

DAY TRADING: AN OVERVIEW

HEARING
BEFORE THE
PERMANENT
SUBCOMMITTEE ON INVESTIGATIONS
OF THE
COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
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DAY TRADING: AN OVERVIEW

THURSDAY, SEPTEMBER 16, 1999

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:37 a.m., in room SD-628, Senate Dirksen Office Building, Hon. Susan M. Collins, Chairman of the Subcommittee, presiding.

Present: Senators Collins, Levin, and Cleland.

Staff Present: K. Lee Blalack, Chief Counsel and Staff Director; Mary D. Robertson, Chief Clerk; Glynnna Christian Parde, Chief Investigator and Senior Counsel; Kirk E. Walder, Investigator; Brian C. Jones, Investigator; Wesley Phillips, Detailee/GAO; Eileen M. Fisher, Investigative Assistant; Elizabeth Hays, Staff Assistant; Linda Gustitus, Minority Chief Counsel; Leslie Bell, Congressional Fellow; Anne Bradford (Senator Thompson); Brian Benczkowski (Senator Domenici); Michael Loesch (Senator Cochran); Felicia Knight and Steve Abbott (Senator Collins); Seema Singh and Gregory Thomas (Senator Specter); Nanci Langley (Senator Akaka); Lynn Kimmerly, John Brownlee, Michael Andel, and Andrew Vanlandingham (Senator Cleland); Darla Silva (Senator Durbin); and Peter Ludgin and Diedre Foley (Senator Lieberman).

OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. The Subcommittee will come to order.

I would like to thank our witnesses for braving the hurricane to be with us here this morning. I know that for some of you, who are coming some distance, that was indeed a challenge, and I appreciate the efforts that you have made to be with us today.

We convene the first congressional hearing on day trading. This hearing is the first in a series that the Permanent Subcommittee on Investigations will hold on this subject.

Today's hearing will provide an overview of the day-trading industry, while subsequent hearings will highlight case studies developed during our on-going investigation. These hearings continue the tradition of the Subcommittee of investigating issues affecting small investors.

Unlike traditional investing, day trading involves taking positions in stocks for very short periods of time, usually minutes or hours, but rarely longer than a day. One day trader was recently quoted as saying, "Wall Street's not about investing anymore, it's about numbers. Who cares whether [the stock] is a car company or

a chemical company? Who cares what they're going to be doing in [the year] 2000?"

Day traders seek to profit in small increments from moment-to-moment fluctuations in the stock's price. The firms that cater to day traders provide high-speed computer access and real-time market quotes, which are necessary to rapidly take advantage of small changes in stock prices.

The technology revolution that is affecting so many aspects of American life is also changing, in a very fundamental way, the relationship between the ordinary investor and the markets. New technology now allows investors to access the markets directly without the aid, or the advice, of a broker-dealer, something that was previously limited to a relatively small number of professional traders. This dramatic change in access raises a host of questions for Federal and State regulators, for the security industry, and for investors.

Ironically, the three developments that have made day trading possible are otherwise very positive for investors. The first is the ability to execute transactions at the investor's convenience using the Internet. The second is dramatically lower commissions, and the third is greatly expanded access to financial information, including documents such as a company's Form 10-K contained in the SEC's EDGAR system.

I should emphasize that day-trading firms differ significantly from traditional brokerage houses, and even from the discount brokerage industry. Online discount brokerage firms, such as Charles Schwab, do not provide their customers with direct access to the trading floor.

Moreover, the Subcommittee recognizes that the use of the Internet to obtain information about investing or to place, buy, and sell orders has given consumers substantially greater access to financial information and investment opportunities previously available only to industry professionals. Day trading, however, raises serious concerns unrelated to the use of the Internet for trading or as a source of financial information.

I would like to show something that illustrates why it is so imperative for the investing public to better understand day trading and its risks.¹ This course, and you can see the cover of the Adult Education leaflet that was circulated, is from an adult education program in Gardiner, Maine. It was recently sent to me by one of my constituents. As you can see from the course offerings, folks in Gardiner, Maine, can learn from their adult education course dried floral arranging, perennial gardening, and Christmas wreath design, and for a fee of only \$5, they can go to the local high school and attend Day Trading for Beginners.

The very fact that adult education programs in small communities like Gardiner, Maine, might be teaching day-trading strategies reflects the increasing pervasiveness and popularity of the day-trading phenomenon and the degree to which it is being presented to ordinary investors as just another bona fide investing strategy. As an interesting side note, this particular course was canceled after the tragic shooting by the Atlanta day trader.

¹ See Exhibit No. 1 on page 213 in the Appendix.

Our hearing today will attempt to answer three questions. First, is day trading really nothing more than gambling? To answer this question, the Subcommittee is examining the profitability of day trading, the risks involved, and the responses to this development from the industry and the regulators.

Policymakers need to know whether day-trading firms teach investing or simply another form of card counting. Many day-trading firms provide seminars for customers who wish to learn day-trading strategies. These seminars generally run for only several days and cost anywhere from \$1,500 to \$5,000. One such course is called "1-800 RetireNow!" Enticed by such exaggerated promises, some individuals who complete these courses actually give up their careers to day trade full time.

Now, very few Americans would think it prudent to quit their jobs or to cash in their retirement savings to become professional gamblers who support their families at a Las Vegas casino. Yet, the day-trading industry estimates that nearly 5,000 citizens are full-time day traders. The SEC's estimate is even higher.

For example, a 28-year-old bank employee in California left his job and borrowed \$40,000 from credit cards to become a day trader, only to lose all of his money day trading within 2 months. This young man is now deeply in debt and living with his parents.

In Chicago, a waiter with no investment experience became a day trader and lost an inheritance of more than \$200,000. The waiter told the Subcommittee staff that many of the people with whom he day-traded knew as little about investing as he did.

In Boston, an elderly man with severe health problems lost about \$250,000 of his wife's savings in just a few hours at a day-trading firm.

The second important question is whether some day-trading industry firms are engaged in deceptive and fraudulent practices, and if so, how pervasive is this misconduct? State regulators have charged the day-trading industry has engaged in widespread abuses, including deceptive advertising, trading by unregistered broker-dealers, and violations of rules relating to suitability and margin requirements. Although several day-trading firms settled cases brought by State regulators, the industry as a whole strongly contests these findings. We will hear testimony on these general issues today, while the Subcommittee continues to investigate the practices of specific day-trading firms.

The third question that is central to our inquiry is what is the impact of day trading on individual companies and the markets? The industry's own estimates indicate that between 10 and 15 percent of the daily volume on the NASDAQ exchange is attributable to day trading. Now, some critics argue that day trading increases and creates excessive market volatility. Other observers, however, contend that day trading increases market efficiency and liquidity, while still others believe that day trading simply has had very little impact on the markets. By the conclusion of our investigation, the Subcommittee hopes to have a much better understanding of the economic impact of day trading on the markets and capital formation.

Finally, let me add that I convene this hearing highly skeptical of day trading, but not as an advocate for banning the practice alto-

gether. State securities regulators have estimated that more than 70 percent of day traders lose money and only about 12 percent demonstrate the capacity to be successful. I find those statistics to be very troubling.

These figures also raise critical questions about whether investors are truly informed of the risks involved or whether they are simply being fleeced by some unscrupulous day-trading company.

If an investor is fully aware of the risks and decides to engage in day trading anyway, that is his choice. If, however, a day-trading company fails to disclose the risks and entices the unsophisticated investor with deceptive advertisements and exaggerated claims, that is quite another matter.

While we are confronted with many complex issues today, we are very fortunate to have an outstanding group of witnesses to assist us as we attempt to sort through the conflicting claims about day trading. I particularly look forward to hearing testimony from the Securities and Exchange Commission Chairman and the National Association of Securities Dealers Regulation President about their recent examination of more than 60 day-trading firms. The preliminary results of these examinations will be released for the first time at our hearing today.

It is now my pleasure to recognize my distinguished colleague and the Ranking Minority Member of this Subcommittee, Senator Levin, for his opening statement.

Thank you.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Madam Chairman, and thank you for your leadership in trying to protect American consumers.

Earlier this year, this Subcommittee held hearings on sweepstakes, and today, we are talking about day trading. To me, they fall under the same category of business practice, which involves enticing consumers with the promise of quick money.

Many of us would love to get rich quickly and retire young, and when you are told that there is a ready-made investment system that holds out quick and large returns, the instinct to jump aboard and try it out is there for many people. What can be overlooked, however, is the fact that the system being promoted does not involve investment in the sense that we know it and understand it, and that it does involve significant risk.

Once in the system, when you realize that you are starting to lose money and think perhaps that this is not the right business to be in, you can be enticed to recover your losses by borrowing money and making more trades. That is a sketch of day trading, and its visibility and allure to the public is growing.

Just the other day, I was exiting a freeway near my home in Detroit, and I came across a sign on a fence at the exit ramp.¹ In big bold letters, it announces "Day Trading" and gives an 800 number to call.

Now, that particular notice does not use any promotional language other than getting people to notice the name and the number, but it shows just how pervasive this allure to day trading is

¹ See Exhibit No. 2 on page 215 in the Appendix.

that they put signs on fences for people to see if they can get them to call 800 numbers to get into the system.

Too many firms, once people make that original contact, entice consumers with deceptive and misleading advertisements, such as "earn 12 percent per day before a commission" and "6 to 7 figure income per year." One company claims to have a "trading system with a profit-to-loss ratio of 12 to 1 and an average return better than 18 percent per trade before slippages."¹

Moreover, it claims that no experience is needed, and when asked by State regulators to prove those claims, the company, TCI, could not do it. Apparently, most day traders lose money.

Regulators have said that day traders must make a 56-percent profit just to cover commissions and fees. A recent report by the North American Securities Administrators Association revealed that at one branch office, over 70 percent of the traders lost money.

In analyzing the trading strategy used through the types of trades made, the report concluded that the majority of traders appeared to use strategies which engendered 100-percent risk of loss.

Day trading is not investing, and most people, even in the day-trading industry, acknowledge that. The SEC says it is gambling.

Given the estimate referred to in the testimony of the North American Securities Administrators Association that 70 percent of day traders lose money, you would have a better chance of playing the slot machine.

Now, if day trading is gambling, and it sure looks like it to this outsider, and more importantly, if it is gambling as is stated by the SEC, a key insider, then on-site firms are gambling casinos and should be regulated as such.

We have rules in the securities industry with respect to suitability and margin requirements in order to protect consumers. If these rules are not sufficiently protective of persons solicited for and engaged in day trading, I hope that we can develop legislation and enact legislation which will protect those consumers.

Again, I want to thank you and commend you, Madam Chairman, for your leadership in another area where there is just too much consumer abuse going on in this country.

Senator COLLINS. Thank you very much, Senator Levin.

I am now pleased to call on Senator Cleland. Senator Cleland and I both in previous life were involved in securities regulations of State officials, and he has been an active participant in all of our investigations on securities issues.

OPENING STATEMENT OF SENATOR CLELAND

Senator CLELAND. Thank you, Madam Chairman.

Ladies and gentlemen, welcome to this hearing.

I am intrigued by the comments by the distinguished Senator from Michigan, Senator Levin, and marvel at the insight of our wonderful Chairman here who has decided to focus on a very fascinating issue of the world of securities and investments in America. I am delighted to be here at this hearing.

Let me just say that tragically enough, I have a personal interest in the whole issue of day trading. Maybe the good news first. The

¹ See Exhibit No. 3 on page 216 in the Appendix.

good news is I was securities administrator in Georgia for 12 years, and my Administrative Assistant today in the Senate is Wayne Howell who was the Assistant Commissioner of Securities in Georgia for 12 years—but we had a tragic incident in Atlanta.

We had a situation in which an individual killed his family members and then came in with guns ablazing into two different office complexes killing and maiming a number of other people that he day-traded with, and then after being apprehended off of an interstate north of Atlanta, killed himself after losing almost half-a-million dollars as a day trader.

That is an incredible situation. It has been discovered that in one 3-day binge, this day trader lost \$153,000, according to a trading report from Momentum Securities in Atlanta. Ultimately, his losses totalled a half-a-million dollars.

In the wake of the shootings, the news reports and other studies have led me to the conclusion, the risks associated with day trading are extremely serious. While many day traders are aware of the possibilities of large losses, some are not.

The interesting thing about going to Las Vegas is it is sometimes called “Lost Wages,” and that people understand they can go in, in a \$20,000 car and come out in a \$200,000 bus, but people who day-trade are not necessarily aware of those kind of risks.

The recent tragedy in Atlanta showed us just how stressful day trading can really become. Traders without the proper experience or training are at the greatest risk of losing their entire portfolios. I do not think most people who day-trade are aware of that.

I believe I do echo the sentiments of my colleagues on this Subcommittee when I state that there is an obvious need, as stated by our Chairman and our Ranking Minority Member, and I state that there is a great need to take a closer look at this issue.

Specifically, I am concerned with an apparent abuse of existing regulations by many day-trading firms, as highlighted in the North American Securities Administrators Association Day Trading Report.

My Administrative Assistant now, who was the assistant administrator for securities in Georgia, is a former head of the North American Securities Administrators Association.

So I am optimistic that in addition to shedding light on the problems associated with this segment of the securities industry, this hearing will act as a catalyst for increased cooperation between representatives of the trading firms, regulators, and investors. Such cooperation, I think, is essential to ensuring the continued viability of this practice, while also protecting the interest of the American people.

We used to say in our office in Atlanta, and in Georgia, to our investing public, if it sounds too good to be true, it probably is too good to be true, and that caution should certainly be applied to day trading.

Madam Chairman, I am glad to be with you today and look forward to our panelists.

Senator COLLINS. Thank you very much, Senator.

I am pleased to welcome our first witness this morning, the Hon. Arthur Levitt, the Chairman of the Securities and Exchange Com-

mission. Chairman Levitt is now in his second term at the SEC, and he is the longest-serving SEC Chairman in history.

I also want to add as a comment that I think of all the SEC Chairmen in history that there is no one who has been more dedicated to educating the small investor than Chairman Levitt, and I commend him for the emphasis that he has placed on that important duty.

We were here previously in this Subcommittee and heard testimony from Chairman Levitt on the persistent problem of fraud in the micro-cap markets. We benefited tremendously from his testimony then, and we look forward to hearing his views on day trading as well.

I would note that the SEC has just announced today that they will be posting an investor alert on day trading on their Web page. I think that is an excellent example of the Chairman's commitment to investor protection, and I look forward to hearing his testimony.

Pursuant to Rule 6 of the Subcommittee, all witnesses who testify are required to be sworn in. So, at this time, I would ask Chairman Levitt to stand and raise his right hand.

Do you swear that the testimony you are about to give to the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. LEVITT. I do.

Senator COLLINS. Thank you.

Please proceed. We would ask that you attempt to limit your formal testimony to 10 minutes to allow time for questions.

TESTIMONY OF HON. ARTHUR LEVITT, JR.,¹ CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY ROBERT L.D. COLBY, DEPUTY DIRECTOR, MARKET REGULATION, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Chairman Collins, Senator Levin, Senator Cleland, and Members of the Subcommittee, thank you for the opportunity to be here this morning to discuss day trading and its impact on our Nation's securities markets.

This hearing could not be more timely. It seems almost every day we hear one story or another about day trading. As we speak, the Commission is conducting examinations of day-trading firms. I will have more to say about this in a moment, but let me begin by stating the obvious.

Technological developments are revolutionizing our capital markets from how people invest to how brokers do business to how our markets function. Today's individual investor, for example, has ready, instant access to market data, and in some cases markets, that up until a few years ago was available only to securities professionals.

One of the byproducts of this revolution has been the emergence of the day trader. Through the use of sophisticated computer software, day traders sit in front of computer screens and look for nothing more than real-time price movements.

What it is that they are buying or selling is of absolutely no concern to them. The coin of the realm for the day trader does not ex-

¹ The prepared statement of Mr. Levitt appears in the Appendix on page 55.

tend beyond volatility. If you sense a stock will rise, buy. And if you sense that it might fall, sell. That is the strategy of day trading. It is not illegal, it probably is not unethical, but it is highly risky.

In recent months, I have been asked more than once why the SEC cares whether a day trader loses his or her money. It is their life, and it is their choice, but I do not think that is the issue.

I am concerned that many day traders do not fully understand the level of risk that they are assuming. I am concerned that many people may be lured into the false belief that day trading is a sure-fire strategy to make them rich, and, when individuals are swayed by misleading advertising, the Commission has a duty to act.

That is why I believe we should be focusing on the advertising and marketing practices of a number of day-trading firms. It is in this area that I believe that the Commission's partnership with the States and State regulators is absolutely crucial. A number of States have been leaders in addressing this issue not just as a matter of securities law, but more importantly, as a matter of consumer protection.

The NASD also has proposed rules that are designed to address the sales practices of day-trading firms. This proposal will require these firms to disclose up-front risks associated with this activity and to screen potential day traders to determine suitability. Eliminating deceptive marketing and advertising practices is a large part of the solution. Another is how day-trading firms comply with the law.

The Commission is in the process of completing an examination sweep of day-trading firms. Our preliminary findings indicate that many of these firms have extremely lax compliance practices. The inability of some firms to monitor their adherence to the capital, margin, and short-sale rules or to maintain adequate books and records, raises very serious concerns. These rules, in many ways, go right to the heart of the integrity of our markets and market participants.

The Commission intends to vigorously pursue any violations of law and has a number of enforcement investigations underway. The use of margin in particular raises a number of issues.

We found that many day traders do not fully appreciate that, by borrowing to buy securities, they can actually lose substantially more than their initial investments. So when day-trading firms aggressively promote the lending of equity between day traders to cover margin deficiencies, I find it very troubling. We are reviewing the practice to ensure that firms are following the law and are fully disclosing to customers the risks of day trading on margin.

The SEC can regulate, and the Congress can probably legislate if they wish, but if an individual does not take the personal responsibility to be informed of the risks involved in day trading, I believe that no rule or law will ever fully protect him or her.

I do not minimize, in any way, the responsibility of the firm to fully disclose the risks involved, but day traders really need to take the time to consider what they are getting themselves into.

I commit to you that the SEC will do everything it can to ensure that day-trading firms are operating within the boundaries of the law, but I sincerely hope that individuals considering this type of

strategy do their homework before risking their hard-earned money. Thank you.

Senator COLLINS. Thank you very much, Chairman Levitt.

Day trading has really arisen out of a booming stock market and an unprecedented access to technology. On some days, it is the dark side of the booming stock market.

However, the boom is not going to go on forever. What is going to happen if stock prices plunge to people who have given up their careers and are day-trading full time when we know already, on the basis of some preliminary studies, that the profitability is very questionable in a booming stock market?

Mr. LEVITT. Just from my own experience and in our markets, having lived through more cycles than most present investors have ever experienced, I would say that my expectation would be that many day traders will be completely wiped out, and most, the vast majority of day traders, will endure punishing losses. But the discipline of the marketplace will do more to dis-abuse investors of the notion of easy profits by day trading than almost anything else we can do.

Senator COLLINS. The day-trading industry has been very critical of a report that was issued by the State regulators association, NASAA, and has criticized it as focusing on one branch office that was badly run of one day-trading firm. However, we now have considerably more data to look at as a result of the examinations that NASDR and the SEC have conducted, which I understand you have some preliminary results from.

It is my understanding that together you have examined around 67 day-trading firms. Could you share with us what the preliminary results of your examinations have been and whether the findings from those examinations have supported the conclusions of the NASAA report or not?

Mr. LEVITT. I think that the NASAA effort is absolutely critical to anything that we hope to accomplish in terms of eliminating some of the really bad practices of day trading.

Our joint investigation and examination done with the NASDR resulted in approximately 10 referrals to the Enforcement Division for scrutiny. I find that worrisome. That is a very high percentage of referrals, and clearly, there is a problem.

Senator COLLINS. Can you give us some further idea of the types of problems that your investigators found?

Mr. LEVITT. Some of the problems involved the use of margin. Some involve lending deficiencies, short sale violations. There were some net capital violations, including both incorrect computations and net capital deficiencies. We observed a number of advertising violations, including failures to obtain NASD approval of advertising and potentially the kind of misleading advertising that you have cited before.

We noted supervision deficiencies, including instances where there were no written procedures and deficient supervision with respect to lending, review of branch offices and short sale activity. We also found books and records violations where firms were simply sloppy in basic procedures. These were the areas that came to light during these recent examinations.

Senator COLLINS. Would it be fair to say, then, that many of the problems uncovered by your examiners were similar to those that were found by the State regulators?

Mr. LEVITT. I think there clearly was some overlap, yes.

Senator COLLINS. I would like to turn to the issue of appropriateness or suitability. When a broker in a traditional brokerage house recommends a stock, the broker has to determine its suitability for the investor and does a review of the investor's investment objectives, financial status. Those kinds of issues are carefully reviewed.

By contrast, it is my understanding that day-trading firms currently do not do any sort of suitability review. Is that correct?

Mr. LEVITT. I am not aware of any suitability reviews that are being engaged in by day-trading firms. I can recall, again, in my days as a stockbroker, when a client came in who was overly aggressive, we were very concerned about the appropriateness of their embarking on that kind of activity.

We have asked the NASD to take a look at this issue because I think—I certainly feel that there is a responsibility on the part of any firm to see to it that individuals who clearly are not in a position to engage in that kind of activity, to take that kind of risk—an individual, for instance, a retired person, who depended for his or her very survival on a return from their investments—are not allowed to day trade. That, I would regard as absolutely irresponsible. The NASD is examining this, and I believe they will have some very specific recommendations in that regard.

Senator COLLINS. I would like to follow up on that point by showing you an exhibit that suggests to me that some day-trading firms may actually be targeting people who are not suitable for day trading, who are unsophisticated investors, or who simply would be taking risks that they cannot afford to take.

This particular exhibit is a marketing pitch by All-Tech, and I think it illustrates my concern. This was on All-Tech's Web site as of July 26 of this year, and in case it is difficult to read, I am just going to read through it. It says, "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."¹

This is the part that concerns me: "Electronic day trading appeals to executives, victims of downsizing or layoffs, retirees, graduating students, and anyone who recognizes the unlimited earning potential and quality of life which day trading may achieve."

Is day trading generally appropriate for someone who has been laid off from his job or has just graduated from college?

Mr. LEVITT. Absolutely not.

Senator COLLINS. So would this be the kind of advertising pitch that would concern the SEC or—I realize the NASDR has been delegated the authority to review such matters.

Mr. LEVITT. Without regard to the Nation's securities laws, just as a private citizen, I find that kind of advertising absolutely appalling. It is a plea to the worst instincts of people who might otherwise be spending their time in casinos rather than in engaging in that practice. I think it is very, very bad.

¹ See Exhibit No. 4 on page 218 in the Appendix.

What the NASD is considering is requiring day-trading firms to determine whether day trading is appropriate for particular customers.

Senator COLLINS. And it is my understanding those proposed rules are now before the SEC or have just been submitted to the SEC for review. Is that correct?

Mr. LEVITT. We have published them for comment.

Senator COLLINS. So they are now in the public comment phase?

Mr. LEVITT. Yes.

Senator COLLINS. Unfortunately, we have a vote that has just begun. I am going to yield to Senator Levin for questions and go vote, and we will hope to keep the hearing going between us. Thank you.

Senator LEVIN [presiding]. Thank you.

While Senator Collins' chart is up there, the unlimited earnings potential, do you have any comment about unlimited earnings potential?

Mr. LEVITT. Unlimited loss potential would be more appropriate. [Laughter.]

Senator LEVIN. I would like to put up another picture from a Web site of a company called TCI.¹ You have a provision in the Securities Act and a rule which prohibits deceptive practices, including material misstatements and omissions.

This firm, I do not think actually is a broker. This firm is a trainer of day traders. It allures people with these promises here of what day trading can do for them.

