

**INTERACTIVE BROKERS  
THE TIMBER HILL GROUP**

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**David M. Battan**  
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February 15, 2000

**VIA HAND DELIVERY**

Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

**Re: Amendment of NYSE Rule 431 (Margin Requirements for Day Traders), SR-NYSE-99-47**

Dear Mr. Katz:

Interactive Brokers, on behalf of itself and its parent company, The Timber Hill Group<sup>1</sup>, respectfully submits these comments on the proposed rule change submitted by the New York Stock Exchange (“NYSE” or “Exchange”) to amend its margin requirements for so-called “day traders”. While we appreciate the Exchange’s attempt to limit the potential risk to the Exchange, member firms and their customers from excessive leverage, the proposed rule changes – by decreasing margin requirements from 50% to 25% for day traders – would actually increase that risk. Compensating for this increased leverage by raising the minimum equity requirement for “pattern day traders” to \$25,000 is not appropriate because it discriminates against smaller investors – who generally pose less risk to the system because they trade in smaller size.

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<sup>1</sup> The Timber Hill Group includes Timber Hill LLC, Interactive Brokers LLC and other affiliates which, through the use of proprietary communications technology, trade standardized derivative investment products on organized securities and futures exchanges worldwide. Timber Hill LLC is registered with the Commission as a broker-dealer and is a member in good standing of the Chicago Board Options Exchange, American Stock Exchange, National Association of Securities Dealers, Philadelphia Stock Exchange and Pacific Exchange. Interactive Brokers LLC, also a registered broker-dealer, engages exclusively in agency trading. It is a member in good standing of the Chicago Board Options Exchange, American Stock Exchange and Philadelphia Stock Exchange, where it offers execution of customer orders in all option classes.

We also respectfully disagree with the Exchange's expansive definition of "pattern day trader", which would cover customers who execute as few as four "day trades" in five business days and subject them to the increased account equity requirement. Moreover, the Exchange has not provided sufficient detail as to how firms are to implement the special requirements that will apply to pattern day traders, in light of the fact that a customer's status as a pattern day trader may constantly be in flux, depending on their recent trading patterns. Finally, we urge the Exchange to allow an exemption from the \$25,000 minimum account equity requirement for customers of NYSE-member brokers who, as we do, calculate margin on a real-time basis and automatically prevent customers from trading in excess of their buying power. Real-time margining and credit control systems provide greater protection to customers and member firms than any minimum account equity requirement could.

**I. The Proposed Rule Changes Take the Wrong Approach to Reducing Risk.**

The proposed new margin rules for day traders seek to control risk by raising the minimum account equity required in customer margin accounts from \$2,000 to \$25,000 for customers falling within the definition of "pattern day trader." While raising the required stake to maintain an account, however, the rules then would allow pattern day traders to carry their positions with only 25% equity (4:1 leverage), rather than the 50% (2:1 leverage) generally required now.

This is the wrong approach. Raising the minimum account equity to \$25,000 for pattern day traders -- combined with the broad definition of that term in the proposed new rules -- will exclude many smaller (often younger) investors from participating in the markets. Yet at the same time, traders with more capital at risk, taking larger positions, will be able to double the leverage they use. The rules thus discourage smaller traders from establishing smaller positions at lower leverage, while at the same time encouraging large traders to finance larger positions using twice as much debt. Systemic risk will increase, while at the same time a large class of customers will be excluded from participating in the marketplace.

Strong, free securities markets should be as widely accessible as possible, and traders' choices should not be artificially constrained for fear that a certain type of trading will subject them to being effectively banned from the markets. Numerous studies have shown that so-called "day traders" contribute to increased liquidity and pricing efficiency. By contrast, there is no evidence that the small traders who will be harmed by the new rules pose a particular risk to the market or to themselves. If anything, having more such traders, trading in smaller amounts with lower leverage is preferable to excluding them from the market altogether in lieu of bigger players with larger, riskier positions.

**II. The Definition of "Pattern Day Trader" is Overly Broad.**

The problems with the proposed margin rules for "pattern day traders" are made worse by the expansive definition of that term. Any customer who executes four "day trades" -- trades in and out of the same security on the same day -- within five business days will find him or herself classified as a "pattern day trader" and be subjected to the

\$25,000 minimum account equity requirement (unless such trades constitute six percent or fewer of all trades during that period).

