NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
10 G Street N.E., Suite 710
Washington, DC 20002
202 737-0900
Telecopier: 202 783-3571
E-mail: general@nasaa.org
Web Address: http://www.nasaa.org

NASAA

TESTIMONY OF PETER C. HILDRETH
Director of Securities Regulation
New Hampshire Bureau of Securities

President,
North American Securities Administrators Association

Before the

Senate Governmental Affairs Committee
Permanent Subcommittee on Investigations

"THE PRACTICES AND OPERATIONS OF THE DAY TRADING INDUSTRY"

September 16, 1999

Chairman Collins, Senator Levin and members of the Subcommittee:

I am Peter Hildreth, Director of Securities Regulation for the State of New Hampshire and current president of the North American Securities Administrators Association ("NASAA")[1]. I want to thank you for the opportunity to appear before you once again and to present the views of NASAA as you look into issues and problems surrounding electronic stock day trading. We recognize and appreciate your leadership in focusing attention on the problems in this area.

Chairman Arthur Levitt of the Securities and Exchange Commission has called state securities regulators the "local cops on the beat." It is a good analogy. State regulators tend to get the first complaints from investors. We read the local newspapers for questionable advertisements for investment products and services.

We often do the first examinations, bring the first actions, and shine a spotlight on an emerging problem. This leads to the national regulators becoming more involved and addressing the problem from a national perspective. Two years ago, this was the case with microcap stock fraud when we first testified before this Subcommittee, and we believe it could be the case with day trading now.

NASAA's Involvement with Day Trading

Early last year, Phil Feigin, then-Colorado Securities Commissioner and now NASAA's executive director, raised some concerns about day trading firms in his jurisdiction and imposed some restrictions on their operations.

The more he learned about day trading the more questions he had. Later in the year, Massachusetts and Texas took the lead in examining day trading firms in their jurisdictions and bringing enforcement actions.

Last December, in part because of those actions, the NASAA Board of Directors formed a Project Group to conduct research about the industry, prepare a report of its findings and make recommendations.

The Project Group, chaired by David Shellenberger, chief of licensing at the Massachusetts Securities Division, worked through July 1999 gathering information and analyzing issues, and had consultants study trading records. The NASAA Day Trading

[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.

Project Group Report dated August 9, 1999 was the result of that effort. A copy of the report and appendix is available on the NASAA web site at www.nasaa.org.

As you may know, state securities regulators have been warning investors about the risks of day trading for nearly a year now, beginning with a press release NASAA issued last November following several cases brought by Massachusetts. Based on conversations we have had with your staff, I know you, too, have spent several months investigating the evolving practices of day trading firms.

While both the NASAA Project Group and your Subcommittee had been researching the day trading industry for a significant time before the tragedy in Atlanta, that event dramatized the issues presented by the industry. The tragedy heightened regulators' concerns, and drew global attention to problems in the industry.

We believe there are indeed problems associated with the day trading industry, not the least of which is the hype about how average people can get rich quick, with no experience necessary.

We believe our report, the first of its kind, will help Congress and the public, as well as our fellow regulators, better understand the issues and problems. We also believe the report will be helpful in framing appropriate responses from Congress and regulators.

In just a few short years, electronic day trading has become part of our culture. It has captured the national imagination in part because it combines two major developments that characterize America in the late Nineties – the bull market on Wall Street and the technology revolution brought about by the personal computer and the Internet. There are best-selling books that purportedly teach people how to day trade successfully, cover stories in national magazines, and features on network, cable and local television. Day trading has even made it into cartoon strips like Doonesbury and Foxtrot.

Unfortunately, much of the early media coverage tended to glamorize day trading. The fact is day trading is anything but glamorous. As our report makes clear, day trading is very risky and most people who day trade will lose all of the funds they put into it.

NASAA Project Group Report

We hope our report will serve as a first step toward a better understanding of the issues and the problems, and point to some solutions. We are not suggesting it is the final word, but merely the beginning of the investigation into the day trading industry.

We have not examined all the approximate 62 day trading firms and their branch offices we believe exist but at the firms and branch offices we have examined, we've found problems—problems with marketing, suitability, loan arrangements, supervision and customers trading other people's money without regard to licensing requirements.

There are several issues you asked us to address in our testimony:

- **A general discussion of day trading, including any estimates of the number of day trading firms, the estimated number of individuals who day trade at day trading firms or from remote locations, and how the practice of day trading differs from online brokerage and investing services;**

The Project Group developed a chart that listed firms believed to offer day trading services. Included are those registered with the NASD and those registered with the Philadelphia Stock Exchange. The chart identifies a total of 62 firms that are currently active, with a total of 287 branch offices. The Electronic Traders Association (ETA) estimates that 4,000 – 5,000 people trade full-time through day trading brokerages, making 150,000 to 200,000 trades a day.[2] The transactions of these day traders "represent nearly 15% of daily Nasdaq volume." [3] We are relying on industry numbers and press accounts for these latter statistics. The Project Group did not independently verify these numbers since we considered it beyond the scope of our report.