It says their potential earnings, 6 to 7 figure income per year, and then later down on the screen, it says no experience, no selling, no boss, no employees, no inventory, no traveling, no invoice collection. All you need is a computer and a small amount of start-up capital. That is all that you need.

Now, would you agree that is a misleading advertisement?

Mr. LEVITT. Yes.

Senator LEVIN. The Massachusetts Attorney General got a cease-and-desist order against TCI for that statement. We then went to the TCI's Web site in preparation for this hearing to see what they are saying now, and here is what we found. This is as of yesterday. This is after a cease-and-desist order against them. "The absolute best and most mechanical trading system that we know of in the financial market with a profit-to-loss ratio of 12 to 1 and an average return better than 18 percent per trade before slippages."

Do you believe that day trading will produce a profit-to-loss ratio of 12 to 1?

Mr. LEVITT. I think that claim is ridiculous.

Senator LEVIN. Now, this firm trains people, allegedly. I do not know if that is the word I would pick, but, nonetheless, shows people how to day-trade, and, yet, I do not know that it is subject to SEC enforcement. It is, I think, to State enforcement, but because they do not do the actual trading for the person, but train the person, I think we have to find a way in our law nationally, federally, to get at that kind of misrepresentation.

¹ See Exhibit No. 3 on page 216 in the Appendix.

I am wondering whether or not there is anything you are considering which would get to this situation where TCI is not engaged in the actual brokerage operation, but is misleading and using deceptive advertising in order to try to lure people into buying their course. Is there anything you are considering which would get at this?

Mr. LEVITT. As you have noted, because TCI is not a broker, not registered with the SEC, we would have to prove that the ad is fraudulent in connection with a securities transaction. We would certainly examine that connection with this or any other advertising that really goes beyond the pale as this one does.

Senator LEVIN. You have to show that there is fraud in relation to a specific transaction.

Mr. LEVITT. Yes.

Senator LEVIN. But if there is fraud in relation to a process of trading, then the current law at least would not seem to cover that. Is that correct?

Mr. LEVITT. I believe so.

Senator LEVIN. And that is one of the issues that we need to face because these are not specific transactions that are being promoted.

Mr. LEVITT. It is a process.

Senator LEVIN. It is a process which is being promoted, and that, it seems to me, is one of the big issues we should address, to get at that problem that we are now dealing with a process which is being held out too often as a process of big returns, and where there are deceptive representations about that process. We have got to find a way to get at the representation, even though it does not relate to a specific stock transaction. Would you agree that would be a—

Mr. LEVITT. Yes.

Senator LEVIN. OK. Now, on the issue of margin—well, no. Let me go back to the suitability requirement because this relates to this same process question that we were just talking about.

Is the current suitability requirement that a broker determine whether an investment is suitable for a customer—is that what the suitability requirement is in general?

Mr. LEVITT. Yes.

Senator LEVIN. All right. Would that requirement then apply to whether a process is suitable for a customer or only whether a specific transaction is suitable for a customer?

Mr. LEVITT. I believe that the process would be covered by suitability requirements. In other words, again, a broker or a firm that took an elderly widow with limited resources and allowed that person to engage in a strategy such as this would run afoul of—

Senator LEVIN. Of the current suitability rule.

Mr. LEVITT. Yes.

Senator LEVIN. All right. Now, who makes the determination on suitability? Is it the broker, or is it the customer?

Mr. LEVITT. I think it is the broker that has the responsibility.

Senator LEVIN. That responsibility falls on the broker to make.

Mr. LEVITT. Yes.

Senator LEVIN. OK. Now, on the margin issue, I do not know that there has been a survey of this, but do you believe that the average new day trader understands that he or she would be sub-

ject to a margin call if that day trader buys too much stock on margin during a day even if at the end of the day the day trader no longer holds that stock and even if the day trader did not lose money on that stock transaction, indeed maybe made a profit? Would the average new day trader realize that the margin rules apply to a position at a moment in time during the day?

Mr. LEVITT. My guess, again, based on my own experience handling retail customers, is that the typical customer does not understand and is often surprised by that.

I have also been corrected, Senator, in response to an earlier question which I would like to call to your attention. That is, that today's rule requires a broker to make sure the recommendation of a security is suitable for the investor, but the NASD is expanding that requirement now to include the recommendations of a strategy. So the rule today deals with the security. The rule, as will be expanded if this proposal is approved by the Commission, would include strategies.

Senator LEVIN. All right. I think that is a very important change. I was not sure, but that was my understanding, too. So I am glad that you have clarified that point because that is a critical issue. That is now under consideration?

Mr. LEVITT. Yes. That has been put out for public comment.

Senator LEVIN. Now, going back to margin, assume a situation where someone who has a \$50,000 equity capital investment is allowed to buy \$100,000 with that \$50,000, so there is a margin of \$50,000 using somebody else's money. They are in and out in a day. Assume that there is no loss on the transaction, but at some moment in time during that day, the person had a purchase of \$120,000, more than was allowed, even for an hour. What does the margin rule provide in that situation? \$50,000 in the account in cash. At a moment in time, they were—\$120,000 purchase, more than is allowed by the rules, no loss at the end of the day because it was sold, let's say, for as much as it was purchased for, plus commissions or whatever. What, then, is supposed to be the result?

Mr. LEVITT. That is a violation of the margin rules.

This is Bob Colby who is the head of our division of Market Regulation. I would like him to respond to that, if I may.

Mr. COLBY. The New York Stock Exchange margin rules, which apply to this trading for day traders, require them to take margin on the largest position, short or long, outstanding at any point during the day, even if the trading is flat at the end of the day.

Senator LEVIN. What is the effect of that violation that I just outlined, if it was clear? Was I talking your language?

Mr. COLBY. Yes, but I did not get the numbers perfectly.

Senator LEVIN. Well, they had \$120,000 position, I think you call it.

Mr. COLBY. Yes.

Senator LEVIN. So they only had \$50,000, let's say, in the bank. They are only allowed \$100,000 under my hypothetical, but they were \$120,000.

Mr. LEVITT. They are in violation.

Senator LEVIN. Right, there is a violation, but what is the practical effect? Are they then required to increase their account to \$60,000? What happens?

Mr. COLBY. They are required to put into the account enough margin to cover their largest position.

Senator LEVIN. But it is done.

Mr. LEVITT. During the day, they should be asked for additional funds.

Senator LEVIN. As a practical matter, does that happen where broker firms dealing with day traders will ask people for funds for an hour or 20 minutes?

Mr. LEVITT. It happens in our markets. It happens in the commodity markets all the time.

Senator LEVIN. Where people are actually asked right then, write out a check, give me cash?

Mr. COLBY. They are asked at the end of the day.

Senator LEVIN. Not at the end of the day. The end of the day, there—

Mr. COLBY. They are asked at the end of the day, which means that they have to have the capability to come up with the funds at the end of the day to cover that large position.

Senator LEVIN. And if they do not?

Mr. COLBY. If they do not, then the firm is in violation, and they have to close the customer account down.

Senator LEVIN. So the customer must at the end of the day come up with the \$60,000, the extra \$10,000?

Mr. COLBY. Margin to cover its largest position open during the day.

Senator LEVIN. And if that customer does not have that \$10,000, under my hypothetical, at the end of the day, put in that account, the account must be closed?

Mr. COLBY. That is right.

Senator LEVIN. OK. I am going to have to put us in recess just for a few minutes to go vote.

I note that Senator Cleland wanted to ask you some questions, and I know that the Chairman is going to be back for some additional questions. So if we could just ask you to stay there.

Mr. COLBY. Senator, I spoke too concisely on that. They are required to come up with it at the end of the day. They are required to have that amount, but they do not have to get it in for 7 days.

Senator LEVIN. And if they do not get it in for 7 days—

Mr. COLBY. If they do not get it in 7 days, that is when the account is closed.

Senator LEVIN. The account must be closed. The word "closed" is the word I am emphasizing.

Mr. COLBY. I believe it actually has to be frozen.

Senator LEVIN. At what level? Frozen so you cannot act on it?

Mr. COLBY. Yes, but I—could we supplement this?

Senator LEVIN. I have got to run. Can you figure out what the right answer is?¹

Mr. COLBY. Yes. [Laughter.]

Senator LEVIN. Because I think there may not be any effective penalty, and if there is no effective penalty, because there was no loss, then it seems to me we have got a problem we also ought to address as well, but let me run and come back.

¹ See Exhibit No. 6 on page 221 in the Appendix.

We will stand in recess.

[Recess.]

Senator CLELAND [presiding]. The Subcommittee will come to order.

May I just say that this is a scary moment in American history with me in charge. [Laughter.]

I am on the Armed Services Committee also, and at one moment of distress, everyone was gone and I was the last person sitting. I had decided that instead of declaring war, we would just adjourn for lunch. So that might be our best course today.

Chairman Levitt, you have decided to have a wonderful staff person join you at the table. I do not know whether I should swear in the gentleman there. We will assume—I will make a command decision. I will assume that you both will be truthful, as a good staff person always is.

Chairman Levitt, would you just give us a little bit of insight here on day trading? I thought I knew a little bit about securities, again having been a securities regulator at the State level for a dozen years, up until about 1996. I thought I knew the business fairly well, though not the technicalities of it. As I mentioned to Wayne Howell, my current administrative assistant, who was my assistant administrator, Assistant Secretary of State for Securities Regulation in Georgia, day trading seems to me a relatively new phenomenon.

Is it a part of this whole world of e-commerce that we have learned is revolutionizing our society, and that enables, shall we say, a consumer, in this case an investor, to directly access a commodity, cars, books, in this case, stocks, and, therefore, bring to the table in effect their own needs or whatever without going through a whole series of professional standards, laws, regulatory environments that have been set up since 1934, say since the SEC was created? Do you see this day trading as risky business, in effect part of e-commerce, bypassing the normal regulatory environment that was set up for people accessing the securities industry?

Mr. LEVITT. I think we have always had day traders in the securities industry. We have always had people who were prepared to take extraordinary and, in some cases, foolish risks to make a quick dollar. Clearly, a market such as we have experienced tends to bring the more aggressive, less careful practices on the part of individuals. We see more bad thinking and bad decisions than you do during other kinds of markets.

We have also seen the technology changes that you have referred to making it possible for traders to do what they never could have done in the past because, with a few strokes of a key, they can buy or sell hundreds of thousands of dollars worth of securities.

I think what that implies is kind of an emotional linkage there. Our literature and our television and movies have stressed the machismo of the trader, and individuals sitting behind their computer terminal begin to think that, well, they are as strong and smart and willing to take risks as that revered professional trader. What they do not know is that they lack the resources; they lack the experience, and, perhaps most importantly, they lack the emotions of a professional.

I think I mentioned before, that of the 30 examinations we have completed of day-trading firms, a third of them have resulted in enforcement recommendations. That is a significant number, and that, I think, substantiates your observations.

Senator CLELAND. I do not want to beat that point too much to death, but I guess I am hypersensitive to the question of, shall we say, the psychological mood of those who are attracted to get-rich-quick schemes just in general.

Senator COLLINS [presiding]. I am glad you did.

Senator CLELAND. I am in the middle of a question. Would you like for me to continue my question?

Senator COLLINS. I would like you to continue. Thank you.

Senator CLELAND. It has to do with one of your charts.

Senator COLLINS. OK.

Senator CLELAND. If we could put that first chart back up.¹

Chairman Levitt, again, I do not want to beat this to death, but having lived through the Atlanta tragedy where a guy named Mark Barton took a number of lives and went down with his ship and ultimately took his own life, all in the space of a few days, I guess I came onto several words here. It just jumped out at me. It attracts people who are dead end, unhappy in their current field, victim, layoffs, then, on the other side, the flip side, the real get-rich-quick part of it, the unlimited earnings potential. In other words, on the one side, you have that kind of psychological profile—but on the other side is gold.

Now, quickly—and that, as it has come to be discovered, was basically Mark Barton's psychological profile, dead end, unhappy in the current field, a victim, and all of a sudden day trading became his way out, but it was his way down, and he took his family and his associates—he went right back to the scene of his day trading and started pulling the trigger. And as I recall—maybe I am incorrect, but as I recall, before he pulled the trigger with one of his fellow associates, he said, "I hope this does not spoil your day."

I mean, it seems to me that in this world of securities, there always has been that side of the securities industry that attracted those who wanted to get rich quick and those things at the margin, the boiler rooms that prey on the elderly with the nonexistent gas stocks and oil stocks and so forth and gold mines, on the phone, the penny stock ripoffs, that maybe this is in that genre.

I wonder, from your point of view, do you think it is the role of Congress to require day-trading firms to live under the same auspices and under the same laws and regulations as, say, Merrill Lynch?

Mr. LEVITT. I do not think so, Senator.

I think that the proposal now out there from the NASD to address the issue of suitability really goes a long way toward doing that job.

I think hearings of this kind are terribly important in terms of alerting the public to the fact that day trading is not the kind of business that this ad would suggest.

The tragedy in Atlanta was one involving an aberrational personality that could have occurred with someone who had been to the

¹ See Exhibit No. 4 on page 218 in the Appendix.

racetrack or casinos too often and taken out his frustrations in a similar way in a different venue.

So I think that the important job that all of us have is to call public attention to the fact that investors simply have to be careful; that as far as I am concerned, it is a casino mentality that brings people to day trading, and that the overwhelming numbers of people practicing day trading will lose their money, and it is not easy money. It has always led investors to a very sorry ending. I do not think legislation could be sufficiently pointed to go to the emotional depths of individuals who have a predilection toward making the easy dollar.

Senator CLELAND. I agree that Congress cannot be everyone's personal psychologist, but the attitude that it is their life and their choice—I guess in my State the total laissez-faire attitude resulted in a loss of life and a loss of choices for a number of people, and somewhere in between, I think we have to find a reasonable solution.

Mr. LEVITT. I agree, Senator. I do not have a laissez-faire attitude about this, and I think the process that is being played out today is critically important.

Senator CLELAND. You are so kind to comment and state with such a strong and firm conviction your warning to American investors as you have done so beautifully.

Madam Chairman, I turn the hearing back to you.

Senator COLLINS. Thank you very much, Senator Cleland.

Chairman Levitt, I just have two final questions for you before we move on to our next panel of witnesses.

First, I want to give you the opportunity to respond to criticisms of the SEC's efforts to crack down on some troubling marketing and other practices of day-trading firms by giving you an opportunity to respond to Saul Cohen's previous comments about the SEC's efforts. We will be hearing from Mr. Cohen later today.

In his written testimony today, he was very critical of the NASAA study, but in previous writings, Mr. Cohen wrote an article called "The Empires Strike Back, Part Two," in which he also sharply attacks the SEC for its efforts to oversee the day-trading industry and to correct abuses.

Specifically, he labels the SEC's policy regarding day trading as "a war" and accuses the SEC of resorting to intimidating examination tactics and of "coming down with hobnailed boots on day-trading firms."

I want to give you the opportunity to address those very pointed criticisms.

Mr. LEVITT. The SEC historically has dealt with a number of constituencies that make up our great American capital markets, and it has been the position of this Commission and I expect our predecessor Commissions, that no constituency is more important than the individual investor.

At this point in time in the history of our country's markets, with more investors involved in equities today than ever before, it is essential that the SEC serve to protect investors and place their interests above those of firms, brokers, or anyone else in the system.

Part of the process is the collaboration of the commission with the NASD and other self-regulatory organizations and State regu-

lators. I believe that the combined efforts of the SRO's, the States, and the SEC with a commitment to protecting investors in the midst of a rapidly proliferating interest in gambling practices such as day trading, has been a balanced effort and an important effort. This effort, as part of our process, is exposed to public comment, protects the interests of investors, is fair, and, I believe, is reasonable and balanced.

Senator COLLINS. Well, I want to go on record as commending the SEC for its examination and consumer protecting efforts, as well as the other regulatory bodies involved.

The comments of a prominent representative of the Electronic Traders Association being so harsh towards the regulators raises real questions in my mind about their willingness to correct the problems that you have identified, and it is something that we are going to continue to watch closely.

I have just one final question for you, and that is the question that I raised at the very beginning of this hearing, and that is, based on your observations to date, do you believe that day trading is having an impact on the market in terms of increasing volatility or perhaps in a positive sense increasing liquidity, or do you think the volume is too small to have an impact?

Mr. LEVITT. As best I can tell, the volume of day trading probably amounts to not more than 5 percent of total volume in our markets. I think an argument can be made that it does represent some modest increase in liquidity. I do not think it has had a significant impact on volatility in our markets, and I do not intend to sound a note of doom with respect to electronics. I think electronics and technological changes in our markets have been exciting and important, critically important developments as our markets move ahead. I am very supportive of technology as being the best, and perhaps only, way that this Nation's markets can compete in increasingly globalized markets. It is where we target individuals who are inappropriate for certain techniques such as day trading that I take exception. The appropriate response to that, I believe, is hearings such as this, as well as the kinds of alerts and warnings that all of us can convey to see to it that we eliminate bad practices and clamp down hard on fraud.

Senator COLLINS. Thank you very much, Chairman Levitt. I want to thank the SEC for its efforts and——

Senator CLELAND. Madam Chairman.

Senator COLLINS. Yes.

Senator CLELAND. I would just like to associate myself with your remarks particularly commending the Chairman with his strong consumer protection and investor protection role that he plays in our government.

Thank you very much, Chairman Levitt.

Mr. LEVITT. Thank you.

Madam Chairman, Senator Levin, before he left, asked a number of questions about margins which I would like to supplement our testimony with. Within the next several days, we will send follow-up responses to those questions.¹

¹ See Exhibit No. 6 on page 221 in the Appendix.

Senator COLLINS. That would be very helpful. I, too, am very interested in the whole issue of the margin issues and the borrowing and the increased lending among customers. So I look forward to getting your replies.

In addition, your full testimony and any additional information will be included in the hearing record.¹

Again, thank you very much for your assistance.

Mr. LEVITT. Thank you.

Senator COLLINS. I would now like to welcome our next panel of witnesses this morning.

Mary L. Schapiro is the President of NASD Regulation, and Peter Hildreth is the President of the North American Securities Administrators Association, known as NASAA.

As the President of the NASDR, Ms. Schapiro is responsible for regulating member brokerage firms, individual registered representatives, and overseeing the NASDAQ Stock Market.

We look forward to hearing about her organization's recent examinations of day-trading firms, as well as NASDR's recent proposed rules to strengthen disclosure and suitability or appropriateness determinations for day trading.

Mr. Hildreth testified before the Subcommittee earlier this year on securities fraud on the Internet and was extremely helpful to us in that investigation as well.

In addition to serving as President of NASAA, he is Chief of the New Hampshire State Securities Commission. He is accompanied by David E. Shellenberger, who is the Chief of Licensing of the Massachusetts Securities Division. Mr. Shellenberger took a lead role in preparing NASAA's report on day trading.

As I have explained earlier, all witnesses are required to be sworn. So I would ask that you stand and raise your right hand.

Do you swear the testimony you are about to give to the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Senator COLLINS. Ms. Schapiro, I am going to ask you to begin, please.

**TESTIMONY OF MARY L. SCHAPIRO,² PRESIDENT, NASD
REGULATION, INC., WASHINGTON, DC.**

Ms. SCHAPIRO. Thank you very much, Madam Chairman. Good morning, Senator Cleland.

I appreciate very much the opportunity to testify on behalf of NASD Regulation, Inc., and I also want to commend the Subcommittee for conducting these hearings which can only serve to further the education of investors about these important issues.

NASD Regulation is the world's largest securities self-regulatory organization. It has responsibility for the oversight and surveillance of the NASDAQ Stock Market but, more importantly for these hearings today, we are also responsible for regulation, licensing, testing and examination for and enforcing compliance with our rules and the securities laws for our 5,600 broker-dealer members.

¹ See Exhibit No. 7 on page 225 in the Appendix.

² The prepared statement of Ms. Schapiro appears in the Appendix on page 79.

I would like to preface my comments today by emphasizing that day trading is a legal trading strategy and to the extent it is conducted in accord with regulatory requirements, by individuals who are capable of understanding and assuming the risks involved, we neither encourage nor discourage it. However, with that said, we see day trading as a highly risky form of trading that deserves the closest scrutiny of regulators.

Thus far, NASDR has taken a three-pronged approach to addressing the investor protection concerns that arise from day trading. First, we have been disseminating information and advisories to our members, reminding them of their many obligations under existing rules, and these advisories are fully outlined in my written statement. We have also been emphasizing to investors the risks involved with day trading.

Second, we have enhanced our examination and enforcement programs and, third, we have proposed new rules in this area and are exploring additional rulemaking initiatives.

With respect to examination and enforcement activities, we have been engaged in a cooperative day trading examination initiative with the SEC, as you have heard from Chairman Levitt. As part of that effort, NASDR examined 22 day-trading firms that varied significantly in size and makeup. Fifty-five NASDR examiners received special training in the intricacies of day trading.

During these specialized exams several potential problem areas surfaced. In the area of advertising, for example, we found sales materials and advertisements that range from assertions of immediate execution to statements of profits that can be generated from day trading.

One practice under review is the dissemination through public statements or Web sites, training materials and public statements of what may be materially misleading information regarding the success rate of customers. Our staff is investigating whether the firms' claims of customer success rates can be substantiated as our rules require.

In addition to our ongoing investigations, we have already filed one formal disciplinary action against Lakeside Trading. That complaint alleges, in the advertising area, misleading statements that imply direct access to the markets by their day-trading customers and the failure to disclose material risks associated with the trading.

Our examinations also surfaced Regulation T and margin lending and disclosure practices that are of great concern to us, particularly when we find firms facilitating and even encouraging loans from one customer to another customer, loans from a principal of a firm to a customer, and loans arranged by the firm from third parties to customers. Absent these infusions of capital, many of the recipients of the loans would be unable to continue to trade.

Another area of concern relates to registration issues. Our exams identified individuals engaged in day trading for firms' proprietary account who are not qualified and registered. One disciplinary action has been filed and concluded in that area in which we fined a day-trading firm \$25,000 for failure to properly qualify and register 14 people.

Problematic short-selling practices at some day-trading firms have also been identified, including short-sales that are not properly marked, and where no affirmative determination has been made that the shares can, in fact, be delivered to the buyer. We have seen potential violations of our rules prohibiting customer short-sales on what is commonly known as a "down-tick."

Supervision deficiencies were also identified during our examinations. Our rules require that a firm establish and maintain a supervisory system that allows them to carefully supervise the activities of each associated person. We found that at some day-trading firms, written supervisory procedures did not adequately address many aspects of their core business including lending practices, advertising and marketing, and short-selling.

We are currently reviewing the results of our examinations and completing investigations growing out of them. To the extent that these investigations indicate that violations of our rules or the Federal securities laws have taken place, further enforcement actions will be instituted.

In addition to our examination and enforcement activities, we have been working on several rulemaking initiatives to address the investor protection concerns associated with day trading that we believe are not adequately addressed under existing rules.

As you heard earlier, in April of this year we solicited comment on and in August filed with the SEC, proposed rules that would require firms that promote day-trading strategies to first determine the appropriateness of day trading for each customer. And, second, to disclose to customers the risk that are associated with day trading.

In order for a firm to approve an account for day trading, the firm would be required to have reasonable grounds for believing that a day-trading strategy is appropriate. To do so, they must obtain and keep information about the customer such as their financial situation, their tax status, their prior investment and trading experience and their investment objectives.

The proposed rules also require that a firm that promotes day trading deliver a specialized risk disclosure statement to a customer prior to opening an account, informing investors that day trading can be extremely risky, that investors should be prepared to lose all of their funds used for day trading and that they may lose funds beyond their initial investment.

In addition to this proposed rule, we are looking very closely at whether changes to existing rules regarding margin and lending practices are necessary. We have solicited comment on some of these issues.

Concerns that we have identified include what levels of margin are appropriate for these types of activities, whether the timing of the margin deposit requirements should be changed, and whether minimum initial and maintenance cash deposits should be required.

