be included. Any combination of four liquidations in a 12-month period in the margin account and/or the cash account will result in a restriction. Additionally, we will be reducing the restriction period from 1 year to 90 days.

2. Cash accounts that daytrade will be permitted to use unsettled funds only once per settlement cycle. For example, a cash account with a $20,000 free credit balance may buy and sell $20,000 worth of the same stock on a Monday, but may not reuse the $20,000 toward another purchase until the sale proceeds have settled on Thursday (or Tuesday for options transactions). Cash accounts that demonstrate a pattern of reusing free credit balances before sale proceeds have settled will be restricted and coded "FUNDS IN ADVANCE OF TRADING DUE TO EXCESSIVE CASH ACCOUNT DAYTRADES" for a period of 90 days. A pattern will be defined as four occurrences within a 12-month period.

3. Cash accounts that demonstrate a pattern of using unsettled sale proceeds towards new purchases and then selling the newly purchased shares before the sale proceeds have settled, will be restricted and coded "FUNDS IN ADVANCE OF TRADING DUE TO GOOD FAITH VIOLATIONS" for a period of 90 days. For example, a customer who uses sale proceeds of shares sold in his cash account on a Monday may purchase another security on Monday through Wednesday, but may not sell the new shares until the original sale proceeds have settled on Thursday. Cash accounts that demonstrate a pattern of selling shares that were paid for with *still unsettled* sale proceeds will be restricted. A pattern will be defined as four occurrences within a 12-month period.

It is recommended that if customers wish to continue the method of trading as discussed above that they do so in a margin account. In a margin account no consideration is given to the settled or unsettled status of sale proceeds when computing margin account SMA and buying power.

The following text is an excerpt from *NOTICE-TO-MEMBER, NASD 04-38, 04-38 Credit Extension/Day Trading Requirements Legal & Compliance*

04-38 Credit Extension/Day Trading Requirements Legal & Compliance

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

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.

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.

[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...").

[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.