Day trading firms differ from traditional brokerage firms, discount brokerage firms and on-line brokerage firms. The more common and conventional day trading firms, those registered with the NASD, provide the means for customers to trade their own accounts. They promote and facilitate a particular type of trading. The firms provide computer terminals, sophisticated software to track stock prices in real time and direct, dedicated line access to the market, access that only a few years ago was limited to brokerage firms alone. The firms' customers, the day traders, attempt to make profits on small changes in the prices of stocks. They are known as day traders because they make intra-day trades, i.e., they are taught to close out positions by the end of each day.

Day trading firms furnish customers with information on order flow and provide electronic execution of orders. They also often market and provide courses in day trading basics, strategies and techniques to their prospective brokerage customers. Day trading firms charge commissions that are less than those charged by traditional full-service brokers but more than discount brokers or on-line brokerage firms. And because day traders trade so frequently, often dozens of times per day, their commissions add up quickly.

The concepts of "on-line trading" and "day trading" have been confused and sometimes referred to interchangeably. There are big differences. The term "on-line trading" simply describes the ability to access a brokerage account and effect transactions over the Internet. Often, this account is maintained with a discount brokerage firm, offering

[2] Randy Whitestone and Phil Serafino, *Day Traders' Invasion*, Bloomberg, May 1999, at 36, 39.
[3] Britt Tunick, *Day Traders Working Hard to Influence How the Profession is to be Defined*, Securities Week, May 24, 1999.

inexpensive, self-service brokerage transactions. Reportedly, there are millions of open, on-line brokerage accounts. On-line services are simply a tool, while day trading is a strategy promoted by a brokerage firm.

Traditional brokerage firms have focused on making recommendations to customers, processing orders from customers and handling accounts on a discretionary basis. Discount brokers tend to passively accept orders from customers, eschewing the making of recommendations.

- **The risks that day trading poses to investors and any estimates on the percentage of individuals who actually profit from day trading;**

Trading refers to purchasing and selling securities on a short-term basis, with the intention of achieving quick profits. Trading is, by definition, a form of speculating, as distinguished from investing. Day trading is trading on an extremely short-term basis, and is highly speculative.

When firms promote their services with claims as to the potential for success and profitability, they have an obligation to tell their customers the truth about the risks. We also believe they have an obligation to determine whether day trading is suitable, or appropriate for a particular customer. That means not accepting just anyone who comes through the door with a check and wants to sit down at the computer and trade.

As part of this report we commissioned an outside expert, Ronald L. Johnson, who analyzed customer account records from a day trading firm in Massachusetts that was the subject of an enforcement action[4]. Mr. Johnson's analysis suggests the majority of day traders – more than 70 percent – lose money. Only about 12 percent showed the capacity to possibly be successful day traders, he concluded.

Mr. Johnson also found that day traders would have to generate annual returns of 56 percent just to cover commissions and margin interest. These are long odds indeed just to break even.

As I said earlier, this was the first objective analysis of retail day trading account data. It was a limited sample, but the results are consistent with what we have found in other investigations, such as evidence from the Block Trading branch office in Massachusetts that 67 of 68 accounts lost money. The results are also consistent with common sense. We urge others – especially academics – to conduct further research on the profitability of day trading by retail customers. However, the burden of proof remains on the day trading firms. They must justify their claims of customer profitability and their marketing that suggests that average people can make a career of day trading.

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[4] Ronald L. Johnson, *An Analysis of Public Day Trading at a Retail Day Trading Firm,* August 9, 1999.

- **The general findings of state securities regulators' recent examinations of day trading firms (Appendix 1);**

Some of the abuses and problems that the Project Group has observed include:

•Deceptive marketing, including inadequate risk disclosure. For instance, one firm, On-line Investment Services, Inc., maintained a web site claiming that 85 percent of its customers were profitable. We have a poster before you today showing the relevant portion of the web site (Appendix 2). They deleted the claim when Massachusetts asked for proof.

•Violation of suitability requirements. In the Massachusetts case against Landmark Securities, Inc., the Complaint alleged that the manager falsified information on a customer's new account form to create the impression day trading might be appropriate for the customer. The customer, a recent college graduate, was a part-time bartender with an annual income of $15,000, a net worth of $10,000 to $15,000, and no prior investing experience.

•Questionable loan arrangements, including promotion of loans among firms' customers and loans to customers by brokers. The Complaint against Landmark alleged that with respect to one account alone, that of the part-time bartender, whom I just mentioned, $2.7 million was transferred into the account.

•Abuse by brokers who have day traded customers' accounts on a discretionary basis.

•Encouragement of activity by unregistered investment agents or advisers through customers trading the funds of third parties.

•Failure to maintain proper books and records.

•Failure to supervise.

- **The National Association of Securities Dealer's proposed rules to strengthen disclosure and appropriateness determinations;**

In a comment letter dated May 28, 1999 to the NASD, the NASAA Project Group endorsed the draft rules on appropriateness and risk disclosure and made suggestions for enhancing the rules. We believe that NASDR's existing rules and policies concerning suitability and risk disclosure already create obligations concerning the day trading industry. Nonetheless, we support the issuance of the proposed rules that explicitly specify the industry's obligations. The revised version of the rules filed with the SEC on August 20, 1999 reflect certain of NASAA's comments.