We are also addressing the role of firms that arrange loans between customers. We are particularly concerned about what, if any, risk disclosures are being made both to the customer obtaining the loan and the customer who is providing the loan. We believe facilitation of these lending activities by firms may pose a fundamental

conflict of interest between the firm and the customer, given that these are the loans that often allow customers to continue to trade when they would not otherwise be in a financial position to do so and, thereby, continue generating commission income to the firm.

We pledge to continue to be very vigilant with respect to day trading through examinations, regulatory initiatives, and the prompt completion of ongoing enforcement actions. We intend to continue to work together with the SEC and the States to address the many issues raised by day trading.

At this time, we do not see a need for any new legislative initiatives, but believe that by continuing our current approach of dissemination of information to our members and investors, examination and enforcement efforts, and the development of new NASD rules and other policy initiatives, we can effectively address investor protection concerns associated with day trading.

Thank you.

Senator COLLINS. Thank you, Ms. Schapiro.

Mr. Hildreth, welcome.

TESTIMONY OF PETER C. HILDRETH,¹ PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, WASHINGTON, DC; AND DAVID SHELLENBERGER, CHIEF OF LICENSING, COMMONWEALTH OF MASSACHUSETTS SECURITIES DIVISION, BOSTON, MASSACHUSETTS

Mr. HILDRETH. Thank you.

Chairman Collins, Senator Levin and Senator Cleland, I am Peter Hildreth, Director of Securities Regulation for the State of New Hampshire and President of the North American Securities Administrators Association.

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 day trading. We recognize and appreciate your leadership in focusing attention on the problems in this area.

Last December, in part because of the enforcement actions taken by Texas and Massachusetts, the NASAA board of directors formed a project group to research the industry, prepare a report of its findings and make recommendations. The project group, chaired by David Shellenberger, gathered information, analyzed issues and studied trading records. The NASAA day-trading project group report, released in August, was the result of that effort.²

We believe there are problems associated with the day-trading industry, not the least of which is the hype about how average people can get rich quickly with no experience necessary. We hope 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 believe it will also help in framing appropriate responses from Congress and regulators.

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 1990's:

¹ The prepared statement of Mr. Hildreth appears in the Appendix on page 167.

² Exhibit No. 8 is retained in the files of the Subcommittee.

The bull market on Wall Street and the technology revolution brought about by the personal computer and the Internet.

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.

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

There were several issues you asked us to address in our testimony. The first was a general discussion of day trading. I think that Chairman Levitt has already discussed how day trading is distinguished from other investment strategies. My written testimony provides NASAA's perspective on this issue. So, in the interest of time, I will move on to other issues you asked us to address, such as the risk of day trading.

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 that 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.

We commissioned an outside expert, Ronald L. Johnson, to analyze customer account records from a day-trading firm in Massachusetts that was the subject of an enforcement action. His analysis suggests the majority of day traders, more than 70 percent, lose money. Only about 12 percent showed the potential to be profitable.¹

Mr. Johnson also found that day traders would have to generate annual returns of 56 percent just to cover commissions and margin interest, never mind taxes. These are long odds, indeed, just to break even.

This was the first such analysis of retail day-trading account data. It was a limited sample but the results are consistent with what we found in other investigations, such as evidence from a Block Trading branch office where 67 of 68 accounts lost money.

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 in their marketing that suggests that average people can make a career of day trading.

As to the findings of State regulators' exams, some of the abuses and problems that the project group has observed include: Deceptive marketing, including inadequate risk disclosure. As you noted in your presentation, Chairman Collins, one firm On-Line Investment Services, Inc., maintained a Web site claiming that 85 per-

¹ Exhibit No. 8 is retained in the files of the Subcommittee.

cent of its customers were profitable. They deleted that claim when Massachusetts asked for proof.

We also found violation of suitability requirements. In a case against Landmark Securities, Inc., the complaint alleged that the manager falsified information on new account forms to create the impression day trading might be appropriate for that customer. The customer, a recent college graduate, was a part-time bartender with an annual income of \$15,000, a net worth of less than \$15,000, and no prior investing experience.

Other abuses we noted are questionable loan arrangements, including promotion of loans from one firm's customers and loans to customers by brokers, and also failure to supervise.

The next issue is our position on the NASD proposed rule. In a comment letter to the NASD, the NASAA project group endorsed the draft rules on appropriateness and risk disclosure and made suggestions for enhancing the rules. We recommend that the SEC approve the rules.

As to other legislative or regulatory initiatives, we believe the NASD should also adopt a rule prohibiting the abuse of loans I have discussed. We also recommend enhanced regulatory attention to day-trading firms.

First, the proposed NASD rules on appropriateness and disclosure. 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, suggest that specific day-trading rules are warranted.

Day trading is a particularly risky program of trading that warrants heightened suitability and disclosure requirements. The NASD already has special suitability requirements for opening option accounts and the like.

Second, the matter of a ban on loan programs. 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. Some of these loans come with interest rates that in some States may exceed legal limits. A typical rate is a tenth of a 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 transfer of customers' funds.

We believe the loan programs are highly questionable under existing law. Nonetheless, we believe the NASD should adopt and explicit rule prohibiting the programs.

Finally, enhanced focus on day-trading firms. Too many day-trading firms continue to engage in highly questionable conduct as you heard from Chairman Levitt's report. More enforcement actions should be brought.

But let me be clear. State regulators do not 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 will sell you a training course, you can sit in front of the computers and you will get rich." This is hucksterism. The odds are that you will not get rich. The odds are you will lose all the money with which you trade.

The fact is day trading is not investing, it is gambling. There are no other words for it. Day traders can lose a lot of money in a hurry. People should not be gambling with money they cannot afford to lose.

As Chairman Collins mentioned, All-Tech's recent Web site illustrates that some firms have held out day trading as an option for retirees, people laid off from their jobs, even college graduates just starting out. This sort of marketing is irresponsible, reckless and predatory.

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 have 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 chair the NASAA project group's findings with the Subcommittee today. NASAA and its members stand ready to assist you as you continue your investigation into the practices and operations of the day-trading industry.

Senator COLLINS. Thank you very much, Mr. Hildreth.

Mr. Shellenberger, do you have any formal comments you would like to make?

Mr. SHELLENBERGER. No, Chairman Collins. I am prepared to answer any questions that may be asked, though.

Senator COLLINS. Thank you very much.

Ms. Schapiro, you stated in your written testimony that NASDR examiners had identified questionable practices, questionable marketing and advertising practices at nearly 80 percent of the day-trading firms that you have reviewed to date. Is that correct?

Ms. SCHAPIRO. Yes.

Senator COLLINS. That is of great concern to me because that suggests that we are not dealing with isolated examples of misleading advertisements or exaggerated claims but rather an industry pattern of deceiving unsophisticated investors.

Could you give us some examples of the kinds of deceptive marketing practices that your examiners uncovered?

Ms. SCHAPIRO. Sure.

I think as a general matter we have seen extremely aggressive marketing and promotional campaigns engaged in by a number of day-trading firms. Some of the advertisements and sales literature which have been of particular concern to us includes promises of enormous profit potential, very high levels of customer success

rates without there being any counter balancing information about either the risks or the fact that you can lose all of your money and more than your initial investment.

We have seen ads that suggest that you are guaranteed immediate execution in the market place. When we all know that as good as the technology is, you are not *guaranteed* an immediate execution.

And, we have seen advertisements that suggest that anybody can do this with just a little bit of a training or studying a manual when, in fact, sophisticated understanding of market operations and how stocks react in different markets and areas is very important to be successful.

So, generally, I would say exaggeration, potentially misleading information and wild claims would characterize many of the ads that we have looked at and are investigating.

Senator COLLINS. And I would note that the SEC examiners and the State regulators have also found a similar pattern of widespread abuse with advertising in this area.

Ms. SCHAPIRO. I think that is right. It is interesting to me that the examinations done by all three of us are very similar and largely parallel in their findings.

Senator COLLINS. That does seem to be a consistent and very troubling theme or finding of all three regulatory organizations.

Your examinations also indicated, Ms. Schapiro, that nearly half of the day-trading firms had established lending programs whereby day-trading customers who cannot meet the margin calls can borrow from other day-trading customers. This raises real concerns in my mind about suitability and appropriateness.

If a day trader can't meet the margin call and is encouraged by the firm to borrow from a fellow day trader, what does that say about whether the individual should be day trading in the first place?

Ms. SCHAPIRO. That is a wonderful question and I think that my greatest concern in this area is that it is fundamentally a very severe conflict of interest for a firm to suggest to a customer who has run out of capital that that customer borrow money from other customers or from principals of the firm in order to continue to generate commissions for the firm. We are looking very closely at this issue and I would hope that in the next several months we will have taken some action with respect to the facilitation of lending arrangements by the broker-dealer.

Senator COLLINS. Mr. Hildreth, I know this has been of particular concern to the State regulators. Would you like to comment on this and should NASDR simply ban this practice?

Mr. HILDRETH. Well, I think that certainly the NASD should look—what they are seeing in these exams is what we talked about in the report. And I know that Dave Shellenberger has some things to say about those also. But it would seem to me that with that widespread, as it appears in the industry, practice, is something that we have some real grave concerns about for the same reasons that Ms. Schapiro stated. Keeping people trading when there are some real concerns if they don't have the money, perhaps just to generate commissions.

So, I think certainly it should be looked at.

Senator COLLINS. Mr. Shellenberger.

Mr. SHELLENBERGER. Yes, thank you, Chairman Collins.

One of the problems with the loan programs, and by the loan programs, of course, what we are referring to is day-trading firms promoting and arranging loans between customers so that customers can meet margin calls that they otherwise could not meet.

The purpose of these loan programs is simply to keep accounts alive that would otherwise be closed and allow the brokerage firms to obtain a continuing stream of commissions.

These programs encourage people to lose even more money. They certainly, as Madam Chairman has recognized, raise suitability concerns. If people are trading beyond their own means, don't have enough funds to meet margin calls, should they be day trading in the first place? To indicate the magnitude of this issue, we alleged in Massachusetts in the case against Landmark Securities that with respect to the tiny retail account held by the part-time bartender and recent college graduate in that office, \$2.7 million in loans flowed through this person's account in only 9 months.

Senator COLLINS. I think this is an area where we really do need to see regulatory action. It just raises all sorts of concerns.

We also need to do a better job upfront screening out people for whom day trading is not appropriate. And I think that is why the NASD's appropriateness regulations are very important in that regard because we would have fewer people who would be tempted to borrow from fellow day traders if we were screening, if the industry was screening potential clients upfront.

Would you agree with that, Ms. Schapiro?

Ms. SCHAPIRO. Yes, absolutely.

Senator COLLINS. Mr. Shellenberger, as you are very well aware the day-trading industry has been extremely critical of NASAA's report on profitability of day trading in which it was found that more than, I believe it is, 70 percent of day traders are going to lose their money, perhaps even more, and only 12 percent were found to have the capacity to perhaps make a profit.

The industry has countered with a study on day-trading profitability that was conducted by Momentum Securities. Have you reviewed that study and could you give us your thoughts on it?

It is my understanding that the Momentum study acknowledges that 56 percent of day traders lose money in the first 3 months but it claims that after that point 64 percent of day traders actually make money.

What are your views on the Momentum profitability study?

Mr. SHELLENBERGER. Chairman Collins, on behalf of the NASAA project group I requested copies from the Electronic Traders Association of any studies, including Momentum's purported study. I have yet to receive any documentation, anything related to that study. So, I am only familiar with the press clippings concerning it.

Senator COLLINS. Well, that is problematic in and of itself, I would say. If you, as a regulator, are making a request for information that is that vital and are not receiving the cooperation of the day-trading industry that is of great concern to me.

Mr. SHELLENBERGER. Yes. I should clarify, Chairman Collins, that Momentum Securities is not registered in Massachusetts so

we cannot legally force them to produce these records. Nonetheless, we did request them through the ETA. Claims of profitability or losses are meaningless unless the data are subject to scrutiny.

So, I have been unable to scrutinize these claims. However, on the face of the claims there is a problem. And that is Momentum has acknowledged that the majority of its customers did lose money at least for a period of months. They claim that after that apparently the surviving customers were profitable. I don't know whether that is true or not.

The question would be, how many people are going to burn through their capital and still have some money left once they supposedly learn how to day trade? I suggest that it may be too late.

For instance, Ron Johnson, in reviewing our sample, found that the average account was only open 4 months.

Senator COLLINS. So, in other words, given the high turnover of day traders, many of them aren't going to still be able to day trade because they will be broke by the time they may finally have figured out how to do this profitably?

Mr. SHELLENBERGER. Absolutely. Assuming that it is even possible for them to learn.

Senator COLLINS. Have you seen anything, based on your further examinations, that leads you to question your initial findings that more than 70 percent of day traders will lose their money?

Mr. SHELLENBERGER. No, Chairman Collins.

In fact, I believe that the 70 percent figure probably understates the problem. Ron Johnson concluded that if many of these people beyond the 70 percent continued to trade, those that had shown profits would end up losing money because, for instance, in many instances the profits had been gleaned from only one trade. Well, if you can make 50 percent of your profits in one trade, you can lose 100 percent of your capital in the next trade.

Senator COLLINS. Ms. Schapiro, has the NASD done any work on the profitability of day trading?

Ms. SCHAPIRO. We haven't done a broad look at the profitability. In the context of the specific investigations of day-trading firms that are ongoing where they have made claims of customer success rates, we are requiring them to substantiate that those success rates are, in fact, true.

Through that mechanism we will have a better sense, at least anecdotally, of what the success rates are and what the profitability is of day trading at particular firms.

Senator COLLINS. I hope you will share that information with the Subcommittee.

Ms. SCHAPIRO. We will be happy to do that.

Senator COLLINS. The appropriateness regulations that the NASD has proposed, and which are now pending before the SEC, apply, it is my understanding, to only new accounts. Is that correct?

Ms. SCHAPIRO. As the rule was proposed, yes, we applied it on a "going forward" basis to new accounts.

Senator COLLINS. Would it not be useful to apply it also to current accounts, so that there at least is a disclosure of the risks?

Ms. SCHAPIRO. We will certainly revisit that issue.

We targeted it to an account opening because that's a very definitive event that can trigger the need to do the appropriateness determination.

To the extent that there are accounts already out there at firms that aren't even traditional day-trading firms but where people are, in fact, day trading, we thought it would be very difficult, as an operational matter, to go back and try to apply the rules to all of those accounts. But it is something we will look at very carefully.

In submitting these rules to the SEC, we have said that this is a first step. And, if we determine there are additional regulatory initiatives that are needed in this area, we won't hesitate to recommend those.

Senator COLLINS. Thank you very much. My time has clearly expired, and I will now turn to Senator Levin for his questions.

Senator LEVIN. Mr. Shellenberger first, I believe you were the folks who got the restraining order against TCI; is that correct?

Mr. SHELLENBERGER. Yes, Senator Levin. Specifically, the cease and desist order applied to what we had alleged in the licensing section as a Ponzi scheme, beyond what we allege were false claims as reflected by the advertisement. Then the hearing officer referred the matter of the deceptive advertising to the Attorney General's office because he had concerns regarding our jurisdiction.

Senator LEVIN. That is the original one, I believe, and I want to show you the new one that is currently on their Web site and ask you whether or not those concerns are still real, when they say that this system is the absolute best that they know of, and it says a profit to loss ratio of 12 to 1 and an average return of better than 18 percent per trade before slippages.¹

It seems to me it's worse than their first site.

Mr. SHELLENBERGER. Yes. Senator Levin, I would share your concerns. The response, once regulators have raised questions regarding specifically Web sites, has been that these Web sites change. I believe this site has been modified. But I share your concerns that this remains unacceptable.

You had asked a prior witness, Chairman Levitt, regarding the SEC's jurisdiction in this matter, and this is a very technical area. But I would note, if I may, that there are State consumer protection acts that prohibit deceptive advertising and, in addition, such matters may be under the purview of the Federal Trade Commission.

Senator LEVIN. This is a current Web site, by the way. This is after the change. So at least as of yesterday, it was their Web site.

Is this under Massachusetts' jurisdiction if that is false advertising? Is that what your Attorney General is looking into now?

Mr. SHELLENBERGER. Senator Levin, the referral was made to the Attorney General's office from the Massachusetts Division of Securities, because Massachusetts, I believe, like most States, has a Consumer Protection Act Chapter 93(a) which, among other things, prohibits unfair or deceptive acts or practices, including advertising. So this, in my view, would be subject to scrutiny under that law.

¹ See Exhibit No. 3 on page 216 in the Appendix.

Senator LEVIN. If the Attorney General concluded that was false and deceptive advertising, and if TCI is located—and I don't know where they're located——

Mr. SHELLENBERGER. In California, Senator.

Senator LEVIN [continuing]. In California, would you be able to get at them because the advertising is on a Web site which obviously comes into Massachusetts? Would you be able to get a subpoena, for instance, under existing legal theory?

Mr. SHELLENBERGER. Senator Levin, I know that this area of States being able to obtain jurisdiction in response to Web site advertisements has been the subject of some brilliant *Law Review* articles that I have only skimmed.

I can tell you that TCI has at least closed down its branch office in Massachusetts, and I don't expect them in my back yard again. Whether we would be able to enforce a subpoena on a California corporation that, to our knowledge, did not do business with any of our citizens, would be questionable.

Senator LEVIN. Madam Chairman, I think this is an area that we also want to add to our list of things that we're looking into, because, given the amount of electronic trading, given the fact that this kind of a course and strategy is available electronically, or the touting of it is done electronically, it would be good to have not just the watchdogs in Washington, the Federal Trade Commission or others looking into these kind of phony representations, it would be good to have 50 States being able to go after them as well. That may require some kind of change in Federal law to authorize subpoenas. I'm not sure exactly what the legal complexity is, but I think we ought to add this, given the amount of electronic trading and the way in which these courses are advertised, to our list of things that we're looking into for possible legislation.

I think this question will go to you, Mr. Hildreth. You indicated in your testimony that the odds are you won't get rich, and the odds are you'll lose all the money with which you trade. We will hear testimony later on this morning from Mr. Cohen that day trading is not gambling. But then he says the majority of those who do day trade after training do not lose money.

You're telling us that the odds are you will lose all the money with which you trade?

Mr. HILDRETH. That's right.

Senator LEVIN. That's about as sharp a conflict as we can possibly have. I'm just wondering what your reaction is to his comment?

Mr. HILDRETH. My statement is based on the report¹ that was produced by Dave Shellenberger's project group, and hiring an outside consultant. It is based on the data that we have.

We also had the testimony of the manager of one of these sites, who said 67 out of 68 lost money.

Senator LEVIN. They also will be testifying later on this afternoon that much of NASAA's report, that this mumble jumble would be unnecessary if NASAA had accepted ETA's March, 1999 offer to provide current trading information.

¹ Exhibit No. 8 is retained in the files of the Subcommittee.

Now, we're going to be getting testimony under oath later on this morning that ETA offered NASAA, in March of this year, to provide current trading information. I'm wondering, did they, and if so, what was it?

Mr. HILDRETH. Dave Shellenberger is the appropriate person to respond, since he's the Chairman who would have dealt with them on that issue.

Mr. SHELLENBERGER. Thank you, Senator Levin.

The answer is that that's a false assertion. What had happened is that the ETA, through its counsel, asked me to comment on a possible study that might be done by the ETA. The project group determined not to make any suggestions or comment but, rather, to reserve comment. The reason is that we did not want to endorse a study or survey of which we did not know the particulars.

I would stress, Senator, if I may, that the burden of proof is on the industry. Before they make these claims of 85 percent success rates, before they make the claims that retirees should make careers of day trading, they should have the facts. It disturbs me that apparently studies have not been done to date, other than the alleged Momentum study.

Senator LEVIN. Can any of you comment on the adequacy of current laws and regulations to address the problems which we have identified, and if you would prioritize the new regulations or laws that are needed in terms of their importance? Maybe we can start with you, Ms. Schapiro.

Ms. SCHAPIRO. OK. Well, we have identified a lot of problems, as you've heard. I think, with respect to advertising, for example, there are adequate regulations in place, assuming sufficient enforcement resources, to pursue all of those advertisements and marketing materials in an aggressive way.

I think we have said, with respect to margin, and particularly margin lending practices, that we need to do some more work, as SRO's and the SEC, to look at whether there ought to be a prohibition and, at a minimum, enhanced disclosure of the risks of margin lending or some other modification to address the practices that we have seen with respect to margin lending.

I think we also ought to look at whether, under the margin rules—and you asked these questions earlier, Senator Levin—we should be shortening the time frames by which Regulation T margin deposits must be made. It's currently 7 days and perhaps it ought to be shorter, given the kind of mismatch we have of these trading strategies that are intraday, with margin payments being required only within 7 days.

I think with respect to short sales or short selling, the current regulatory and legal structure is adequate.

With respect to supervision, there is a very detailed and comprehensive supervisory structure in place in the largest broker-dealers, and the best run small- and medium-size firms. Day-trading firms need to adopt those kinds of supervisory structures and hire compliance people who can ensure that they are following the rules and regulations that apply equally across the board to all broker-dealers.

Senator LEVIN. Just very quickly, if I may, does your organization support the proposed rule on suitability, that it apply to strategy as well as—

Ms. SCHAPIRO. We wrote it. It is our rule and we are 100 percent behind it.

Senator LEVIN. Mr. Hildreth.

Mr. HILDRETH. We support it, as I said, and filed a comment letter in support of that.

We wouldn't be here today if the current rules were met by the industry. What we found is the rules are being broken. I think that there is a need to look at the loan issues, and perhaps just ban them outright.

If the current rules were being complied with, I don't think we would be here. I think the day-trading industry just has to comply with those.

Senator LEVIN. But in terms of new regulations and rules, the first thing would have to be with the loan, and second, would be suitability or not?

Mr. HILDRETH. Well, we have supported the suitability proposal, and we hope that that's going to be approved quickly. We would like the NASD and the SEC to look at a ban on the lending programs.

Senator LEVIN. Is there anything else from our third witness?

Mr. SHELLENBERGER. Senator, I concur with Mr. Hildreth's comments, and I emphasize that the industry seems to be doing a good job of violating existing law.

Senator LEVIN. Thank you. Thank you, Madam Chairman.

Senator COLLINS. Senator Cleland.

Senator CLELAND. Thank you very much, Madam Chairman.

Ms. Schapiro, we're glad to have you with us today. I have spoken to your organization, mostly as Secretary of State in Georgia, and as a State regulator. Mr. Hildreth, it's nice to see you. I have great respect for your organization as well.

I mentioned earlier today that Wayne Howell, my AA, has been very instrumental in my understanding of the regulatory process, in terms of the world of securities, and he was the former head of your organization. Mr. Shellenberger, as a former State regulator, we respect your role immensely.

I think it is fascinating, Madam Chairman, a couple of things I have gotten out of this today. First, Mr. Hildreth, you're the second person to sit in that chair today to refer to day trading as gambling, the first being Arthur Levitt, head of the SEC, and then you, heading the North American Securities Administrators Association, referring to it as gambling.

That is certainly far beyond any understanding of investment or even just speculative investment. It seems to me that our testimony today has reflected that it is, indeed, gambling.

As a matter of fact, I started off somewhat quizzically about the relationship with Las Vegas, that it is now clear you have better odds in Vegas than in day trading, and that it's not roulette but it's Russian roulette, where there's a bullet in the chamber. If you keep playing this roulette game long enough, you're going to be dead.

To hear the fact that, as a minimum, some 82 percent that go into day trading don't make anything, and 70 percent lose money, 12 percent have a potential of maybe making some money, that's astounding odds against you. So I think something is broken here. I'm not sure what's broken, but I think some things need fixing.