The Exchange has not specified why it considers as few as four day trades in five days (less than one “day trade” per day) to pose a risk to the customer, the member or the Exchange. Even customers who are not pursuing a day trading strategy may decide to open and close out a position in the same day for a variety of reasons, for example because of a change in market conditions, an unexpectedly large gain or loss in the position, or because the trade was done to take advantage of an available arbitrage opportunity. By artificially constraining investors’ decisions, because those investors may fear being categorized as a “pattern day trader”, the new rules will reduce the liquidity and efficiency of the market.

Indeed, the rise of cheaper and more sophisticated electronic order routing systems -- like the one Interactive Brokers provides to its customers -- is providing to customers for the first time in history the opportunity to trade very quickly and inexpensively and to compete with exchange insiders on a level playing field. Because of lower spreads and lower transaction costs, customers may now be able to trade in and out of positions more quickly at a profit – something that was nearly impossible in the past because of prohibitive transaction costs. The new margin rules have the effect of punishing customers who would never consider themselves “day traders” but who may wish to take advantage of a short-term profit (or minimize a short-term loss) by closing out a position quickly. The new rules will be a trap for the unwary for these customers, and the member firms that carry their accounts

To the extent that an increased minimum account equity of \$25,000 would be useful in reducing risk under certain circumstances, the requirement should be triggered based on the actual risk posed by the particular customer, rather than the mere nature of their trading activity. For example, the increased equity requirement could apply to customers who have a pattern of trading in excess of their buying power, or who have failed timely to meet margin calls. This would be a more moderate and targeted approach than punishing every small investor who may fall within the broad definition of pattern day trader.

### **III. The Rules Are Unclear on How to Implement the Pattern Day Trading Requirements.**

An inherent problem arises from defining the customer’s “riskiness”, and imposing more stringent equity requirements, merely based on the pattern of the customer’s trading activity, because that trading activity is subject to change. This poses a number of problems for broker-dealers in determining how to implement the new rules.

For example, a customer may open a margin account with \$5,000 and with no intent to engage in pattern day trading. However, if the customer at some point later happens to do four “day trades” in a five day period, even if that customer holds a variety of other long-term positions, the broker-dealer now must treat that customer as a pattern day trader. The rules do not specify what the broker is supposed to do if the customer inadvertently has become a pattern day trader but cannot raise his or her account equity to \$25,000; or if fluctuations in the value of the positions in the customer’s account cause the account equity to drop below \$25,000. What if the customer has open positions that the

customer wishes to close out? Must the broker refuse to execute the trades? If so, this would seem to increase the risk to the customer and the member firm. If not, must the firm itself close out the customer's positions if the customer cannot deposit additional equity? Are the customer's positions "frozen" until enough time passes that the customer is no longer a "pattern day trader" based on the rolling five-day calculation? These problems could recur repeatedly for customers whose account equity fluctuates near \$25,000.

These questions highlight the problems that arise from defining a customer's risk profile merely by reference to his or her recent trading activity – particularly where the "day trading" threshold is set so low.

**IV. There Should Be an Exemption to the Minimum Account Equity Requirement for Traders at Firms Using Real-Time Credit Controls.**

With the advent of electronic trading, member firms that choose to implement the technology can impose real-time margining and credit controls in order to reduce sharply, or eliminate, risk posed by traders exceeding their margin limits. Interactive Brokers, for example, marks its customers' positions to market in real-time and will not allow customers to trade in excess of their buying power during the trading day. Likewise, all our customers agree when they open their accounts that we will automatically liquidate their positions to the extent necessary to cover an intra-day margin deficit. Deployment of credit control technology like this is a far more effective means of controlling credit risk than end-of-day margin calculations that – particularly for day traders who are typically "flat" by the end of the day – may not reflect the real intra-day risk posed by a particular customer. Customers benefit as well because they are never allowed to become overextended and suffer the kind of grievous losses that are possible absent real-time margining and automatic close-out.

Because of the superior protection provided both to customers and member firms, we would urge the Exchange to allow an exemption to the minimum account equity requirement for day traders for firms that can demonstrate that they have real-time margining systems that do not allow customers to exceed their buying power.

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In closing, while we share the Exchange's concern regarding the potential risks from excessive leverage, we think that the proposed new margin rules will increase these risks while at the same time effectively excluding a large segment of smaller traders from the market, thereby reducing liquidity and price efficiency. We also urge the Exchange to consider an exemption to the proposed minimum equity requirements where member firms implement strict, real-time credit controls.

Sincerely,

David M. Battan  
Vice President and General Counsel