For instance, the rules as filed will apply to all firms that promote day trading, not just those that "recommend" day trading to a customer. Also, the rules will apply not only to individuals, but to any non-institutional customers, which includes small partnerships and corporations. Day traders need a lot of capital both to get started and to stay in the game (particularly given the probability of suffering heavy losses identified in our study). Firms sometimes encourage customers to form partnerships, corporations, or other pooled arrangements.

- **Any legislative or regulatory initiatives that you believe may be necessary to strengthen investor protections and to penalize fraudulent practices within the day trading industry.**

NASAA's list of recommendations is based upon the information we have developed to date. As we continue to investigate the practices of day trading firms, we may uncover other problems that should be addressed.

Promotion of Suitability and Disclosure of Risks - As mentioned previously, the Project Group endorses the NASDR's proposed rules on appropriateness and disclosure and suggested enhanced protections for customers. The Project Group believes that the existing rules on suitability apply to day trading. The failure by some day trading firms to adhere to the existing suitability rules, however, suggests that explicit rules are warranted. Day trading is a particularly risky program of trading that warrants heightened suitability and disclosure requirements.

This would not be without precedent. The NASD already has special suitability requirements for opening options accounts; for purchasing stock index, currency index and currency warrants; for participation in direct participation programs and for purchasing certain low-priced securities.

Explicit Prohibition of the Lending Arrangements – Day trading firms' promotion and arrangement of lending among customers to meet margin calls is problematic. Firms have promoted the loans in order to keep accounts open that would otherwise be closed or restricted for failure to meet margin calls. These loans serve to undermine margin requirements and encourage customers to trade beyond their means. The maintenance of accounts that cannot meet margin calls raises serious concerns of suitability.

Some of these loans come with usurious interest rates. A typical rate is .1 percent for an overnight loan, or 36.5 percent on an annualized basis. In addition, the loan programs have invited severe compliance problems, including forgeries and the unauthorized transfers of customers' funds.

The Project Group believes that the loan programs are highly questionable under existing law. Nonetheless, the Project Group believes the NASD should adopt an explicit rule prohibiting the programs.

Enhanced Regulatory Focus – Too many day trading firms continue to engage in highly questionable conduct, despite the attention that has been called to compliance problems by regulators and the media. More enforcement actions should be brought.

State regulators don't have a problem with day trading per se. It has been around a long time, long before the personal computer. We believe investors should have available to them all the latest technologies. Technology and information have revolutionized investing; they have leveled the playing field between Wall Street and Main Street.

Our concerns are with day trading firms that aren't being honest with their customers about the risks.

Firms that essentially say, "Hey, come on down...we'll sell you a training course and you can sit in front of our computers and you'll get rich." This is hucksterism. The odds are you won't get rich; the odds are you will lose all money with which you trade.
The fact is day trading isn't investing, it's gambling. There is no other word for it.

Day traders can lose a lot of money in a hurry. People should not be trading—gambling, I should say—with money they can't afford to lose. The poster before you illustrates that some firms are holding out day trading as an option for retirees, people laid off from their jobs, even college graduates just starting out (Appendix 3). In our view, this sort of marketing is irresponsible, reckless and predatory.

Our view is conservative. Day trading firms need to play by the same rules that the rest of the brokerage industry has to follow.

Frankly, in the examinations we've conducted of day trading firms, we have found a cavalier attitude toward regulatory compliance. Too many firms either don't know the rules or are flouting them because they think the rules don't apply to them. Well, the rules do apply. We expect that more enforcement actions will be brought, and that these will send a message to the firms that appear to believe they are above the law.

Chairman Collins, I greatly appreciate the opportunity to share the NASAA Project Group's findings with the Subcommittee today. NASAA and its individual members stand ready to assist you in any way possible as you continue your investigation into the practices and operations of the day trading industry.

APPENDIX

NASAA Recommends:

NASAA

Day trading firms should:

1. Stop the hype

2. Disclose true risks

3. Follow the law: suitability, supervision, etc.

Regulators should:

1. Adopt explicit suitability/disclosure rules

2. Explicitly ban loan schemes

3. Bring more enforcement actions

On-Line Investment Services Inc.

Member NASD*SPIC

Press Releases

Major Day Trading Firm Opens 6 New Offices

May, 1998

"On-Line's Training and Mentoring programs boast an 85 percent success rate for new traders, unusually high for an industry in which some analysts claim there is a 90 percent failure rate."

Welcome To All-Tech Investment Group, Inc
Home Of The *ATTAIN*® System

14. How much money do you need to start trading?

... Electronic Day Trading attracts people dead-ended or unhappy in their current field of endeavor and people with a desire to make trading their life's work.

Electronic Day Trading appeals to executives, victims of downsizing or lay-off, retirees, graduating college students and **anyone who recognizes the unlimited earnings potential and quality of life which an Electronic Day Trader may achieve.** Trading allows people to work a 6 1/2 hour trading day, to take vacations on demand and leave for the day on a whim ...