What I would like to suggest here, before I leave the panel, is to ask Ms. Schapiro, Mr. Hildreth, and Mr. Shellenberger, what is your best shot here and what can this Subcommittee or Congress do to help get this thing back on track, to help main street get back in line with Wall Street, not abandoning the technology and certainly not wiping out the opportunity for the individual investor to get involved in the process, but how do we make this work?

Ms. Schapiro.

Ms. SCHAPIRO. I believe, from the perspective of the U.S. Congress, the most important thing—because we don't have any recommendations at this point for specific legislative initiatives—would be to continue to support the regulators through hearings like this, that help us have an audience to air some of these issues and concerns, and continue to support the regulators in their initiatives to enact some new rules governing this kind of trading, have adequate resources, particularly for the Securities and Exchange Commission, to do the kinds of examinations and enforcement cases that will help protect investors.

Senator CLELAND. Mr. Hildreth.

Mr. HILDRETH. I would also say that this type of hearing goes a long way, toward publicizing this issue. When we released the report, there was a great deal of coverage, and that's good, because people need to know the real risks. They are not being told that when they see an ad that says you can come in here, be trained for a few days, and you can retire—or you've already retired and you can make extra money.

It is important to get the message out, that day trading is risky. This kind of hearing, what you're doing here today, I think goes a long way in that regard. Again, I do think that the SEC and the NASD need the support of Congress, the SEC more directly, certainly, with the funds to do it.

I would note once again, as I think Chairman Levitt mentioned earlier, that the three groups—the SRO's, the SEC and the States—really do work well together on these kinds of issues, and we look forward to doing that. We hope you give the SEC the resources to do it.

Senator CLELAND. Mr. Shellenberger.

Mr. SHELLENBERGER. Senator, I concur with the statements of Ms. Schapiro and Mr. Hildreth. I'm not sure additional legislation is needed. However, we find hearings of this nature very helpful in alerting the public, not only to the risks and problems, but reminding them that, as one of the Senators noted earlier today, if something sounds too good to be true, it probably is.

Senator CLELAND. That was me. [Laughter.]

Mr. SHELLENBERGER. It was a brilliant remark, with which I concur. [Laughter.]

Thank you.

Senator CLELAND. Help me understand day trading just a little bit. First of all, I'm an individual citizen. Can I buy stocks through the Internet?

Ms. SCHAPIRO. Absolutely.

Mr. HILDRETH. Yes.

Ms. SCHAPIRO. Without day trading, you may open an on-line account at any one of hundreds of brokerage firms—

Senator CLELAND. But you've got to go through a brokerage firm to do that?

Ms. SCHAPIRO. Yes. Well, you do, if you're not going to engage in day trading. If you're going to engage in day trading, you have a couple of options. You can go on site, at a brokerage firm that is an NASD member and sit at what is the equivalent of a work station that one might see on a trading desk in a NASDAQ trading room at a big firm, and you may access the market through that terminal at the brokerage firm.

You may also go into a limited liability company that might not be a member of the NASD and, therefore, not subject to all the rules and regulations of the NASD, but perhaps a member, for example, of the Philadelphia Stock Exchange, and trade as a limited partner of that LLC. You would deposit your own capital, which becomes part of the firm's capital, and trade as a partner, not as a customer and, therefore, not benefit from suitability and a number of other rules that protect customers.

You would also have the benefit of even greater leverage, because you wouldn't be subject to the Regulation T margin requirement of 50 percent initial margin and 25 percent maintenance margin but, rather, whatever margin level is arranged between that limited liability company and their clearing firm. It could be as low as 15 percent margin. So you have several alternatives on how you want to approach day trading.

Senator CLELAND. Thank you. The panel has been most gracious with their time.

Madam Chairman, thank you for holding this hearing. It is obviously a very fascinating part of the world in which we live, and certainly day trading is very risky business and these people are trying to help. Thank you very much.

Senator COLLINS. Thank you very much, Senator.

I want to thank our panel for their very helpful testimony. We look forward to continuing to work with you as we continue our investigation as well.

Our final witness this morning is Saul Cohen, the consulting counsel to the Electronic Traders Association, which is known as ETA. Mr. Cohen has extensive experience in securities regulation and is currently a partner in the law firm of Proskauer, Rose in New York City.

ETA is a nationwide association of firms and individuals which promote the interests of the day-trading industry.

Mr. Cohen, before you get too comfortable, I do need to swear you in.

Do you swear the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. COHEN. I do.

Senator COLLINS. Thank you very much. You may proceed.

**TESTIMONY OF SAUL S. COHEN,¹ CONSULTING COUNSEL,
ELECTRONIC TRADERS ASSOCIATION, NEW YORK, NEW YORK**

Mr. COHEN. Thank you, Senator. I'm the notorious Mr. Cohen referred to before.

For those who are interested, the quote is from a much larger and broader article on philosophical concepts of regulation. It appears in two parts, in the Wall Street Lawyer.com, and it really deals with the threats of the Internet.

But, in any event, I thought I would start with two quick quotes from Chairman Levitt's written testimony, because they are so much at odds at what anything else anybody has said here.

"To date, however—" page 7 "—we have not found marked and widespread fraud by these firms." Page 13, "The staff has found isolated instances where day-trading firms appear to have failed to comply with margin requirements or properly disclose terms and conditions of loans in contravention of SEC rules." Mr. Levitt was also kind enough to say that day traders don't add to volatility.

Senator Levin had asked a very perceptive question before, he never got an answer, and that had to do with margin. It was perceptive in two ways. One was what would happen if you didn't come up with money, and the answer is, if you didn't come up with money, then after 7 days your account would be frozen and you will not be able to do anything but liquidating transactions. That's a universal rule.

The part that I thought was interesting was that it indicated that it was possible to make a profit on a margin trade. All we've heard today so far is people going to margin because otherwise they're going to go broke sooner. But the point is that you can go into margin, and lots of people go into margin transactions because they want to keep profitable trades.

On-site traders will emphatically tell you that they're not gamblers and day trading is not gambling. ETA traders have an extremely high percentage of college and professionally educated people. The *New York Times* pointed out just in August that "many former professional traders, brokers and financial service professionals are becoming full-time day traders."

Successful day trading requires skill, hard work, and access to state-of-the-art technology.

And while I'm at it in regards to this, in terms of risk disclosure, ETA has supported risk disclosure much broader and deeper than the NASD risk disclosure. It has been in place for months. And it requires that the particular individual involved sign the risk disclosure statement.

Senator Levin, because I know margin is of interest to you, there is language in here that says you may sustain a total loss of the initial margin funds and any additional funds you deposit with your broker, and you may incur losses beyond your initial investment. There is lots and lots of disclosure in that form.

You may well be, to go back to the subject of gambling, aware of people who are called "quant" traders. These are people who in-

¹ The prepared statement of Mr. Cohen appears in the Appendix on page 178.

vest millions of dollars in computers, special phone lines and software, so that they can day trade successfully. They're not gamblers. They are market professionals.

Day trading is not a cult, although sitting here today, I wondered about that, from a regulatory view, and there is nothing new about day traders. They have always existed on exchange floors. They're still there today. At least since the advent of Thomas Edison's stock ticker, there have been day traders in what are called upstairs offices.

Now, I have repeated on-site day traders several times to differentiate these 4,000 or so individuals who Mr. Levitt also mentioned in his written statement have a very limited reach, so it's important to understand what we're looking at. From the estimated 250,000 people encouraged to trade on line through such household names, including the one the Chairman mentioned, Charles Schwab and Discover. You may have seen the Discover ad which shows a pig farmer who trades on line. The copy for the ad runs, "Gorden Gekko, Eat Your Heart Out. Wall Street used to be about greed. Now it's about brains, about taking control of your money. So go ahead. Yup." That's a New York advertiser trying to be a farmer. "Just a mouse click away."

Now, contrast the pig farmer with the on-site trader. ETA members get almost instantaneous executions, very often instantaneous executions. The farmer doesn't. ETA traders get price improvement. And if we're talking about consumer issues—and that's the most important consumer issue this Subcommittee ought to be concerned with—the pig farmer does not get price improvement. His order goes to a market maker in a preferencing arrangement. ETA traders take advantage of the firm's intellectual capital. That is, the people around them, the experience of the other traders—well, I guess the pig farmer has his pigs.

It's very important, when we talk about on-site trading and risk, to understand that you would have to be totally oblivious to the world to not understand the risk because you are sitting in that office, cheek by jowl, with other traders.

Now, there are, of course, lots of complaints by day traders, but they're from the on-line day traders. "Why is the system down? Why did it take so long for my order to get executed?" There are virtually no complaints from on-site day traders, so we've got a mystery on our hands. If there are no complaints, why is NASAA, not the SEC or NASD, seeking to isolate on-site day-trading brokerages from every other part of the securities industry?

According to NASAA, on-site firms are a public danger in three respects. On-site firms routinely violate securities regulations. To quote Mr. Hildreth, "day-trading firms need to play by the same rules the rest of Wall Street follows. If they don't get their act together, they'll be under increasing regulatory pressure."

The NASAA report charges on-site firms with order entry failings, short sale, margin and books and record violations, even omissions to disclose the risk of loss, and false marketing. But NASAA, in its survey of regulatory cases, apparently hasn't noticed that just over the past 18 months, and just looking at the top 100 well-capitalized firms by the SIA, not the hundreds of others—that Merrill Lynch and half a dozen other firms were disciplined for

order entry matters. Piper Jaffray fined for short sale violations. Schroder, Cowen, and Fahnstock cited for margin. Salomon Smith Barney and three other firms, books and records. Merrill Lynch fined \$2 million for sales materials which "omitted material facts in the risks of investment losses." And Prudential Securities was fined \$500,000 for false marketing information regarding CMO's.

The Subcommittee also, I think, is aware that institutional investors have been buying interests in on-site firms. I think you're aware then that these investments are made after considerable due diligence and simply would not be made if day-trading firms were securities industry rogues. That's one of the reasons why I think Mr. Levitt felt comfortable in writing that there's no widespread fraud.

The second charge against day-trading firms by the NASAA was that on-site firms engage in deceptive advertising. But it should be noted that no advertising, even as compelling as the Discover ad about the pig farmer that I just went through, can withstand reality. And, by the way, ETA has a statement of principles that decries in any sense deceptive advertising. It talks about giving a full picture to people and so forth.

Day traders, as I have said before, are intelligent and well educated. They are on site. They can quickly observe from the traders around them what the range of risks and rewards are. To go back to Senator Levin for a minute, his comment about "well, isn't this a surprise when you get the margin notice?" Well, if it's a surprise, it's a surprise once. It's not going to be a surprise the second time.

It is important to understand, by the way, with regard to risk and the risk of loss, that if this market collapses, you're much better off being a day trader holding securities for 4 minutes than people who are holding securities for months and years, as I am in some of my accounts.

ETA members need not advertise for customers. Most prospects are references from customers.

A third charge, on-site day traders lose money in wholesale lots. We have heard over the last year all kinds of numbers. We have heard 7 out of 10, 8 out of 10, 9 out of 10 lost money. Massachusetts—and they were here before, Mr. Shellenberger—67 out of 68 lost money at one firm. Well, if that happened, you would think the Boston press would pick it up and they would notice 67 people running out of the office yelling "plague." No one is that dumb.

Now the report is out, and I've got to tell you, as somebody who is a professional in this business, this is an amateurish report. NASAA's expert, Mr. Johnson, turns out to be a former commodity trader who earns his living as a plaintiff's witness, and whose resume, which we have put in our materials, lists with pride that, for 2 years, he "published daily hot line trading recommendations," a fancy way, Senator, of saying that he gave option tips, and that he "developed a low-price stock strategy that returned over 30 percent." You would think NASAA would be going after him for that kind of advertising.

This expert, who operates out of his apartment, studied a grand total of 17 day-trading accounts. These, on average, traded for 4 months, 2 years ago, one office, on non-ETA firms. His conclusion? Sixty-five percent of the accounts had a risk of ruin; that is, if they

kept going, never learned anything but just kept making the same mistake they made before, they were going to lose money. They would never stop and would never quit before they lost all their money. They would lose all their money.

We tried to avoid the numbers game. We tried, no matter what Mr. Shellenberger is telling you—and there is correspondence on this and I will supply it to this Subcommittee afterwards, supply the Blue Sky people with current information for use in an independent survey. We provided them with a methodology of four pages. NASAA demurred. He told you why they demurred. They didn't want to endorse an independent study.

We estimate, without any claim of scientific accuracy—but I can tell you that I spoke to a half-a-dozen on-site firms—that most customers will lose money or break even in the first 3 to 5 months. They're not going to wipe themselves out in the first 3 to 5 months. They'll lose some money. And that thereafter nearly two out of three are going to net \$28,000 a month, with the odd man out losing \$6,000 to \$8,000.

But, hopefully, to put this particular matter to rest, because it is so important, ETA is in the process of retaining KPMG to conduct a day-trading profitability study.

Let me go back to another point that was made before, Senator—and you've really made a number of perceptive points. One of them had to do with—I think this was asked of Mary Schapiro—would you allow somebody right out of college to day trade? A good question. How about right out of Wharton? I interviewed somebody right out of Wharton in January, who was out day trading for a year, and he made \$750,000 in January. I felt very foolish being a lawyer.

Given these facts, why has NASAA sought to demonize on-site day traders? The reason, quite frankly—and they said it here—is that they want the publicity. This is what Mr. Hildreth said last January. “We need to reposition ourselves to cultivate media contacts. The news media is hungry for good crime stories, and with a little imagination, we can find them stories to write about.”

Now let me move finally to something that is more positive. ETA members seek to meet all regulatory requirements and to foster high standards of ethics. We have statements of principles and we have risk disclosure that goes well beyond the NASD. ETA members tell prospects that day trading is not for everyone. In fact, ETA's own risk disclosure statement is broader and deeper than NASD requires, and acknowledging signature by the customer. We frankly urge that in the NASD's risk disclosure that they get it signed by customers. ETA's statement of principles reads, “We will not make misleading or exaggerated claims, and will provide a balanced perspective in our presentation.” We think you ought to consider asking the entire securities industry to adopt the statement of principles along these lines.

The hardest issue to deal with is the appropriateness issue. It is very, very difficult. It's difficult because it undercuts what has been years and years of suitability theory. The security industries association has taken the position opposed to the NASD proposal because, in the past, all suitability decisions—and this was spoken to

before by Mr. Colby—dealt with particular trading recommendations, not overall strategy. So this is a strategy.

We have been working very hard to get to the point where we can agree with the kind of appropriateness standard. We think that, in doing that, one of the ways to do it is there are existing—and you might ask Ms. Schapiro about this—the NASD has existing rules on option trading. Option trading is a lot like day trading. It's a collection of different strategies. It's an approach to the market, not a particular recommendation thing. It starts off with somebody being approved, getting a risk disclosure statement and then being approved to trade options, or in this case, to day trade. We think that's a much better approach to appropriateness. It's much more focused than the generalized language they've been using.

Senator COLLINS. Mr. Cohen, I'm going to ask you to wrap up your comments.

Mr. COHEN. I will wrap up. OK.

Let me wrap up with what I know is a particular concern of this Subcommittee, and that is consumers. Day traders help consumers. Day-traders' activities drive electronic communication networks, the ECN's. These ECN's provide market transparency. They are real competitors to market makers. The market makers are the group disciplined by the SEC and the Justice Department for collusive pricing, so the result for the small investor, the consumer, is better quote information and better handling of retail size orders.

Day traders add importantly to liquidity and depth in the market without adding to volatility, so the small investor will find another side when he's ready to buy or sell.

Last, day traders limit orders—and day traders put in a large amount of limit orders—compete directly with market makers. The result of that is that dealer spreads are narrowed and the small investor, the proverbial "Aunt Janet in Portland," who is selling stock to pay for her daughter's or her niece's first year in college, is going to get a better price on her trade because there's a day trader in between the market maker's spread.

This is the way the SEC intended it, and this is how it's working.

Thank you very much.

Senator COLLINS. Thank you, Mr. Cohen.

We are going to take a 10-minute recess because, unfortunately, we have another vote on.

[Recess.]

Senator COLLINS. The Subcommittee will come back to order.

Mr. Cohen, I think it's important for the record that I clarify that the SEC has confirmed to us that the reference in Chairman Levitt's testimony to the absence of widespread fraud in the industry was referring to such things as forgeries and other kinds of outright fraud, as opposed to the widespread pattern of deceptive advertising.

Mr. COHEN. Did you also ask him about the isolated instances of margin problems?

Senator COLLINS. I think, Mr. Cohen, that I'm the Chairman and you're not.

Mr. COHEN. OK. I'm sorry. I had the belief we were going to have a discussion of these issues.

Senator COLLINS. I did want to set the record straight in that regard.

Mr. Cohen, in your testimony this morning you cited ETA's statement of ethical principles to support your contention that day-trading firms do not make exaggerated or misleading statements regarding trading results. Indeed, the statement of ethical principles indicates that ETA members "will not make misleading or exaggerated claims about our services or the benefits of day trading, and will provide a balanced perspective in our advertisements and presentations." It goes on to say, "We will not obscure the reality that most people lose money in their initial training period and that many will not ultimately become successful day traders."

I would like to show you two statements that were taken off the Web site of On-Line Investment Services, Inc. It is my understanding that this company is a member of your board of governors. Is my information correct on that?

Mr. COHEN. They're an ETA member. I don't know whether they're a member of the board.

Senator COLLINS. On-Line Investment Services was one of the five members of ETA, it is my understanding, who adopted the statement about the principles from which you quoted in your testimony. Is that correct, to your knowledge?

Mr. COHEN. Yes.

Senator COLLINS. I want to show you this first statement, which says, "We have a successful rate of about 85 percent with customer traders, meaning people who come here and actually make money at this over time."¹

Is that consistent with the ethical principles?

Mr. COHEN. It would be consistent if it's accurate. I don't know whether it's accurate. But the point I would make, because I have no information on it, is that the language on the bottom—and I can just about read it without my glasses—"Cited information is no longer found on Web site."

The statement of principles is a learning curve for all industries. The statement of principles was adopted a couple of months ago. I don't know when this statement was made or when it came off, but it's conceivable that it's as long ago as a year or more.

But the two parts to it, that somebody ought to ask again, is whether or not this is accurate as a statement, and second, when it was on and when it came off and what the circumstances were. But I don't know.

It's important to understand——

Senator COLLINS. Let me understand. Are you saying that this statement is OK if it was before the statement of principles?

Mr. COHEN. I'm saying it's OK if it's correct. I'm saying it shouldn't have been there if it's incorrect, but in any case, it's before the statement of principles.

What I would say is—and this is important to understand—ETA represents something like 54 percent of all day traders who enter a majority of orders. It does not represent all day-trading firms, nor does it have the power of government to say do this or do that. The fact that someone may or may not subscribe to ethical principles

¹ See Exhibit No. 5 on page 219 in the Appendix.

doesn't mean they're going to do it. On the other hand, the ethical principles were formulated and the discussion was formulated over the past few months, as this industry continues to learn and to grow, because it's very important to this industry—and I will now go back to what the Blue Sky people said, that this industry gain community acceptance. So the purpose of us being here is to dispel a number of misconceptions with the hope that we will get a fair hearing, so that a number of these misconceptions, in fact, can be dispelled.

Senator COLLINS. Well, one reason you're being asked to testify today, and were given the opportunity to make your opening statement, was to make sure that the industry's viewpoint was represented.

Mr. COHEN. I'm sorry, Senator. I'm not making it clear, and it's my fault, not yours.

We represent 54 percent of the day traders. I cannot tell you we represent the entire day-trading industry.

Senator COLLINS. I understand that, Mr. Cohen, and that is why we selected examples of deceptive advertising to show you that are from members of your association. We're not asking you about non-members.

Mr. COHEN. Well, I appreciate that. I have seen just one, and what I've said with regard to it first is that I don't know whether it's deceptive because I don't know what the number is, from an accuracy standpoint, and I don't know what the date is and whether it reflects the statement of principles that was adopted 2 to 3 months ago.

Senator COLLINS. My point is that a company should not be making deceptive statements—

Mr. COHEN. If it's deceptive. I agree with you. There is no dispute—

Senator COLLINS [continuing]. Regardless of whether it's before or after the statement of principles.

Mr. COHEN. If it is deceptive, it shouldn't be on there. If it's not—

Senator COLLINS. Let me show you a similar statement, again by On-Line Investment Services, which is a member of your board of directors. I have confirmed that—

Mr. COHEN. Again, can you tell me when these were? Are you talking about 1998?

Senator COLLINS. I believe that these were within the last year. I am uncertain when they were removed.

But that is not my point. My point is that it is troubling if it is misleading consumers at any point.

Can I ask you about this statement: "On-Line's trading and mentoring programs boast an 85 percent success rate for new traders."¹ Do you think that is accurate? Could it possibly be accurate?

Mr. COHEN. Could it possibly be accurate? I don't know whether it is accurate or not accurate. I just wouldn't hazard a guess as to whether it's—

If it is not accurate, it should not be used. I don't think there's any doubt. And I agree with you. Whether you have a statement

¹ See Exhibit No. 5 on page 219 in the Appendix.

of principles or not, you should not use statements that are inaccurate. I just can't tell you whether it's accurate or inaccurate.

Senator COLLINS. You noted in your testimony—you said in a very straightforward way that disclosure of risk is simply not an issue. That's on page 6 of your testimony.

Mr. COHEN. That's right.

Senator COLLINS. The problem with that is the preliminary results of the joint examinations, the results announced by the SEC and NASD today, suggest otherwise. We have written testimony from Chairman Levitt saying that the SEC staff examined the Web sites of 40 day-trading firms and discovered that half of those Web sites today—I'm not talking about last year—had little or no risk disclosure, and many of them downplayed the risk associated with day trading.

Do the SEC's preliminary findings that you've heard today change in any way your view that the disclosure of risk is not a problem with this industry?

Mr. COHEN. I don't believe disclosure of risk is a problem, and I'll tell you why.

First, ETA members, although we're 54 percent of the industry, six firms, I don't know what the other 34 firms are doing. But beyond that—and this is the important point, and I don't seem to be able to get it across—no matter what the risk disclosure was, you could put it in neon lights, when you show up at a day-trading firm, if you're there a day, 2 days, 3 days, you will know every risk. You don't have to have it spelled out.

I'm not suggesting there shouldn't be risk disclosure, or that people shouldn't sign off on it. What I'm saying is that common sense will tell you that if you spend 24 hours in day-trading firms, you're going to know what's going on. This is very different from where people are in the rest of the brokerage business. Because in the rest of the brokerage business, you're isolated. You are one customer with one broker, or one customer with an on-line firm, and you don't know what's going on. You don't know what the risks are.

But here you're present and viscerally you know what the risks are. You cannot miss the risks if the guy next to you is losing a lot of money. You will know what's happening, or someone else will.

Senator COLLINS. Do you support the NASD's appropriateness rule?

Mr. COHEN. I have gone through that before. I think the difficulty with it is that the Securities Industry Association has pointed out—and it's important to understand, that day trading, as a group, is just a small part of the securities industry, that there has never been a test like that in general, that all tests have dealt with specific securities. That was the testimony, the recommendation as to specific securities.

ETA would like to have some form of appropriateness test. It doesn't think the model that's been given is a good one. The model we're suggesting that people look at is the option rule, 2860, the NASD option rule, which says that first you give people risk disclosure, they sign off on the risk disclosure, and then they sign up for particular strategies. Because what day trading is, just like option

trading, it is a series of strategies. All risky, some riskier than others.

Senator COLLINS. I don't see what you could object to in the appropriateness rule. All it is doing is requiring a day-trading firm to sit down with the customer, to get basic financial information, to look at whether or not day trading might be an appropriate strategy for this individual, to look at their investment goals.

What's wrong with that? Wouldn't that screen out some of the people——

Mr. COHEN. Senator, I——

Senator COLLINS [continuing]. Who should not be engaging in this practice?

Mr. COHEN. Senator, what I heard——

Senator COLLINS. Mr. Cohen, I would appreciate you letting me finish my question.

Mr. COHEN. I'm sorry. I thought you had. I apologize.

Senator COLLINS. My point is, what is wrong with having an up-front screen that would screen out some people for whom day trading is clearly inappropriate because of their financial status?

Mr. COHEN. May I answer now?

Senator COLLINS. I would appreciate your answer.

Mr. COHEN. I was one of those who watched Chairman Greenspan's testimony on the long-term capital management disaster. He made a number of points, one of which was regulation for the sake of regulation really doesn't do much good.

An appropriateness test, in general, is not going to do much good if it's blurry and is completely generalized, which is why we have suggested focusing on an options test. What I will tell you is that these things can have an unfortunate effect, what is known as regulatory "creep," which is that when you start off with regulations that are blurry to begin with—if you look at the NASDR's regulation, for example, they say we don't define the word "promote." We're not saying who promotes day trading. That's very important. They don't define it. They say we're not going to define it. Leave it open.

Well, I think it's a lot less of concern to on-site day-trading firms than it is to on-line firms, who I think are in an impossible position, because one of the tests the NASDR has in its suitability proposal is that you are promoting day trading, even if you do not advertise. I think I indicated before from the Discover ad, where the advertising is, that even if you don't advertise, if you have any day traders. Well, there are on-line firms with a million and a half customers. If one percent of them, one percent, are day trading, doing two or three trades a day, that's triple the amount of day traders in the day-trading industry.

So this is a much broader and wider question, which is why the Securities Industry Association is opposed to this. What we have tried to do is look at it constructively and say let's get something that can work. We think the options model is the one that works.

It's a little hard, frankly, to be criticized—I'm not suggesting you're criticizing—but to ask pointed questions when we're saying look at something more focused than more general with regard to this.

Senator COLLINS. Let me turn to another practice that troubles me. Many day-trading firms have customer lending programs and they, in fact, promote and arrange loans from 1 day trader and customer to another.

Isn't the result of that practice to encourage people who are losing money to keep on trading?

Mr. COHEN. Senator, you may have been out for a vote when I answered that before, with regard to Senator Levin. He had used a very good example of somebody who made money, and I pointed out to him that yes, in fact, there are perfectly good reasons why one would lend money to someone else.

First of all, this loan was no risk. These are closed transactions. They're not open transactions. So the risks are known.

The practice of lending money from account to account has gone on as long as the securities industry has gone on. It is noted. There's a New York Stock Exchange rule, 431(f)(4) that deals with it. There are letters of authorization forms that have existed since I've been in practice. So there is nothing special about it.

One of the problems that this Subcommittee seems to be having is building on an edifice that I don't think is there, on a base that's there. You're focusing and trying to turn this part of the securities industry into something separate from the rest of the industry. But every regulation you write has an impact on the rest of the industry, and that's why you get opposition from the Securities Industry Association.

Senator COLLINS. I think the problem the Subcommittee is having is that we're very concerned when we hear from State regulators, from the SRO, from the SEC, that day trading is a real problem and that we do need effective new regulations in order to ensure that small, unsophisticated investors realize what they're getting into, realize how highly risky this practice is, and realize, in fact, that they are likely to lose their money.

Mr. COHEN. I'm sorry. If I may just finish---

Senator COLLINS. You may respond.

Mr. COHEN. I'm in agreement with you up to the last five words, and that is, yes, it's risky, they should have these disclosures made, there are disclosures. I don't think there's a certainty that people will lose money in on-site day trading.

But hopefully, when the study, the real study is done and it's over, there will be a much better feel of statistics to argue about than we have now.

Senator COLLINS. Senator Levin.

Senator LEVIN. One of the day traders that we're familiar with says the following in their literature, the material that they hand out. "Prior experience in trading is not essential to be successful in this business, although it is important to understand that all forms of investing involve risk in the loss of capital. An investors lack of familiarity with securities trading can even be a strong asset, not a liability."

Do you agree with that?

Mr. COHEN. Yes.

Do you want an explanation?

Senator LEVIN. If you want, sure.

Mr. COHEN. Mr. Levitt and I, I guess, share one thing, which is age. We were around in the Sixties when there were “gunslingers,” people who traded the market successfully because they hadn’t learned any of the lessons of the past, because each market is different and each thing changes. So not having previous experience can be an advantage because you’re starting fresh.

I have gone to day-trading firms. I have sat down with the people. They are more or less uniform, the ones I have seen. They are young, they are computer types, people who have grown up with video games, and they sit there in half-darkened rooms, like a movie theater, looking at screens—it’s not something I could do for 10 minutes, and they can do it endlessly, looking at it. And up until the end of the day, they count it as counting points.

Now, whether or not that is a comfortable style of investing for people of my age, I can’t tell you. But that’s where the world is. It’s taking advantage of the information edge that is provided by this technology in the same way that people took advantage of the information edge of Mr. Edison’s stock ticker 110 years ago.

Senator COLLINS. Senator Levin, would you allow me to intervene on just one point on that, because I think you’ve raised a very interesting point, and Mr. Cohen’s response is interesting to me.

The NASD has proposed as part of the risk disclosure statement that potential clients of day-trading firms receive a statement saying that day trading requires knowledge of securities markets. So would you oppose that statement being included?

Mr. COHEN. By the time you start day trading, you will have knowledge of the securities markets. I don’t think we’re talking about—

Let’s see what we’re talking about. I don’t think Ms. Schapiro is going to say we expect you to have taken courses in finance or have an MBA, and no one is going to start day trading in an on-site firm, day one, without any knowledge of how the business works. So I don’t think that’s a problem for anyone in terms of how the markets work.

Does it mean you could get a job at Goldman Sachs as an analyst or a technical analyst somewhere? No. But I don’t think that’s anybody’s test.

Senator COLLINS. Senator Levin.

Senator LEVIN. Do you think these day traders are investors?

Mr. COHEN. No.

Senator LEVIN. Pardon?

Mr. COHEN. No. It’s an approach to the market to make money. Some are going to be successful and some won’t.

Senator LEVIN. Then you don’t agree with the part of the statement I read, which says an “investor’s” lack of familiarity—

Mr. COHEN. Senator, the trouble is, when somebody writes articles, you can only use so many words for the same thing. An investor is one of these—

Senator LEVIN. This isn’t an article. This is the day trader’s literature.

Mr. COHEN. “Investor” is a word that is used commonly for anybody who trades in the market. It’s an old—

Senator LEVIN. You would agree they’re not investors?

Mr. COHEN. They're not investors. These are people who are traders.

Senator LEVIN. Are you telling your members not to describe themselves as investors?

Mr. COHEN. I'm sorry?

Senator LEVIN. Are you telling your members not to describe these folks as investors?

Mr. COHEN. If I'm asked, I'll tell them to try to find better phrasing. Traders would be better.

Senator LEVIN. You're telling your members a number of things, though, aren't you?

Mr. COHEN. When I'm asked. I should point out——

Senator LEVIN. Aren't you asking them to get risk disclosure statements signed?

Mr. COHEN. Let me answer it in two ways, OK?

First, I have been counsel to ETA only since August, although my views and theirs are the same broad identification. Second, I don't see a reason why you wouldn't have them sign risk disclosure statements.

Senator LEVIN. You are asking them to do that?

Mr. COHEN. The ETA is asking them.

Senator LEVIN. Your client.

Mr. COHEN. ETA, as my client, is asking its members to have day traders sign risk disclosure forms.

Senator LEVIN. So when I say "you," I mean you or your client.

Mr. COHEN. The client. I don't see anything wrong with it, so if you want me to identify with it, I will.

Senator LEVIN. Good. Your client then is asking its members to sign this risk disclosure statement, which is Appendix C in your materials. Is that correct?

Mr. COHEN. Yes.

Senator LEVIN. But your client is not asking people to avoid the use of the word "investor"?

Mr. COHEN. Senator, what we will do is, when the NASDR approves its appropriateness rule, which I assume is going to happen, we will send this to NASDR advertising for review and ask them to sign off on it. I don't think they're going to have a problem with the word "investor," but if that's a problem for anyone, it will be changed to "trader."

Senator LEVIN. Relative to that disclosure statement, Appendix C, is this something which is required for signature by your members of their customers, or is this just something which is recommended to——

Mr. COHEN. It's a trade association recommendation. We don't have the power to enforce it.

Senator LEVIN. You have the power to do anything you want and say "you're not going to be a member of this association unless you follow our rules." You can do that, can't you?

Mr. COHEN. Pardon?

Senator LEVIN. Any association can say its members have got to live up to the rules.

Mr. COHEN. Trade associations—and I was at various times associated with membership of the Securities Industry Association—basically provide recommendations to their members, and beyond

that, as long as the member is in good standing, the member stays in good standing. So that is a wonderful example, and perhaps you ought to apply it to a group that represents hundreds of brokers rather than six.

Senator LEVIN. My question, though, is this, that you can make the adoption of this risk disclosure statement a condition of membership of the association.

Mr. COHEN. I assume we could if somebody thought that was crucial to life, yes.

Senator LEVIN. All right. Do you know how many of your members in fact require their customers to——

Mr. COHEN. I don't.

Senator LEVIN. Do you care?

Mr. COHEN. Do I care? Yes. I would certainly like to know later on.

Senator LEVIN. Could you find out for us?

Mr. COHEN. Oh, absolutely.

Senator LEVIN. How many members do you have again?

Mr. COHEN. We have 6—we have 40-something members, but 6 are——

Senator LEVIN. I'm sorry. Forty?

Mr. COHEN. Forty-something firms. Six are on-site trading firms. Those on-site trading firms represent 54 percent of all traders, day traders, so far as we know.

Senator LEVIN. So——

Mr. COHEN. It is, again, our estimates.

Senator LEVIN. I understand. Your estimate is that you represent a majority of the day traders.

Mr. COHEN. Right, and a majority of the day-trading orders being placed.

Senator LEVIN. I would like to ask you about the informal survey that you referred to on page 11 of your testimony.

Mr. COHEN. Right.

Senator LEVIN. You have surveyed certain of its members to obtain a rough estimate of customer profitability.

Mr. COHEN. Right.

Senator LEVIN. Then you said these estimates were that after an initial period of 3 to 5 months of losses, 60 to 65 percent netted in the range of \$28,000 per month, but the balance of customers losing \$6,000 to \$8,000 per month.

What was the capital investment that that represents?

Mr. COHEN. I'm sorry. I don't understand the question.

Senator LEVIN. Well, how much of \$28,000 is what percentage of their investment that they have put down in the firm of their capital?

Mr. COHEN. Anywhere between, I would say, 28 and 56 percent.

Senator LEVIN. Of their what?

Mr. COHEN. Twenty-eight and 56 percent.

Senator LEVIN. Of their capital?

Mr. COHEN. Of their capital. I am talking \$28,000 a month, 300 percent a year, current, if you make that kind of money, on \$100,000.

Senator LEVIN. Let me say that the—let's talk about that initial period of 3 to 5 months of losses. Let's just focus on that. What was the average loss in that 3 to 5—

Mr. COHEN. I didn't—and I apologize for this. I didn't take it down to a number, but the understanding I had when I was finished was that it was not a significant number. It was a loss number, but it wasn't a wipe-out loss number. It was a loss number.

Senator LEVIN. Can you provide that to the Subcommittee?

Mr. COHEN. From our six firms? Yes.

Senator LEVIN. Well, whoever you did this informal survey of.

Mr. COHEN. Yes, absolutely.

Senator LEVIN. I mean, you have told us—

Mr. COHEN. Senator, yes.

Senator LEVIN. Were you asked for this information by Massachusetts or by the NASAA?

Mr. COHEN. I don't—I really have nothing to do with Massachusetts. I'm not sure. You are talking about ETA being asked by Massachusetts?

Senator LEVIN. Yes.

Mr. COHEN. The Massachusetts thing is fascinating in itself.

Senator LEVIN. Without getting into that, we had testimony this morning that you were specifically asked for the backup information here.

Mr. COHEN. And we were willing—not with regard to—we are talking apples and oranges.

Senator LEVIN. Relative to this survey of yours.

Mr. COHEN. Let me see if we can define it, OK? Massachusetts is talking about some comments that the *Los Angeles Times* ran in an article in January in which—and then there was correspondence back and forth, and I was not the counsel involved in it, between Massachusetts acting, I guess, for ETA, acting for the Blue Sky people from NASAA and ETA.

That correspondence is apparently subject to two interpretations. I think the Subcommittee ought to look at the correspondence. My understanding of it is that the—and that is what is reflected in the written submission—is that ETA offered to submit current information to NASAA with the methodology, which I have actually seen the methodology, we can supply it, and NASAA said no. And I think Mr. Shellenberger told you why he said no, because they did not want to endorse, as he put it, what the results would be.

So the second survey that we are talking about is one that is at a later point, that I participated in, in this past summer—and I don't recall. I think it was in August—in which I spoke to a number of the firms and got those responses.

Senator LEVIN. I am referring to the informal survey. Were you asked by them for any information relative to that informal survey that you refer to page 11?

Mr. COHEN. ETA—I should look at the statement because I think we are talking about different things.

Senator LEVIN. That is what I want to find out. Are you saying to us that that informal survey that you have taken, that you refer to on page 11, is not the subject of any request by the—

Mr. COHEN. It says there are—it is actually clearly written as I look at it: Earlier this year ETA informally surveyed certain of its

members to obtain a rough estimate of customer profitability. Its members considered these numbers still to be representative in August. My understanding was that earlier this year, membership—one or two of the members had been asked about it—these were their numbers. For the purpose of dealing with this as an issue, there was a—as part of a phone conference, the subject came up, what are the numbers, can I get a feel for the numbers. I raised the question. These are the responses I got from the particular people. So I am comfortable that is what I was told, and these are estimates. And the only way anybody is ever going to get comfortable with this is to do what ETA now proposes to do, and that is to get KPMG or someone else to do a study.

Senator LEVIN. But I want to go back to my question.

Mr. COHEN. OK. Senator, I am told the information has been supplied both to the Subcommittee and to the Texas regulator that asked the questions. That's what counsel for——

Senator LEVIN. All right. That answers it. My time is up for this round.

Mr. COHEN. All right. Sorry.

Senator LEVIN. Thank you.

Mr. COHEN. Is that what these lights mean?

Senator COLLINS. I apologize for not giving you an explanation, and I assumed the staff had done so.

Mr. COHEN. I thought I was almost boiled.

Senator COLLINS. I have another commitment that I have to keep. I have asked Senator Levin to proceed with the hearing because there are a number of additional areas that we are both eager to pursue with you, Mr. Cohen. So I am going to turn over the Chairman's gavel to Senator Levin with my thanks.

I do want to take this opportunity to thank our staffs for their very hard work on this hearing and to let people know that the Subcommittee's interest, if anything, has only been strengthened by the overview hearing today. We will be continuing in an ongoing investigation to look at the specific practices of selected day-trading firms to gain a better understanding of this day-trading phenomenon.

So, with that, I would thank Senator Levin for his willingness to continue the hearing in my absence.

Senator LEVIN [presiding]. Thank you, Madam Chairman.

I want to go back to page 11 to understand what it is you are telling the Subcommittee. What is the average amount of capital that was put up at risk that this net of \$26,000 is based on? Is that the capital investment of \$100,000, 60 to 65 percent, in the range of \$28,000 a month? Give us an update.

Mr. COHEN. The \$28,000 is a P&L number. Capital is a balance sheet number. I mean, they are different things.

Senator LEVIN. Right.

Mr. COHEN. My understanding of capital is that—and this is based simply on my understanding, having worked with day traders over a period of months, is that capital runs from \$50,000 to \$100,000.

Senator LEVIN. So you are saying that this informal survey demonstrated that after an initial period of 3 to 5 months of losses that

65 percent profited, in the range of \$28,000 per month based on an average capital investment of perhaps \$50,000 or \$100,000.

Mr. COHEN. Yes.

Senator LEVIN. You are going to supply us the data to support that estimate?

Mr. COHEN. I understand data regarding those estimates have been supplied to the Subcommittee, but if they have not, I will find out from counsel who is doing it.

Senator LEVIN. Now——

Mr. COHEN. I would also think it would be useful to wait for the KPMG study.

Senator LEVIN. That may or may not be useful, but the basis of this representation would be very useful to me.

Mr. COHEN. The representation——

Senator LEVIN. People who have \$50,000 or \$100,000 at risk and are making \$300,000 a year profit, that is an absolutely incredible representation that you are making.

Mr. COHEN. Here is what we wrote. In August, ETA's executive committee members considered these numbers still to be representative. Please note that these are only estimates. Unlike the NASAA report, they do not purport to be scientific. No one is purporting or representing these are scientific. This was the feel of the people who are running these firms that these were the numbers.

Senator LEVIN. You are representing to this——

Mr. COHEN. Absolutely. I am representing that I was informed by the——

Senator LEVIN. Well, let me finish my statement now.

You are representing to this Subcommittee that the estimates, the estimates of certain of your members to get an estimate of customer profitability demonstrates that after an initial period of 3 to 5 months of losses, 60 to 65 percent of those day traders netted in the range of 28,000 per month which is over \$300,000 a year, based on a capital investment of \$50,000 to \$100,000. Now, that is what you are representing.

Mr. COHEN. Absolutely. And let me say further that the capital issue really is not important because it——

Senator LEVIN. It may not be to you.

Mr. COHEN. If the average trade is 700 shares and the average NASDAQ stock is \$27.15, according to the SIA statistics, you are talking about an average trade of \$20,000 that somebody holds for 4 minutes.

Senator LEVIN. I understand.

Mr. COHEN. OK.

Senator LEVIN. I am only talking about a return on how much money you are putting at risk. That is what I am talking about.

Mr. COHEN. Well, we have not done it as a return on capital, but we have put it as P&L numbers, the way it was written here.

Senator LEVIN. I understand.

I will tell you again, I find that estimate incredible, and I would like to see the data that supports it, and I think it is the kind of touting——

Mr. COHEN. Well, it will either be or it will not be.

Senator LEVIN. I think it is.

Mr. COHEN. Well, let's wait for the numbers.

Senator LEVIN. Yes. But I think it is the kind of touting—I am stating my opinion. I am giving you my estimate now. You are telling the world——

Mr. COHEN. Well, as a lawyer, when I speak to clients——

Senator LEVIN. Well, now, let me finish. Keep \$50,000 here or \$100,000 at risk. Play with it for a year. You will make \$300,000—no. Two-thirds of you will make \$300,000.

Mr. COHEN. I don't——

Senator LEVIN. That is what you are saying the estimate of your members are.

Mr. COHEN. I think that is what you are saying it says.

Senator LEVIN. No, that is what you said.

Mr. COHEN. Can I use my own words?

Senator LEVIN. Now it is your turn.

Mr. COHEN. Thank you very much.

What this says is that there is a period of time in which people will lose money. It is part of the normal learning curve, and that after that period, people will make money, and two out of three will average something like \$28,000 net a month. That is based on discussions I have had with people running on-site firms, and I have no reason to believe that since they are there every day and more or less have a feel for it that those are not correct estimates, but we do not represent they are scientific and it says here they are not scientific, which is why we are going out to get KPMG to get these numbers.

Senator LEVIN. You are also representing that they consider these numbers to be representative?

Mr. COHEN. Yes.

Senator LEVIN. That is a tout.

Mr. COHEN. It is a tout—if it is inaccurate, I am saying what it says here.

Senator LEVIN. OK.

Mr. COHEN. We consider them to be representative. We spoke to our people. They believe they are representative.

This is a document produced for this Subcommittee.

Senator LEVIN. It still ought to be accurate.

Mr. COHEN. It is accurate, so far as I know, and I would think you would want us to give you the broadest possible read we can, which is what we tried to do.

Senator LEVIN. Yes.

Mr. COHEN. Apparently, Senator, you have less problems with the NASAA report written by this guy out of his apartment.

Senator LEVIN. Yes. I have a lot of problems with this report here because I do not believe you can put \$50,000 to \$100,000 at risk and then over a period of a year, two-thirds of the people who do that get back a return of over \$300,000. I do not believe it.

Mr. COHEN. Senator——

Senator LEVIN. OK? I just do not believe it.

Mr. COHEN. Well, that is fair. You——

Senator LEVIN. You apparently do believe it.

Mr. COHEN. You certainly——

Senator LEVIN. Do you believe it?

Mr. COHEN. I believe it. I certainly feel you are free not to believe it, but you also might ask yourself the question why haven't there

been any complaints. Why if in fact something like 70 percent of people lose money in 6-month periods which mean 20,000 over 3 years, NASAA, this Subcommittee, the SEC, and the NASD have not been inundated with complaints by losing day traders?

Senator LEVIN. I think maybe people want to gamble.

Mr. COHEN. Well——

Senator LEVIN. If people want to gamble, you say they ought to be free to do so.

Mr. COHEN. The American—I haven't said that at all. What we have said is this is not gambling, that the people who trade in this market—Senator, I do not know what your previous profession was. You are good at it. I assume you were a lawyer. But this is not gambling.

Senator LEVIN. See, you made another assumption here. That I was good at it. [Laughter.]

Mr. COHEN. I have often been criticized for criticizing people, but to be criticized for praising somebody is a little different, but it is Washington and I am not used to it.

I do not know if you were here when we talked about it, but the opening of my statement, I said that day traders do not regard this as gambling. That is a quote that is in the newspapers. That is something you can find. The people who do it do not think they are gambling. They think they are using informational edges in order to trade successfully.

Senator LEVIN. I would like to go to another statement of yours on page 17 of your testimony, where you say day trading is not gambling.

Mr. COHEN. Yes.

Senator LEVIN. You say the majority of those who day-trade after training do not lose money.

Mr. COHEN. Yes.

Senator LEVIN. What is that based on?

Mr. COHEN. That is based on the same survey.

Senator LEVIN. This same unscientific survey?

Mr. COHEN. This same unscientific survey.

Senator LEVIN. I do not see all of those qualifiers next to your statement here.

Mr. COHEN. Senator, I kind of feel that when people read the document, they read it as a whole, but that may well be a failing, and I will footnote things in the future.

Senator LEVIN. No, I think——

Mr. COHEN. When I write *Law Review* articles, I put footnotes after every sentence, so——

Senator LEVIN. That is the kind of unqualified statement which people believe.

Mr. COHEN. Well, if they don't read the whole thing.

Senator LEVIN. Most people do not read 25 pages of testimony. They will look at one flat-out statement. The majority of those who day-trade after training do not lose money. That is what they hear.

Mr. COHEN. I was here this morning sitting in the audience when somebody quoted something out of context that I said in an article that I wrote. So I know people on this Subcommittee certainly don't read entire articles.

Senator LEVIN. Well, are you saying that that is out of context, what I just read?

Mr. COHEN. What I am saying is that my article was out of context as it was quoted, and what this says, if you refer back to part of the summary—it is part of the summary, which I think fairly said means if it is part of a summary, you go back to the full text where it is referred to.

Senator LEVIN. OK. You are going to let the Subcommittee know what percentage of your members require your Exhibit C to be signed by their members. Is that something you are going to give us?

Mr. COHEN. Yes, sir.

Senator LEVIN. If you have not already given us the material that supports this unscientific survey of yours, you are going to let us have the background material for your conclusion about netting \$28,000, two-thirds of the people per month.

You also indicated that you would supply to the Subcommittee what were the losses during the 3-to-5-month period.

Mr. COHEN. I don't recall you asking that, but if it is part of the same stuff, it is all the same material. So it should be——

Senator LEVIN. Would you do that——

Mr. COHEN. Yes.

Senator LEVIN [continuing]. If I did not ask for it? I will ask for it now.

One other question. You said that after training, you indicate that the majority of those who day-trade based on that informal survey are now saying that they do not lose money. Does that training include the 3 to 5 months of losses?

Mr. COHEN. Yes.

Senator LEVIN. You consider that part of training?

Mr. COHEN. Yes. That is part of the learning process. I could have used a different phrase. I apologize for the phrasing. It could have been after the learning process, but everybody is always learning.

Senator LEVIN. You also have training before the 3 to 5 months begins, don't you?

Mr. COHEN. Senator, let me answer it this way. A lot of people who come into day trading have traded previously. There was a *New York Times* article that said professionals are coming to the business. So they presumably start trading day one with a vast amount of skill and experience. If we are talking about people who have not traded before, what we are talking about in their case is this 3-to-5-month period, which includes training and actual trading.

Senator LEVIN. I guess my question is: You do training prior to the actual trading? Does some of the training that you are referring to take place before the actual——

Mr. COHEN. I believe firms train people who have not been in the market before, that they have training programs. They certainly have training programs. I cannot tell you whether every on-site firm has got one.

Senator LEVIN. If in fact your survey is accurate that most people lose money in the first 3 to 5 months, assuming you are accurate

on that, would you be willing to have your risk disclosure statement notify people that most people lose money for 3 to 5 months?

Mr. COHEN. I think it says it now, but I haven't gone back over it.

Senator LEVIN. No. I do not think it says quite that. It says you can lose money. I am asking—

Mr. COHEN. I thought it says—well, I apologize. I am not able to find it, but I do not have a problem if that is your question that people lose money in the first 3 to 5 months.

Senator LEVIN. That most people.

Mr. COHEN. That most people.

Senator LEVIN. You do not have any problem in modifying your statement?

Mr. COHEN. I don't see a reason not to.

Senator LEVIN. Good.

Mr. COHEN. By the way, that, of course, goes well beyond the risk disclosure of the NASDR, but we are well beyond where the NASDR is.

Senator LEVIN. I think that would support that claim if you did that.

We want to thank you and the other witnesses for appearing today. The hearing will be recessed. We will now adjourn this hearing because it is the first of a series of hearings.

Again, I want to thank our Chairman for her leadership here. We are getting into an area which I think all of us would acknowledge as an extremely important area to consumers, and I think you also would acknowledge that, Mr. Cohen, even though there is obviously a difference here that this is a very important area to consumers. I think that on that, you would not disagree.

Mr. COHEN. What I would say—thank you for the opportunity at least to comment on it. The consumers I would be concerned about are the online as opposed to the on-site people, and what I would say is it depends where you look in the telescope. What I am looking at the telescope is the on-site day traders are providing enormous benefits to consumers, the average guy throughout the market.

Senator LEVIN. I thank all of our witnesses for coming forward.

One other question, just for you and the other witnesses, if we still have them here. If we have additional questions for the record, whether you would be willing to answer those questions?

Mr. COHEN. Of course.¹

Senator LEVIN. I do not know if our other witnesses are all here.

Mr. HILDRETH. Yes.

Senator LEVIN. Thank you all.

Mr. COHEN. Thank you.

Senator LEVIN. We will stand adjourned.

[Whereupon, at 1:10 p.m., the Subcommittee was adjourned.]

¹ See Exhibit No. 9 on page 228 in the Appendix.

APPENDIX

Testimony of Arthur Levitt

Chairman

United States Securities and Exchange Commission

Concerning Day Trading

Permanent Subcommittee on Investigations

Committee on Governmental Affairs

United States Senate

Washington, D.C. – September 16, 1999

Chairman Collins, Ranking Member Levin, and Members of the Subcommittee:

I appreciate the opportunity to appear before this subcommittee today to discuss the recent developments in day trading and the concerns raised by day trading, and the current initiatives to address these concerns. The Securities and Exchange Commission (“Commission”) has been actively monitoring this novel trading strategy and I commend the Chairman, the Ranking Member, and Members of the Subcommittee for holding these timely hearings.

I. Introduction

Technology developments, in recent years, have had a fundamental impact on securities markets. New systems and the explosive growth of the Internet have provided millions of Americans with unprecedented access to these markets and introduced many new investors to the benefits of investing. Technology and the Internet are valuable tools for investors, who can now monitor, manage, and trade their own portfolios. Investors have access to a wealth of information, which enables them to make their own investment decisions. These developments

have also had a great impact on the securities markets by increasing market liquidity and transparency.

Technological advances have also fostered the development of a new kind of broker-dealer. These firms promote day trading, which discards many established investing principles, such as choosing securities to buy and sell based upon company fundamentals and performance. This new trading phenomenon, while well-publicized, is relatively limited in its reach, with the number of day traders estimated to be less than 7,000. By comparison, there are close to 80 million individuals that own stock and more than 5 million investors using the Internet for brokerage services. The Commission also does not believe that day trading currently presents systemic problems for our markets.

Nevertheless, the Commission is well aware of the potential for individuals to be seduced by promises of easy profits by day trading without fully understanding the risks. Investors should understand that day trading involves significant risk of loss, and that they should not trade with funds they cannot afford to lose. Accordingly, in pursuit of the Commission's mission to ensure fair and orderly markets, and to protect investors, our regulatory, examination, and enforcement staff are looking closely at the activities of firms that promote day-trading activities. The Commission achieves its mission through the application and enforcement of a regulatory scheme based largely on full and fair disclosure. Further, the Commission's investor education efforts reinforce the most important message about day trading – that it is very risky. We are diligently pursuing those firms that do not fully comply with the securities laws. Ultimately, however, if full disclosure is made, the securities laws do not prohibit day trading.

This testimony is designed to inform the Subcommittee about the differences between day trading and other types of electronic, or on-line trading, the Commission's principal

concerns about day-trading activities, and some initiatives taken by the Commission, the self-regulatory organizations (“SROs”) and the industry to address these concerns.

II. What is Day Trading?

The practice of marketing day trading on a retail basis appears to have started about three years ago when advances in computer software allowed individuals to have direct links to the securities markets in a way previously available only to registered professionals. Because the level of individual trading activity varies across a wide spectrum, it is difficult to clearly define “day trading” or “day trader.” On one end of the spectrum lie investors who trade occasionally — sometimes on-line — and hold their investments for the longer term. Moving along the spectrum, an increasing number of individuals use their on-line accounts both to invest longer term and to trade short term on momentum or small changes in the price of a stock. On the far end of the spectrum are so-called “day traders,” who exclusively buy and sell stock rapidly throughout the day trying to make money on short-term market moves.

A fundamental distinction between a day trader and a more traditional retail investor who manages investments on-line is the kind of broker-dealer through which he or she trades. The typical broker-dealer the Commission identifies as a day-trading firm advertises the day-trading services it offers along with the benefits of day trading, and solicits individuals to become full-time day traders. Most day-trading firms also teach individuals to engage in strategies based on rapid-fire buying and selling of price-sensitive stocks and then encourage these individuals to use this strategy on an ongoing basis. For a fee, some firms —or their affiliates — provide training on how to make money trading on small price movements. Day-trading firms also frequently provide their traders with proprietary software and systems that analyze and chart activity in particular stocks. Typically, day-trading firms offer these services at on-site trading facilities,

rather than through Internet web sites. On-line firms, by contrast, merely offer an electronic order entry service to their customers and do not encourage the use of any particular trading strategy.

A second distinction between traditional brokerage and day-trading firms is that day-trading firms provide individuals with “real time” links to the major stock markets and the Nasdaq. These linkages give individuals substantial market information not readily available to the average retail investor and provide direct entry to the firms’ order processing systems. This direct access to market-operated order execution systems allows these individuals to send their orders to a particular market or market maker. Through these systems, day traders can receive a trade execution within seconds.

While on-line and traditional retail brokerage firms often provide real-time quotation information, they do not provide the linkages that day-trading firms do to markets and market makers that allow individuals to make their own order routing decisions.¹ Instead, traditional and on-line firms’ systems have pre-set algorithms that determine where a customer’s order is routed for execution.

Although broker-dealers are not required to identify themselves as “day-trading firms,” 62 broker-dealers, with 287 branch offices, were recently characterized as day-trading firms by the North American Securities Administrators Association (“NASAA”).² The Commission

¹ A few on-line firms are beginning to offer their customers services that allow those customers to make their own order routing decisions. However, these services are not promoted as tools for day trading.

² See NASAA, Day Trading Project Group Report, August 9, 1999.

estimates that the number of day-trading firms, in fact, exceeds 100, and believes that there are approximately 5,800-6,800 persons trading full time through day-trading firms.³

III. Organization of Day-Trading Firms

Day-trading firms are typically organized in one of two ways. Most day-trading firms -- like most other broker-dealers -- have customers who open accounts with the firm and use the assets in their own accounts to trade. These day-trading firms are registered with the Commission and are members of the National Association of Securities Dealers ("NASD"). As such, they are subject to all Commission and NASD rules.

Other day-trading firms choose to organize as entities such as limited liability companies ("LLCs"), which sell interests in the firm to individuals wishing to day trade. These firms are registered as broker-dealers, but because individuals who day trade at these firms are part owners of the day-trading firms, they are not considered "customers." Instead, these individuals are "associated persons" of the firm. The day-trading firm allows these individuals to trade using a portion of the firm's capital often an amount tied to the amount of each individual's capital contribution.

There are several implications of day traders being part owners of the firm, rather than customers. First, although the firms are registered as broker-dealers with the Commission, day-trading firms organized as LLCs can avoid becoming NASD members, and are therefore not subject to NASD rules. Rule 15b9-1 under the Securities Exchange Act of 1934 ("Exchange

³ The Electronic Traders Association ("ETA") -- a national association that represents order entry and other related firms -- estimates that there are 4,000 to 5,000 day traders. The ETA's estimate, however, does not include individuals associated with limited liability companies affiliated with the Philadelphia Stock Exchange ("Phlx"). The Phlx

Act”)⁴ exempts a broker-dealer from the requirement of being a NASD member if the broker-dealer does not have customer accounts and is a member of a national securities exchange. Although this exemption was intended primarily for exchange specialists, a number of day-trading firms are organized as LLCs and are using this exemption as a means to maintain membership only in the Phlx. About 12 to 15 day-trading firms are currently members only of the Phlx. Second, as discussed further below, day traders who trade a firm’s capital can lawfully use leverage significantly beyond the levels permitted by the customer margin requirements promulgated by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and the SROs.

IV. Risks and Concerns Raised by Day Trading

Investing in securities always involves some degree of risk. The critical issue is whether the investor fully understands the level of risk he or she is assuming. While technology provides innumerable benefits to investors by making trading easier and faster, new and relatively inexperienced investors may be using this technology to trade in ways that do not match their goals and risk tolerance. The Commission believes that the riskiness of day-trading strategies must not be hidden. While individuals should be allowed to make their own investing and trading decisions, they need a clear and complete understanding of what the risks are so that they can make an *informed* decision.

The Commission’s mission is to preserve market integrity by promoting fair, orderly, and transparent markets, and to protect investors. An essential component of market integrity is

represents that there are approximately 1,800 day traders associated with Phlx member day-trading firms.

⁴ 17 CFR 240.15b9-1.

investor confidence. Investors lose confidence when misleading information and exaggerated claims are allowed to go unchecked. Accordingly, the Commission supports efforts to ensure that day traders completely understand the risk implications of their trading decisions, and understand that a day-trading strategy carries high costs. Day traders invariably generate hefty commissions and often pay fees for computer and other electronic services. Consequently, they need to make significant profits simply to cover the costs of their trades. If day traders are adequately apprised of the risks of their day-trading strategy, the Commission believes that individual day traders bear responsibility to make sure that they do not trade with funds they cannot afford to lose.

The Commission staff is currently undertaking examinations of more than 40 day-trading firms.⁵ Day-trading firms are registered broker-dealers and, as such, must comply with a panoply of Commission and SRO rules. These firms and their principals can be held liable for violations of the securities laws. Our examinations preliminarily indicate that some day-trading firms are not in compliance with applicable rules and regulations. To date, however, we have not found marked and widespread fraud by these firms. Nonetheless, we have concerns that some day-trading firms may not maintain adequate books and records, or comply with the broker-dealer capital rule, the short sale rule, or margin requirements. These rules are important, and the Commission will vigorously pursue any firms that violate them.

We discuss in greater detail below the Commission's areas of concerns about day-trading firms' operations and the current initiatives to address these concerns.

⁵ The NASD has also inspected over 20 day-trading firms.

1. Disclosure and Advertising Practices

The Commission has concerns about the disclosure and advertising practices of broker-dealers that promote day trading and provide facilities for day traders. We also have concerns about some web sites sponsored by unregistered persons that are catering to day traders by providing them with “hot tips” and “expert advice.”

The Commission’s partnership with the states is a critical part of our efforts in this area. A number of states have been leaders in pursuing false and misleading information disseminated about day trading -- not only as a potential violation of securities laws, but also as a violation of state consumer protection laws.

The Commission’s concerns are more fully discussed below.

a. Promotion of Day Trading by Registered Broker-Dealers

Certain of the disclosure and advertising practices of day-trading firms raise concerns under the federal securities laws. Deceptive advertising can be a violation of the antifraud provisions of the federal securities laws. It can also violate the NASD’s rules prohibiting exaggerated, unwarranted, or misleading statements or claims and requiring members to observe just and equitable principles of trade. Because the Commission believes that firms should not give day traders unrealistic expectations about the potential to profit and should provide day traders with a full explanation of the risks of their trading activities, our ongoing examinations are focused on identifying advertising and other promotions that are inconsistent with the antifraud provisions or NASD rules.

Day-trading firms use various forms of advertising to solicit potential customers. Newspapers, magazines, and web sites are among the most popular advertising mediums. These firms promote to potential day traders such benefits as “maximum leveraged capital of 10 to 1,”

“state-of-the-art trading systems,” “after-hours trade execution capability,” “maximum profit potential,” and “training by experienced professionals.” In some cases, firms claim to offer services that they do not actually provide. The Commission is most concerned with unbalanced advertising and exaggerated claims of profitability, in other words, advertisements that detail the benefits of day trading without disclosing the associated risks and costs. In some cases, representations by day-trading firms that promise profits without disclosing the inherent risks of the day-trading strategy, including available information on probability of profit, may rise to the level of fraud.

The Commission staff recently reviewed the risk and related disclosures on web sites of more than 20 day-trading firms. Many of these sites had little or no risk disclosure, and some contained statements that were not fulsome about, or even downplayed the risks associated with, day trading. Nevertheless, half of the web sites had considerable disclosure about those risks. In our ongoing examinations of these firms, we are evaluating whether other materials that are given to customers include exaggerated or misleading claims as well as the adequacy of risk disclosure.

We are also concerned about the promotion by some day-trading firms of lending between day traders to cover margin deficiencies without fully disclosing all of the risks. This practice is often referred to as journaling. Regulation T, which governs extensions of credit by and to broker-dealers,⁶ provides that a firm may arrange for the extension of credit to or for any customer by any person, provided the broker-dealer does not willfully arrange credit in violation

⁶ Section 7 of the Exchange Act prohibits broker-dealers and other persons from extending credit in contravention of the rules and regulations promulgated by the Federal Reserve. In accordance with its statutory authority, the Federal Reserve promulgated Regulation T “to regulate extensions of credit by broker-dealers.” 12 CFR 220.

of Regulations U or X.⁷ Traditionally, journaling has been used in rare instances when one individual — often a relative -- agrees to cover the margin deficiencies of another individual. Typically, these loans are made on an overnight basis to traders who would otherwise face a margin call. The borrowers are typically charged interest of one-tenth of 1 percent daily, which amounts to 36.5 percent on an annual basis. The increasing use of journaling raises significant concerns, particularly if day-trading firms are actively promoting such lending between customers without fully disclosing all of the risks to both lenders and borrowers. It also raises the concern that some day traders may not fully understand that they are trading beyond their own means.

b. Advertising by Unregulated Web Sites

The Commission is also concerned about web sites that, although not operated by day-trading firms, are trying to capitalize on the day-trading phenomenon. These sites offer, for a fee, so-called “expert investment advice.” Often the sites will provide stock recommendations on a daily basis to day traders. Many of these sites feature prominent advertising that trumpets the potential rewards of day trading by use of their recommendations. These sites rarely make sufficient risk disclosure. Whether these sites are operating as unregistered investment advisers, however, depends on the facts and circumstances of a particular case.⁸ Some of these web sites may provide the type of individualized investment advice that could be covered by the Investment Advisers Act of 1940.

⁷ 12 CFR 220.13. Regulation U applies to margin stock credit extended by banks and persons other than broker-dealers. Regulation X requires that credit obtained within or outside the U.S. comply with Regulations T and U.

⁸ In *Lowe v. SEC*, the U.S. Supreme Court held that a publisher of a securities newsletter which provides impersonal investment advice and commentary to subscribers was not

2. Leverage

Leverage is a common element in day-trading firms' and their customers' trading. In general, both the broker-dealer net capital rule and customer margin requirements limit leverage. The relative importance of these rules to day traders is directly related to the structure of the firm through which they trade.

When a firm has customers who are day traders, those customers may only day trade in margin accounts. In addition, the firm may only lend to these customers in compliance with both the initial margin requirements of Regulation T and the maintenance margin requirements under SRO rules. Regulation T allows broker-dealers to lend to their customers up to 50 percent of the initial purchase price of stock ("initial margin"). After the initial purchase, the SROs' margin rules require customers to maintain equity in their accounts equal to at least 25 percent of the value of the stock held in the account ("maintenance margin").

Margin requirements are calculated at the end of each day. Accordingly, to comply with Regulation T, a customer must have on deposit in his or her margin account equity (consisting of cash or fully paid securities) equal to 50 percent or more of the purchase price of any stock purchased that day and still held in the account at the end of the day. To comply with SRO maintenance margin requirements, a customer must leave on deposit in his or her margin account equity equal to at least 25 percent of the value of stock held in that account at the end of the trading day.

Because margin requirements are only calculated at the end of each day, a day trader⁹ who has no positions in his or her account at the end of the day would have neither an initial margin nor a maintenance margin requirement, assuming no losses in the account. Nonetheless the day trader and, to the extent credit is extended, the firm are at risk during the day.

To address this risk, the SROs established separate margin rules for day traders, which require day traders to demonstrate that they have the ability to meet the initial margin requirements for at least their largest open position during the day. More specifically, these rules require a customer to deposit in his or her account at the end of the day, the margin that would have been required under Regulation T (*i.e.*, the 50 percent initial margin requirement) if the customer had not liquidated the positions during the trading day.¹⁰

If a customer's account is below the initial or maintenance margin minimums, the broker-dealer must ask the customer to deposit additional cash or securities to satisfy the margin deficiency. This request is known as a margin call. Customers typically have 15 days to meet a margin call. Customers who are day traders, however, only have 7 days to meet a call for additional cash or securities.

One purpose for establishing margin requirements was to prevent broker-dealers from lending too much money against collateral whose value had the potential to fall quickly (*i.e.*, stock). While margin requirements are designed to protect the financial integrity of broker-dealers that provide credit, they also protect customers from taking on too much leverage. Accordingly, the Commission has concerns when firms fail to comply with margin requirements

⁹ Under SRO rules, a day trader is a person who buys and sells the same security on the same day at least three times in a calendar year.

¹⁰ See, *e.g.*, New York Stock Exchange Rule 431 (f)(8)(B).

or fail to adequately disclose the risks and costs associated with borrowing money. The Commission's staff has found isolated instances where day-trading firms appear to have failed to comply with margin requirements or properly disclose terms and conditions of loans in contravention of SEC rules.¹¹ We continue to scrutinize these issues.

As mentioned above, when day-trading firms are organized as LLCs and individual day traders contribute to the firm's capital, the day traders are permitted to trade using the firm's capital. These LLC firms typically participate in joint back office ("JBO") arrangements, which allow them to enhance their borrowing power.¹² JBO arrangements have become popular because they allow day-trading firms to receive preferential margin treatment from their clearing firms. Specifically, a day-trading firm that participates in a JBO arrangement can receive credit from its JBO clearing firm on "good faith" terms. As a result, the customer margin requirements found in Regulation T and SRO rules do not limit the extension of credit to a JBO participant. Rather, credit can be extended for up to 100 percent of the purchase price of the securities. As discussed below, the SROs have proposed revisions to their rules that would make these JBO arrangements more difficult to use.

Because of the borrowing power permitted by JBO arrangements, the leverage of day-trading firms organized as LLCs is limited only by the net capital rule. This essentially allows firms to leverage their position 6 to 1, rather than the 2 to 1 leverage allowed day traders under SROs' rules.

¹¹ See Exchange Act Rule 10b-16, 17 CFR 240.10b-16.

¹² Section 220.7(c) of Regulation T authorizes the creation of JBO arrangements. These JBO arrangements permit "a creditor [to] effect or finance transactions of any of its owners if the creditor is a clearing and servicing broker or dealer owned jointly or individually by other creditors." 12 CFR 220.7(c).

3. Unregistered Broker-Dealer and Investment Adviser Activities

Some day-trading firms are reportedly encouraging individual day traders to take on “partners” or other third parties from whom the day traders would obtain additional funds for trading. Depending on the facts, these activities could be characterized as unregistered broker-dealer or investment adviser activities. The definitions of broker and dealer under the Exchange Act are very broad and could potentially encompass these day traders’ third party activities. Specifically, an individual who “is engaged in the business of effecting transactions in securities for the account of others” (*i.e.* a broker),¹³ or an individual who is “engaged in the business of buying and selling securities for his own account” (*i.e.*, a dealer),¹⁴ would be required to register as a broker or dealer under Section 15(b)¹⁵ of the Exchange Act. To the extent that individuals are handling funds and securities for others, receiving transaction-based compensation or purchasing securities for third parties, they may be acting as “brokers” or “dealers.”

In addition, while investment advisers with less than \$25 million of assets under management do not have to register with the Commission, they may have to register in one or more states. Some states have found that individuals at some day-trading firms were operating as unregistered investment advisers.¹⁶

4. Short Sale Rule Violations

Selling short is a trading strategy that enables an investor, who believes that the price of a security will decline, to profit from the security’s decline by selling the security without actually

¹³ Exchange Act § 3(a)(4), 15 U.S.C. 78c(a)(4).

¹⁴ Exchange Act § 3(a)(5), 15 U.S.C. 78c(a)(5).

¹⁵ Exchange Act § 15(b), 15 U.S.C. 78o(b).

¹⁶ *See In Re Day Trade, Inc., et al.*, (Tex. SSB Ref. 98-020) (April 6, 1998).

owning it. If the security's price does decline, the investor can purchase the security at the lower price to deliver to the initial purchaser (*i.e.*, "cover" the short position). If, however, the security's price rises, the investor will have to pay the higher price to cover his short sale and thus incur a loss on the transaction.

The short sale rule prohibits investors from selling an exchange-listed stock short unless the stock's last trade was at the same price or higher than the previous trade -- the uptick rule. In addition, firms that sell a stock short or allow their customers to sell short must first make sure that the shares can be borrowed or that delivery of the securities can be made to the purchaser by the settlement date.¹⁷ Although the Commission's short sale rule does not prohibit short selling of Nasdaq stocks, the NASD's rules do.¹⁸

There have been reports of day traders executing short sales in violation of the short sale rule. Examinations preliminarily indicate that some firms may be deliberately circumventing the short sale rule by falsely designating trades as "long" sales when they are actually short sales. This is an area of focus in the Commission's inspections of day-trading firms.

In addition, under the Exchange Act registered broker-dealers have a duty to supervise their associated persons with a view to preventing violations of the federal securities laws. In the case of firms that are formed as LLCs, day traders are associated persons. Therefore, these LLCs have a responsibility to ensure that their traders fully comply with the securities laws. Accordingly, if a day trader who is trading an LLC firm's capital is found to violate any

¹⁷ See Exchange Act § 10(a), 15 U.S.C. 78j(a) and Exchange Act Rule 10a-1, 17 CFR 240.10a-1; and Exchange Act Rule 10a-2, 17 CFR 240.10a-2. See also New York Stock Exchange Rule 440B.

¹⁸ See NASD Rule 3350. The NASD's short sale rule applies only to National Market System securities and prohibits short sales of such securities at or below the current best (inside) bid when the current best (inside) bid as displayed on Nasdaq is below the

provision of the federal securities laws, the firm itself could potentially be held responsible and sanctioned by the Commission. Our examinations have found that day-trading firms do not have strong supervisory structures in place, and in particular, may lack the surveillance systems needed to prevent and detect short sale violations by day traders.¹⁹

When day traders are trading using the firm's capital, and the firm's aggregate position in a stock is "short," the firm must ensure that no trader at the firm executes any trade that violates the short sale rule. In other words, a firm must have procedures designed to prevent a trader from selling on a down tick when the firm's aggregate position in the stock is short. The Commission found that traders at some LLC firms do not have access to the firm's aggregate position, and would therefore be unable to determine whether they were complying with the short sale rule.

Overall, the Commission has concerns that many day-trading firms may not be complying with the short sale rule and, further, some may have no mechanism for ensuring compliance with this rule.

V. Commission, SRO and Industry Initiatives

1. Revising Exchange Act Rule 15b9-1²⁰

Broker-dealers that are members of a national securities exchange currently do not have to become members of the NASD if they do not have customer accounts. A number of day-trading firms have taken advantage of this exemption and are members only of the Phlx. The

preceding best (inside) bid.

¹⁹ In the case of day-trading firms that are not organized as LLC, day traders are customers rather than associated persons. Therefore, these firms do not have a duty to supervise their day-trading customers.

²⁰ 17 CFR 240.15b9-1.

Commission staff is considering revisions to this exemption, found in Rule 15b9-1, to require day-trading firms conducting off-floor activities to become members of the NASD and comply with NASD rules. We are considering this revision because we do not think the existing rule structure of the regional exchanges is well-suited for the day-trading business. By amending Exchange Act Rule 15b9-1, all day-trading firms would be subject to NASD rules.

Rule 15b9-1 was intended to exempt exchange specialists from the requirement under Exchange Act Section 15(b)(8)²¹ that a broker-dealer be a member of a national securities association. Of course, in adopting any change to the exemption in Rule 15b9-1, we will be careful not to interfere unduly with the valuable market making functions firms, such as specialists, provide to exchanges.

2. Leverage Issues

The Commission and the SROs are reviewing the broker-dealer financial responsibility rules and margin rules to determine whether these rules should be modified or enhanced to better address the increase in day trading. The Commission is also studying credit risk practices at day-trading firms to determine whether the firms are applying prudent credit risk procedures when setting trading limits for customers.

- Loans Between Customers

The Commission is reviewing the use of customer-to-customer unsecured loans (*i.e.*, journaling). While lawful, we are concerned about this practice, particularly where broker-dealers are actively facilitating these loans. The Commission is evaluating the adequacy of the

²¹ 15 U.S.C. 78o(b)(8).

disclosure made to lenders and borrowers to ensure that it adequately discloses the risks to both parties.

In addition to the disclosure issues, we are looking at these customer-to-customer loans that are used to satisfy day traders' margin requirements. Rather than serving as a guarantee between accounts, these customer-to-customer loans often take the form of a letter of authorization, where the lender agrees that it will make funds available to the borrower for the purpose of meeting margin calls. Generally, these unsecured loans between customers do not violate margin regulations. The Commission and the SROs, however, do not believe that relying on these letters of authorization is a prudent credit practice. Instead, lenders should be required to commit to transfer funds if, for example, there is a loss in the borrower's account.

Some market participants are also concerned about this practice. It was recently reported that Spear, Leeds & Kellogg, a broker-dealer that clears trades for some day-trading firms, is no longer willing to engage in the practice of journaling for its correspondent firms.

- SRO Actions on Margin and Capital

As part of the Commission's and SROs' overall review of day-trading firms, the New York Stock Exchange ("NYSE") recently issued an Information Memorandum reminding broker-dealers that they are required to maintain sufficient net capital at all times, not just at the end of the day.²² This means that day-trading firms organized as LLCs must be able to demonstrate that they have sufficient net capital for intra-day positions, even if the intention of the firm is to liquidate or cover the positions before the end of the same day. Accordingly, a firm must develop procedures for closely monitoring the day-trading activities of its day-trader

²² NYSE Interpretation Memorandum No. 99-8 (August 1999).

members to ensure that the firm is not leveraged beyond what is permitted under the Commission's net capital rule.

Generally, the net capital rule requires broker-dealers to take a capital charge if a customer fails to meet a margin call. With respect to outstanding margin calls in customer day-trading accounts, the Commission is working with the NYSE on an Information Memorandum that will remind broker-dealers that they must take a capital charge for outstanding special maintenance margin calls associated with day-trading accounts. The Memorandum will clearly state that a capital charge applies to day-trading margin calls as well as other types of margin calls. The Notice also will remind firms that they should be taking this capital charge even for margin calls on day-trading positions that were liquidated at the end of the day.

In addition, the NASD, in December of 1998, released a Notice to Members clarifying member understanding of margin calculations, under Regulation T and NASD Rule 2520, for day-trading and cross-guaranteed accounts.²³ Further, the Notice to Members clarified that members must be in compliance with the Commission's net capital requirements under Exchange Act Rule 15c3-1.²⁴

Specifically, the NASD stated that customers may day trade only in margin accounts because day trading in a cash account could amount to free riding (*i.e.*, purchasing a security and then selling it without having paid for the purchase). Thus, day-trading firms must be in compliance with both Regulation T and NASD margin rules at all times. This requires day-trading firms to perform two separate calculations for each customer, one for Regulation T and

²³ NASD Notice to Members 98-102 (December 1998).

²⁴ 17 CFR 240.15c3-1.

one for the NASD rule, at the end of each day. Moreover, the NASD reiterated that just because broker-dealers must calculate customer margin at the end of each day does not mean that they can disregard intra-day risk and that they may impose margin calls based on intra-day calculations. However, broker-dealers may not grant additional buying power to customers on the basis of intra-day calculations.

- Capital Contributions

In response to day-trading firms organized as LLCs, the Commission staff is preparing a letter to the SROs to restate the Commission's position that an investor must make a long term investment in the broker-dealer before that investment may be included in the firm's net capital. Under current net capital rules, day traders who invest in an LLC cannot withdraw their investment a short time later if they simply decide to stop day trading. In fact, the investor may not be able to withdraw his investment at all if the withdrawal would jeopardize the firm's net capital position. We are examining firms to ensure that they have treated funds contributed by these investors appropriately, including whether investors in day-trading firms received adequate disclosures regarding the restrictions on their ability to withdraw their investment in the firm. Preliminarily, however, we have not found problems with these agreements.

- Joint Back Office Arrangements

Margin and other credit issues are further being addressed through a series of SRO rule filings that propose capital and equity requirements for members participating in JBO arrangements. As discussed earlier, JBO arrangements allow day-trading firms to borrow from their clearing firm on "good faith terms." In other words, the margin requirement is any amount mutually agreed upon by the parties. JBO arrangements are attractive to day-trading firms because they enable these firms to borrow at lower interest rates and for up to 100

percent of the purchase price of securities. The SRO proposals would limit day-trading firms' ability to use JBO arrangements by establishing significant capital and equity requirements. These new requirements would ensure that clearing firms extend good faith credit to day-trading firms under JBO arrangements in a prudent manner.

3. NASD Sales Practice Proposal

The NASD submitted to the Commission, on August 20, 1999, proposed rule changes designed to address the sales practices of day-trading firms.²⁵ The first initiative would require firms that promote day-trading activities to disclose to customers, prior to opening accounts, the risks associated with that type of trading. The disclosure would include several points for customers to consider before engaging in day-trading activities, including that the customer should be prepared to lose all of the funds used for day trading and that day trading on margin may result in losses beyond the initial investment.

The second initiative would require day-trading firms to make a threshold determination that day trading is appropriate for a particular customer. Specifically, a day-trading firm, in approving an account for day trading, would need reasonable grounds for believing that a day-trading strategy is appropriate for a customer by gathering essential facts about the customer. This determination would not be required if the customer signs an agreement stating that he or she does not intend to use the account for day-trading activities. If the firm later discovers that the account is used for day-trading activities, the firm would be required to approve the account for day trading within 10 days of discovery.

²⁵ The NASD, as part of its recent sales practice and disclosure rule proposal, proposed the following definition of day-trading strategy: "An overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities." See SR-NASD-99-41 (August 20,

The Commission published these proposed rules for comment on September 14, 1999.²⁶ The comment period will end twenty-one days after the notice has been published in the Federal Register.

4. Investor Education

The Commission believes that investor protection — at its most basic and effective level - starts with the investor. In this day and age, there is no substitute for investor awareness and caution. Four months ago, the Commission unveiled its new investor education web site, www.sec.gov/invkhome.htm. The site offers investors the best information and advice we have about investing — including on-line trading and day trading.

Day trading is risky, and it is therefore critical for day traders to understand three things. First, investors should make sure the firm is registered with the Commission and the state in which it does business. Second, investors should check with their state regulator to see whether the firm has a disciplinary record or history of complaints. Finally, investors should understand that day trading may result in severe financial losses, with little expectation of ever making a profit.

5. Series 7 Exam

Because some day-trading firms have been able to maintain membership solely in the Phlx, the Commission recently approved a proposed rule change by the Phlx to require persons who are associated with member firms and who trade off the floor of the Phlx to successfully complete the Series 7 Exam.²⁷ The Series 7 Exam is the basic examination used to qualify

1999).

²⁶ Exchange Act Release No. 41875.

²⁷ Securities Exchange Act Release No. 41776 (August 20, 1999) 64 FR 47214 (August 30, 1999).

persons for registration as general securities representatives. The new rule primarily affects about 1800 day traders at 12 to 15 Phlx member firms, which are organized as LLCs or similar structures.

The rule will help to ensure that these day traders have a basic knowledge of the securities markets and laws, as well as investment products and risks. It will also bring the Phlx qualification requirements in line with those of the NYSE, the American Stock Exchange, and the Chicago Stock Exchange, which require securities traders who do not solicit public business to pass the Series 7 Exam. The Pacific Exchange has filed a similar proposal, which the Commission is currently considering.

6. Enforcement Efforts

The Commission's Division of Enforcement is pursuing several active investigations concerning day-trading operations.²⁸ The bulk of the investigations stem from referrals based upon examinations by the Commission's Office of Compliance Inspections and Examinations; others have arisen from customer complaints. The investigations cover a wide array of potential violations described above, including: margin violations, short sale violations, net capital deficiencies, and misleading advertising.

The Division of Enforcement is also investigating several web sites that, while not day-trading operations themselves, are trying to capitalize on the day-trading phenomenon. These web sites provide self-proclaimed expert stock recommendations on a daily basis to day traders in exchange for a fee. The staff is investigating certain web sites that feature advertising

²⁸ Commission rules and privacy considerations prohibit identification of any firm or individual involved in any of these investigations until such time as the Commission may bring an enforcement proceeding. See *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d

trumpeting the potential rewards of day trading by use of their stock recommendations, while making little or no risk disclosure. In addition to potential misleading advertising, these investigations are also focusing on whether anyone associated with these web sites receives compensation to tout any security without making proper disclosure, or whether anyone is illegally trading ahead of the recommendations.

VI. Conclusion

The Commission is concerned that all day traders fully understand the costs and risks of engaging in this strategy, and that they only trade with funds they can afford to lose. As discussed above, the Commission is concerned with some day-trading firms' advertising and disclosure practices, the use of leverage, unregistered broker-dealer and investment adviser activities, and short sale rule violations. The Commission, together with the states and the SROs, will continue to vigorously enforce existing laws to protect investors and the integrity of our markets.



Testimony

of

**Mary L. Schapiro
President
NASD Regulation, Inc.**

before the

**Permanent Subcommittee on Investigations
Senate Committee on Governmental Affairs**

on the

Securities Day Trading Industry

September 16, 1999

I am Mary L. Schapiro, President of NASD Regulation, Inc. NASD Regulation, Inc. and our parent, the National Association of Securities Dealers, Inc. (NASD[®]), would like to thank the Subcommittee for this opportunity to testify on the securities day-trading industry.

My testimony today will address the issues that you identified in your invitation letter to this hearing. Those issues deal with the general characteristics of day trading, risks involved, our examination findings, our recent rule proposals, and any needed legislation.

By way of summary, NASD Regulation believes that day trading is a legitimate trading strategy, and to the extent it is conducted by individuals capable of understanding and assuming the risks involved with such a strategy, we do not intend to discourage such activities. However, with that said, NASD Regulation sees day trading as a highly risky form of trading that deserves close investigation and study by regulators. We have been addressing the risks that we have seen through a combination of continued dissemination of information to our members and investors, focused examination and enforcement efforts, and the development of new NASD rules and other policy initiatives. Given our current experience, we do not now see a need for new legislative initiatives, but we intend to continue to work together with the SEC and the states on these important issues, and will promise to inform you if we perceive a need for new legislation to protect investors and our markets.

The NASD

Let me briefly outline the role of the NASD in the regulation and operation of our securities markets. Established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934, the NASD is the largest self-regulatory organization for the securities industry in the world. Virtually every broker-dealer in the U.S. that conducts a securities business with the public is required by law to be a member of the NASD. The NASD's membership comprises 5,600 securities firms that operate in excess of 75,000 branch offices and employ more than 600,000 registered securities professionals.

The NASD is the parent company of NASD Regulation, Inc. (NASDR), the Nasdaq Stock Market, Inc. and the American Stock Exchange (AMEX). NASDR and Nasdaq operate under delegated authority from the parent, which retains overall responsibility for ensuring that the organization's statutory and self-regulatory functions and obligations are fulfilled. The NASD is governed by a 27-member Board of Governors, a majority of whom are non-securities industry affiliated. The NASDR subsidiary is governed by a 10 member Board of Directors, balanced between securities industry and non-industry members. Board members are drawn from leaders of industry, academia, and the public. Among many other responsibilities, the boards, through a series of standing and select committees, monitor trends in the industry and promulgate rules, guidelines, and policies to protect investors and ensure market integrity.

disciplinary cases and suspended or barred more than 650 individuals from the industry.

While our regulatory jurisdiction is limited to our broker-dealer member firms and their associated persons, our examinations, surveillance, and regulatory intelligence alert us to illegal conduct outside of our jurisdiction. We routinely refer such findings to the SEC, the states and criminal prosecutors for their action. In recognition of the resources we were devoting to assisting prosecutors in bringing securities cases, we formed a Criminal Prosecution Assistance Group in April 1998. Since the beginning of this program, we have provided assistance in more than 100 criminal investigations and prosecutions around the country.

NASDR is responsible for developing rules that govern the conduct of the brokerage industry in areas as diverse as sales practices, advertising, trading and underwriting. Rulemaking is a widely participatory process with broad input from industry members, trade associations, other regulators, and the public. By the requirements of the Securities Exchange Act of 1934, NASDR rules do not become final until they are approved by the SEC.

NASDR has examination responsibilities for all of its 5,600 members. In addition to special cause investigations that address customer complaints and terminations of brokers for regulatory reasons or other cause, NASDR has established a comprehensive routine cycle examination program. This program is carried out through a regulatory plan that focuses each District's examination efforts on the firms, individuals, issues and practices that present the greatest regulatory challenges and concerns. Annual on-site inspections are conducted of high priority areas. In addition, NASDR has

established an examination frequency cycle for all of its members, which is based upon the type of business conducted by the member, the scope of that business, the extent of customer exposure, method of operation, past regulatory history, and other factors. During 1998, 2,606 main office routine examinations were completed and 5,671 customer complaints and 3,535 terminations for cause were investigated.

NASDR shares responsibility for developing and administering qualifications testing for securities professionals. All sales and supervisory persons associated with NASD member firms must demonstrate a requisite understanding of the products offered by their firms, as well as regulatory requirements. Individuals acting in a management capacity must pass the appropriate principal's examination, while sales personnel must demonstrate specific understanding of the products they intend to sell and the regulations that govern those products. In 1998, NASDR administered 267,000 examinations for 29 different qualification areas.

The Nasdaq Stock Market

The Nasdaq Stock Market, Inc., develops, operates, and regulates a variety of marketplace systems and services. Nasdaq is the largest electronic, screen-based stock market in the world, capable of handling trading volume in excess of one billion shares a day. Today, more than one-half of all equity shares traded in the United States each day are traded on Nasdaq.

The American Stock Exchange

The American Stock Exchange is the nation's second largest floor-based securities exchange and is the only U.S. securities exchange that is both a primary market for listed equity securities as well as a market for equity options, index options, and equity derivatives.

Day Trading and On-Line Trading

A recent outgrowth of technological advances in the securities industry has been the increase in popularity of day trading. The term "day trading" refers to a trading strategy where an individual buys and sells the same security in an attempt to profit from very small movements in the price of a security over a short period of time. Although the term is commonly used to refer to aggressively buying and selling a group of securities in a single day (or selling short and then buying to cover the short position), there are varying degrees of day trading currently being employed. For example, some individuals "day trade" in that they execute purchase and sale (i.e., "round-trip") transactions in a single day; however, they limit such activities to only one or two round-trip transactions in a day, and only on an occasional basis. These individuals typically do not rely on their day-trading activities as their primary source of income and may conduct such activities from computers located at their places of regular employment or their homes. In addition, although as a practical matter, day trading typically requires electronic delivery of orders, day trading can include orders transmitted by non-electronic means, such as by telephone.

However, the term “day trading,” as commonly used within the industry, generally refers to the trading activities of the “professional day trader,” that is an individual who conducts intra-day trading in a focused and consistent manner, with the primary goal of earning a living through the profits derived from this trading strategy. This form of day trading requires aggressive and frequent securities trading and, as a result, generally requires a significant amount of capital, a sophisticated understanding of securities markets and trading techniques, and high risk tolerance. Day traders typically have a relationship with a brokerage firm that provides them with more direct access to the markets as well as access to real-time trading and related information.

Another outgrowth of technological advances in the securities industry has been on-line trading. Only a few years ago, most individuals had little or no exposure to on-line trading. Individuals with on-line accounts were more likely to work in the financial or securities industries or to have engineering or other technological backgrounds. Recent reports, however, indicate that there are several million on-line trading accounts in the United States. Access to on-line trading resources has enabled investors to be better informed about their own portfolios, as well as specific trends or news in the markets.

While there are differing opinions of what constitutes “on-line trading,” the term generally refers to accessing and using securities trading resources via the Internet. On-line trading activities can range from occasionally buying or selling securities on-line, to aggressively day trading on location at a brokerage firm. As requested, my testimony today focuses

on issues relating to day trading specifically, rather than on-line trading generally.

Day-Trading Firms

While many factors have contributed to the increase in day trading, one significant factor is recent rapid advances in technology, including the widespread availability of the Internet. The Internet has provided individuals with quick, easy, inexpensive access to the securities markets and information and this, in turn, has encouraged greater participation in the markets by individuals not employed in the securities industry. As a result, individuals have been trading their accounts far more actively than in the past.

Over the past few years, brokerage firms began to consider how best to incorporate technological advances that could impact customer trading activities into their own business model. Certain brokerage firms began to focus primarily, or even exclusively, on promoting day-trading strategies to individuals. These firms generally advertise on the Internet and elsewhere as “day-trading” firms or otherwise promote their execution and other services as desirable for “serious” or “professional” traders. These firms often provide reduced transaction costs through lower commissions and other margin-related costs. In addition, many of these firms offer training on day-trading techniques, as well as provide computer facilities, high speed access lines and software packages specifically designed to support and accommodate day trading. Although day trading can be conducted using the facilities of any brokerage firm, most day trading occurs at these types

of firms due, in part, to their programs that offer more direct access to the markets, relatively favorable transaction costs and access to lenders for margin purposes.

The Use of Margin by Day Traders

Day traders often use margin to leverage their trading activity. Day traders typically do not carry securities positions overnight and therefore do not face standard maintenance margin requirements. However, they are subject to special margin requirements under NASD rules that are calculated based on the largest open position held by the day trader during the day. For example, assume that a trader starts the day with \$50,000 cash, makes 20 buys and sells, and ends the day flat (neither long or short the stock) with \$50,000 cash. During the day, the largest open position at any given time held by the trader was 4,000 shares of a \$25 stock, and 1,000 shares of a \$50 stock (\$150,000). Even though the day trader ends the day flat, he will receive a margin call for 50% of the \$150,000, less the equity in his account, or \$25,000.

The use of margin by day traders can result in financial losses beyond their initial investment. For example, assume that a day trader begins the day with \$50,000 cash in her account. She purchases 5,000 shares of a \$20 stock (\$100,000) and has therefore received a margin loan of \$50,000. The stock price drops to \$9 per share. The day trader sells the stock and receives the proceeds from the sale of \$45,000. As a result, she has lost her initial \$50,000 investment and owes an additional \$5,000.

Regulatory Response to Day Trading

The growth in day-trading activities has raised unique investor protection issues and concerns. Day trading is a risky, speculative activity, and even the most experienced day traders may suffer severe and unexpected financial losses, even beyond their initial investment. At a minimum, day trading requires sufficient capital and a sophisticated understanding of the markets and market dynamics. It also requires an expertise in identifying securities to trade and in accurately timing purchases and sales.¹

Given these risks, the NASD, SEC and state securities regulators have worked together to address the investor protection concerns in this area. Our approach has been three-pronged, relying upon: (1) the dissemination of advisories and other information to NASD member firms reminding them of their obligations under existing rules; (2) focused examinations, investigations and follow-up enforcement actions; and (3) the institution of rulemaking initiatives.

(1) Advisories Concerning Obligations under Existing Rules

¹ In your request letter dated August 25, 1999, in addition to asking about risks, you requested estimates on the percentage of individuals who actually profit from day trading. At this time, we are aware of only one report that has provided any data on the profits derived from day trading, the *Report of the Day Trading Project Group*, dated August 9, 1999, released by the North American Securities Administrators Association, Inc. While limited in scope and based on a small statistical sample, it is a useful first step in gauging the extent to which day trading has been a profitable trading strategy. It is difficult to draw any firm conclusions on this issue pending a more comprehensive review. The NASD has been closely reviewing the issue of day-trading profitability as part of our ongoing examinations and investigations of certain day-trading firms.

In response to the increase in day-trading and other on-line trading activities, the NASD has published the following *Notice to Members* (copies of which are attached, along with any related NASDR press release):

- **Notice to Members 99-33, NASD Regulation Advises Members about Maintenance Margin Requirements for Certain Volatile Stocks and Solicits Comment on Margin Practices (April 1999)**

This Notice provides members and investors with information about current margin requirements and steps taken by the industry to increase maintenance margin requirements for certain volatile stocks. It also solicits comment on issues relating to the use of margin during volatile market conditions, as well as the use of margin by individuals engaging in day-trading activities. It warns that a sudden change in the market value of a security may result in an unexpected margin call, and a customer's failure to meet the call may cause the firm to liquidate the securities in the account.

The Notice also discusses issues regarding investor protection and disclosure practices arising as firms become involved in the extension of credit between customers. It notes that in certain instances, customers loan funds to other customers to finance securities trades, or guarantee each other's margin accounts. Member firms sometimes arrange for these loans or guarantees between customers or arrange loans for customers from other sources. The Notice also advises that customers incur additional finance charges when credit is arranged, and they face additional credit risks when extending credit to other customers.

- **NASD Notice to Members 99-12, NASD Regulation Issues Guidance Concerning the Operation of Automated Order Execution Systems during Turbulent Market Conditions (February 1999)**

In light of the recent intra-day volatility and significant surges in trading volume with respect to certain issues, particularly Internet-based issues, this Notice was issued to provide members guidance concerning the operation of their order execution systems and procedures during extreme market conditions. It describes factors that members should consider in evaluating whether modifications to their order execution algorithms or procedures during turbulent market conditions are consistent with their duties of best execution.

- **NASD Notice to Members 99-11, NASD Regulation Issues Guidance Regarding Stock Volatility (February 1999)**

This Notice recommends that firms provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner. Specifically, it recommends that firms consider disclosing that high volumes of trading at the market opening or intra-day may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was entered. It further notes that firms should consider explaining in detail the difference between market and limit orders and the benefits and risks of each. It also advises that firms consider alerting customers that they may suffer market losses during periods of volatility in the price and volume of a particular stock when systems problems result in the inability to place buy or sell orders. In particular, it notes that customers trading on-line may have difficulty accessing their accounts due to high Internet traffic or because of systems capacity limitations.

The Notice also summarizes current practices that certain on-line firms have implemented in response to the recent market volatility. These practices include: (i) restrictions on on-line trading during initial public offerings; (ii) increased margin requirements for certain volatile stocks; (iii) enhanced investor education on market volatility; and (iv) the use of pop-up or splash screens (i.e., pages that a customer must view when entering a firm's web site) to disseminate important information to customers.

Although the discussion in this Notice relates primarily to on-line trading activities, many of the risks outlined are relevant to day-trading activities, particularly when a day-trading strategy is implemented through an on-line brokerage account.

- **NASD Notice To Members 98-102, Calculating Margin for Day-Trading and Cross-Guaranteed Accounts (December 1998)**

This Notice discusses margin requirements under Regulation T and NASD Rule 2520² for day-trading and cross-guaranteed accounts. The Notice addresses some of the more frequently asked questions regarding the application of Regulation T and Rule 2520 to these types of accounts and provides guidance on common scenarios and questions relating to marginable equity securities.

(2) Examination and Enforcement Activities

² Regulation T of the Board of Governors of the Federal Reserve requires certain minimum margin in connection with the purchase of any security (initial margin). NASD Rule 2520 generally requires initial margin of *at least* the Regulation T amount. Rule 2520 also requires customers to maintain a certain minimum margin – “maintenance margin” – based on the positions in the customer's account.

NASD Regulation is engaged in a cooperative day-trading examination initiative with the SEC. Beginning last Spring, the staffs of NASDR and the SEC launched a broad-based, coordinated examination program of day-trading firms. As part of that effort, NASDR examined 22 day-trading firms that varied significantly in size and makeup. Fifty-five NASDR examiners received special training in the intricacies of day trading. Customized examination modules were developed and used to implement this special program. The two largest firms examined had 1,500 or more day-trading accounts, while at six of the firms, fewer than 20 of its customers were day trading. At about half of the firms examined, day-trading activity accounted for nearly all of the firm's business.

During these specialized examinations, several potential problem areas surfaced, including advertising, Regulation T and margin lending, registration of individuals, short sales, and supervision. We are currently reviewing the results of those examinations and completing the investigations growing out of them. To the extent that these investigations indicate that violations of our rules or the federal securities laws have taken place, formal enforcement actions will be instituted.

Advertising

NASD Rule 2210 governs "Communications with the Public." The Rule applies to "advertisements" and "sales literature" and prohibits "exaggerated, unwarranted or misleading statements or claims." Generally, electronic advertising such as those found on the Internet, are treated no differently from hard copy advertising and marketing materials.

Nearly 80 percent of the day-trading firms examined had potentially problematic advertisements that have been referred to our Advertising Regulation Department for further review. The problem areas noted in these advertisements range from allegations of immediate execution to statements of profits that can be generated from day trading. One practice under review is the dissemination -- through websites, training materials, and public statements -- of what may be materially misleading and unwarranted information regarding the "success rate" of their customers. The staff is reviewing whether the firms' claims of customer success rates in their marketing and communications with the public can be substantiated as our rules require.

Other materials reviewed from day-trading firms have contained unsubstantiated claims regarding "profit potential," "lowest commissions," "trading for a living," or "industry leader in day trading" without corresponding risk disclosure or qualifying language. In addition, day-trading websites and other communications with the public have indicated that losses can be controlled or minimized through the use of certain strategies or techniques. In short, at least some day-trading firms appear to have failed to provide investors with a sound basis for evaluating the services being offered and contain exaggerated statements rendering the promotion or presentation misleading.

We have already filed one formal disciplinary action against a day-trading firm for violations of our advertising rules. On June 10, 1999, a complaint (attached) was filed against Lakeside Trading, a Metairie, Louisiana day-trading firm, and its president and principal. In addition to

alleged margin violations and improper use of customer funds, the complaint alleged that the firm's Internet website contained:

- Misleading statements that implied that individuals accessing the firm's trading systems online had direct access to the markets;
- Statements that exaggerated customers' ability to access the markets;
- Material that failed to disclose that customers' transactions were subject to market fluctuation risks, and that trades may not be executed at all; and
- Material that failed to provide a balanced and complete presentation by omitting disclosure concerning the risks associated with day trading.

Regulation T and Margin Lending

Our day-trading examinations have revealed that at some day-trading firms, principals and employees arrange for credit to be extended from customers who have some equity in their accounts to those who require funds to cover margin calls. Absent these infusions of capital, many of the recipients of the loans would be unable to continue to trade.

Approximately half of the firms examined facilitate the lending of money between customers. At one firm, all the lending was done by one customer. In other instances, the firm works with its clearing firm to identify customers with credit balances who could be lenders. NASDR is investigating potentially violative activity relating to loans made by and between customers that are arranged by the firm or one of its employees for the purpose of meeting initial and maintenance margin requirements. We are reviewing the role of the member in arranging these loans and what, if

any, representations are made to the lending customers concerning the risks associated with making the loans.

Registration

NASD rules prohibit equity traders from trading in the Nasdaq and over-the-counter markets without first passing a qualification examination for trading (the Series 55 examination) and registering with NASD Regulation. The Series 55 registration rule, which became effective in April 1998, applies to market makers, agency traders, proprietary traders, and persons who supervise these activities. The rule was developed in response to concerns about rule violations by traders conducting market-making and principal trading functions in both the Nasdaq and over-the-counter markets.

We have found instances where persons engaging in day trading for a firm's proprietary account are not Series 55 registered. One disciplinary action has already been concluded in this area. On July 7, 1999, NASD Regulation censured and fined On-Site Trading, Inc., a Great Neck, NY day-trading firm, \$25,000 for failure to properly qualify and register 14 individuals. (AWC and press release are attached.) These individuals effected approximately 3,700 trades in 250 Nasdaq securities on behalf of the firm's proprietary accounts. Without admitting or denying the allegations, On-Site consented to findings that it lacked adequate oversight to ensure proper registration of its traders, and agreed to implement new compliance procedures to prevent future violations. Relatedly, we have also found instances in which individuals entering orders on behalf of customers were not Series 55 registered.

Short Sales

We have found short selling practices at some day-trading firms that appear to violate our rules and the federal securities laws. Specifically, our rules require that firms mark all sales as either “long” or “short” and that the firm determine if it can obtain shares of the security sold short to deliver to the buyer. We have seen practices at some day-trading firms that facilitate short sales by customers when the short sales are not marked as such and when no determination has been made that shares can be delivered to the buyer. We have also seen potential violations of our rules prohibiting customer short sales on what is commonly known as a “downtick.” Rule 3350 (the “Short Sale Rule”) prohibits member firms from effecting short sales at or below the current inside bid as disseminated by Nasdaq whenever that bid is lower than the previous inside bid.

The staff of the Market Regulation Department of NASDR reviews and investigates short sale activity. Among other activities, the staff utilizes an electronic surveillance program to conduct sweeps of reported short sale activities. These sweeps review trading by all firms that report short sales and objectively identify those trades that appear to violate the Short Sale Rule. Since initiating these sweeps in 1998, more than one-third of these reviews by the staff have involved day-trading firms.³ Overall, the staff has found a significant number of violations of short sale rules and believes that day-trading firms too frequently lack adequate supervisory procedures to detect and deter such violations. Where appropriate, we intend to initiate

³ For the purposes of this statistic, day-trading firms are those that have customers physically present at the firm or at remote locations that buy and sell stocks throughout the day through the use of a Nasdaq terminal and/or internal electronic software systems.

disciplinary action against the member firms and associated persons involved.

We are also reviewing short selling by customers of day-trading firms of hot IPOs in the immediate aftermarket. We are investigating whether some of these activities violate our rule requiring a firm effecting a short sale for a customer to determine if the shares being sold can be located and delivered to the buyer.

Supervision

Adequate supervision and the development and compliance with supervisory procedures are important issues at all broker-dealers, including day-trading firms. NASD Conduct Rule 3010 requires each of our member firms to “establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations” and NASD Rules.

Day-trading firms have initiated new sales and marketing practices outside the traditional broker-client relationship. They have built a business niche around new technology and new software. These innovations require new supervisory techniques. Yet, at some of the firms we have examined, written supervisory procedures have not adequately addressed many aspects of their core day-trading business. Areas of potentially deficient supervision include procedures in the following areas:

- Loans and lending arrangements between customers;
- Review of advertising, marketing, and training materials;

- Short-selling compliance, such as affirmative determination, selling on “downticks,” marking of order tickets long or short; and
- Cancellation of transactions and use of the firm error account.

NASDR is taking the necessary steps through disciplinary action to ensure that these potential deficiencies are addressed.

(3) Rulemaking Initiatives

Disclosure and Appropriateness Determinations

To effectively address the unique investor protection concerns associated with day trading, the NASD determined that rulemaking in this area was necessary to supplement existing rules and regulations. On April 15, 1999, the NASD issued Special Notice to Members 99-32, seeking comment on proposed rules addressing approval procedures for day-trading accounts including appropriateness determinations and disclosure of risks of day-trading activities. The staff received 39 comment letters in response to the Notice, 16 of which were from individuals and 23 from firms or other organizations. The majority of the commenters generally supported the NASD’s efforts to address the investor protection concerns raised by individual’s engaging in day-trading activities. However, commenters also raised varied suggestions on how best to regulate day-trading activities and presented disparate views on the scope of activities that should be covered by the rules. Based on its review and consideration of the comment letters, the staff made certain revisions to the proposed rules. The proposed rules,

as revised, were approved by the Board of Directors of NASDR at its meeting on July 28, 1999.

On August 20, 1999, the NASD filed the proposed rules with the SEC. (Rule filing and press release are attached.) Specifically, the proposed rules would require firms that promote day-trading strategies to (i) determine the appropriateness of day trading for a customer; and (ii) disclose to customers the risks associated with this type of trading. In order for a firm to approve an account for day trading, the firm would be required to have reasonable grounds for believing that a day-trading strategy is appropriate for a customer. In making this determination, the firm would be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her financial situation, tax status, prior investment and trading experience, and investment objectives. The firm also would be required to prepare a record setting forth the basis on which the firm has approved the customer's account. A firm need not make this determination if it obtained from the customer a written representation that the customer did not intend to use the account for day-trading purposes. If a firm later discovered that a customer who provided this written representation was using the account for day trading, the firm would be required to approve the account for day trading within 10 days of the date of discovery.

In addition, the proposed rules would require a firm that is promoting a day-trading strategy to deliver a risk disclosure statement to a customer prior to opening an account for the customer that provides the following:

- **Day trading can be extremely risky.** Day trading generally is not appropriate for someone of limited resources and limited

investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day-trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses.

- **Be cautious of claims of large profits from day trading.** You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead to large and immediate financial losses.
- **Day trading requires knowledge of securities markets.** Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.
- **Day trading requires knowledge of a firm's operations.** You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures.
- **Day trading may result in your paying large commissions.** Day trading may require you to trade your account aggressively, and you may pay commissions on each trade. The total daily commissions that you pay on your trades may add to your losses or significantly reduce your earnings.
- **Day trading on margin or short selling may result in losses beyond your initial investment.** When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day-trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

Firms would be permitted to develop an alternative disclosure statement as long as it is substantially similar to the mandated statement and is approved by NASD Regulation's Advertising Department prior to use.

Margin and Customer Lending

We are continuing to consider whether changes to existing rules regarding margin and lending practices are desirable and have solicited comment on this issue. Concerns identified include:

- what levels of margin are appropriate for these types of activities;
- whether the timing of margin deposit requirements should be changed (current rules permit deposits for margin purposes within seven business days of the trade);
- whether minimum initial and maintenance cash deposits should be required; and
- what limitations should apply to firms that facilitate loans between customers or third parties and customers to cover margin calls.

We are still considering these issues and will determine whether further rulemaking in this area is necessary.

Conclusion

In conclusion, day trading is a highly risky form of trading that we are investigating and studying closely. We intend to continue to work together with the SEC and the states to address the issues in this area. At this time, we do not see a need for any new legislative initiatives, but believe that through a combination of continued dissemination of information to our members and investors, focused examination and enforcement efforts and the development of new NASD rules and other policy initiatives, we can effectively address the investor protection concerns associated with day trading.

LIST OF ATTACHMENTS – DAY-TRADING TESTIMONY

- Press Release: NASD Issues Notice on Margin Issues and Practices (April 20, 1999)
- Notice to Members 99-33, NASD Regulation Advises Members about Maintenance Margin Requirements for Certain Volatile Stocks and Solicits Comment on Margin Practices (April 1999)
- Press Release: NASD Issues Guidance to Brokerage Firms Regarding Sales practices and Order Execution During Turbulent Market Conditions (January 26, 1999)
- NASD Notice to Members 99-12, NASD Regulation Issues Guidance Concerning the Operation of Automated Order Execution Systems during Turbulent Market Conditions (February 1999)
- NASD Notice to Members 99-11, NASD Regulation Issues Guidance Regarding Stock Volatility (February 1999)
- NASD Notice To Members 98-102, Calculating Margin for Day-Trading and Cross-Guaranteed Accounts (December 1998)
- Complaint Filed against Lakeside Trading (May 26, 1999)
- Press Release: NASD Regulation Censures and Fines On-Site Trading, Inc. for Registration Violations (July 7, 1999)
- AWC against On-Site Trading, Inc. (June 25, 1999)
- NASD Rule Filing No. SR-99-41 – Approval Procedures for Day-Trading Accounts (August 20, 1999) Note: Exhibits to Rule Filing are not included
- Press Release: NASD Board Approves Proposed Rule for Opening Day-Trading Accounts (July 29, 1999)

NASD Regulation Press Release - April 20, 1999



NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1530

Press Release

For Release: Tuesday, April 20, 1999
Media Contacts: Nancy A. Condon
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Amy Hyland
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NASD Issues Notice on Margin Issues and Practices

Washington, D.C.—NASD Regulation, Inc., recently issued an NASD *Notice to Members* that addresses a range of issues regarding the use of margin accounts and solicits comment on a number of practices relating to margin. The *Notice* was developed in response to a number of questions and concerns raised by industry and investors about current volatile market conditions and the risks posed by margin accounts to both investors and securities firms.

Turbulent markets pose considerable risk to investors who have margin accounts. During times of price volatility, market values of securities can fluctuate dramatically, resulting in sudden margin calls by securities firms. Since a margin call can result in serious consequences to the small investor, it is especially important for firms to clearly explain margin rules and disclose all risk and finance charges associated with the loaning and borrowing of funds to finance securities transactions.

In addition to the discussion of current margin rules, NASD Regulation seeks comment from the public on the following issues:

- variable margin requirements based on the size of a customer's account;
- determining if margin requirements should be linked to volatility;
- determining if customers should have the ability to guarantee each other's accounts;
- requiring customers to make margin deposits during the day in response to intra-day risk exposure;
- determining whether customers receive adequate information on loan terms for the purchase of securities; and
- whether current margin rules are compatible with day trading.

NASD Regulation will accept public comment on the *Notice* through May 31, 1999. To view the *Notice* and/or for further investor information on margin accounts, visit the NASD Regulation Web Site, www.nasdr.com.

NASD Regulation oversees all U.S. stockbrokers and brokerage firms. NASD Regulation and the Nasdaq-Amex Market Group are subsidiaries of the National Association of Securities Dealers, Inc., the largest securities-industry self-regulatory organization in the United States.

For more information on NASD Regulation, visit the Web Site at www.nasdr.com.

Special NASD Notice to Members 99-33

NASD Regulation Advises Members About Maintenance Margin Requirements For Certain Volatile Stocks And Solicits Comment On Margin Practices; Comment Period Expires May 31, 1999

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☒ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☒ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☒ Registered Representatives
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☒ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

During the past several months, many stocks, particularly of companies that sell products or services via the Internet (Internet issuers), have experienced sharp increases in both price volatility and trading volume. These extreme market conditions raise concerns regarding the use of margin accounts by individuals to trade volatile stocks. NASD Regulation, Inc. (NASD Regulation) is issuing this *Special Notice* to provide members, as well as investors, with information about current margin requirements and steps taken by the industry to increase maintenance margin requirements for certain volatile stocks. This *Special Notice* also solicits comment from members and other interested parties on issues relating to the use of margin during volatile market conditions, as well as the use of margin by individuals engaging in day-trading activities.

In a companion *Special Notice to Members* issued today, *Special Notice to Members 99-32*, NASD Regulation solicits comment on two proposed rules that would require a member that has recommended a day-trading strategy to an individual to approve the individual's account for day trading, including determining that the strategy is appropriate for the individual, and to deliver a disclosure statement on the risks of day trading.

Questions concerning this *Special Notice* may be directed to Patrice M. Glieniecki, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8014.

Discussion

In recent months, there has been a sharp increase in the price volatility of many stocks, particularly those of Internet issuers. This volatility in price has been coupled with record trading volumes in many of these stocks. While many factors have contributed

to the development of these market conditions, one significant factor is the role played by rapid advances in technology, which have provided customers with easier and less costly access to the securities markets. Customers are now able to trade their accounts far more actively than in the past, and members are often flooded with customer orders for certain individual stocks or groups of stocks (e.g., stocks of Internet issuers).

To address concerns raised by current market conditions, NASD Regulation recently issued *Notice to Members 99-11*, which suggests disclosures that firms can make to educate customers about the risk of price and volume volatility, and discusses steps that have been taken by some firms to respond to this volatility.¹ In a companion *Notice to Members, Notice to Members 99-12*, NASD Regulation provided guidance to firms on the operation of their order execution systems and procedures during extreme market conditions.²

As volatile market conditions continue, questions are raised regarding the risks posed to firms and to investors, and the relationship of margin to those risks. A sudden change in the market value of a security may result in an unexpected margin call, and a customer's failure to meet the call may cause the firm to liquidate the securities in the account. The financial consequences of a margin call or an account liquidation may be most severe to customers with small accounts, and small accounts may be more likely to be subject to liquidation. In addition, the forced sale of securities in margin accounts may further contribute to volatility.

Questions regarding investor protection and disclosure practices also arise as firms become involved

in the extension of credit between customers. In some instances, customers are making loans to other customers to finance securities trades, and some customers are guaranteeing each other's margin accounts. Member firms sometimes arrange for these loans or guarantees between customers or arrange loans for customers from other sources. Customers incur additional finance charges when credit is arranged, and they face additional credit risks when they extend credit to other customers.

Discussions with firms about their responses to volatility indicate that many firms have adopted special procedures with respect to margin. For instance, as further detailed below, many firms have increased maintenance margin requirements for selected groups of highly volatile stocks.³ However, with markets at historically high levels, concerns remain with the amount of funds that customers are borrowing to trade securities, and the manner in which credit is being extended by various sources. Accordingly, this *Special Notice* discusses current margin requirements and certain firm practices when extending credit to customers, and solicits comment on these important issues.⁴

Current Margin Requirements

Federal Reserve Board Regulation T governs the extension of credit to customers by broker/dealers and includes provisions concerning the initial margin requirements for most types of securities transactions. In general, Regulation T requires 50 percent initial margin for long purchases of marginable equity securities. In addition, Regulation T requires 150 percent margin for short sales of equity securities, of which 100 percent can be from sales proceeds.

National Association of Securities Dealers, Inc. (NASD)⁵ Rule 2520 imposes additional margin requirements on customer accounts.⁶ Rule 2520 generally requires maintenance margin of 25 percent of the current market value for all long positions in marginable equity securities, meaning that the equity must not fall below 25 percent of the current market value of the securities in the account. For a short securities position where the stock sells at \$5 per share or above, Rule 2520 requires maintenance margin of \$5 per share or 30 percent of the current market value of the stock, whichever amount is greater. In addition, for a short securities position where the stock sells at less than \$5 per share, a customer must maintain margin of \$2.50 per share or 100 percent of the current market value, whichever amount is greater. Where the same security is carried long and short by the same customer, Rule 2520 permits maintenance margin of five percent of the current market value of the long security.

Rule 2520 also permits customers to guarantee each other's accounts for maintenance margin purposes.⁶ In cross-guaranteed accounts, the amount of maintenance margin excess in one account may be used to offset a maintenance margin deficit in the other cross-guaranteed account. In addition, if the cross-guaranteed accounts are long and short the same securities, including the same number of shares, the maintenance margin requirement on the combined positions is five percent. Day trading is also recognized by Rule 2520 through the definitions of "day-trading," "day-trader," and certain specified margin requirements.⁷ Under these provisions, a day trader may need to deposit additional equity in his or her account to satisfy a day-trade margin call.

Members also may establish their own margin requirements (referred to as "house" requirements), provided that they are at least as stringent as the requirements under Regulation T and Rule 2520. Members also may temporarily raise their margin requirements in response to market conditions.

Increased Maintenance Margin

In light of current market conditions, some members have elected to increase their maintenance margin requirements for certain volatile stocks to help ensure that the equity in each customer account is sufficient to cover the large swings in the price of the stocks. In general, the firms have increased the amount of equity that must be maintained in margin accounts for long positions in these stocks to between 40 percent and 100 percent. In addition, the firms often have raised their maintenance margin requirements on short positions to an even greater degree than on long positions.

Identifying Stocks For Increased Maintenance Margin

Firms have considered a variety of parameters in identifying the stocks that will be subject to increased maintenance margin requirements. A particularly useful approach is to calculate the volatility of the stock and impose more stringent requirements on stocks that are highly volatile. In this context, one appropriate way to measure volatility is to calculate the standard deviation of the relative daily return of a given stock over a specified time period, such as three months (which would capture an entire quarterly earnings cycle).⁸

Firms also may identify stocks for more stringent maintenance margin requirements by reviewing customer accounts to assess trading activity in a particular stock, as well as the firm's aggregate risk exposure to the

stock. This type of analysis should be performed in conjunction with calculating the volatility of the stock. Other factors firms may consider in reviewing their margin requirements during extraordinary market conditions include price fluctuations (such as a recent sharp rise or decline in price), the degree to which trading in a stock is concentrated in a small number of Market Makers, or an issuer's market capitalization or industrial code classification. Firms also have indicated that they regularly review and, where appropriate, revise the lists of stocks that are subject to increased maintenance margin requirements.

NASD Regulation believes that increasing the maintenance margin requirements to be applied to certain stocks is an appropriate response to extreme volatility in those stocks. Discussions with firms have indicated that customers generally have not been transferring their accounts to other firms in response to increased margin requirements for volatile stocks. In this regard, NASD Regulation believes that a firm's decision to adopt such measures should not be influenced by the possible short-term competitive effects. Moreover, NASD Regulation will continue to monitor actions taken by members to adjust maintenance margin requirements in response to market volatility, and the effects of those actions, to determine whether changes to NASD rules may be warranted.

Disclosure Of Credit Terms To Customers

In reviewing margin procedures, firms also should confirm that they are providing appropriate disclosure of credit terms to customers with margin accounts. Under the federal securities laws, brokers that extend

credit to customers to finance securities transactions are required to furnish, in writing, specified information regarding the terms of the loan.⁹

These disclosures must be made on both an initial and periodic basis. For instance, at the time a customer opens a margin account, a broker 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. These initial disclosures help to ensure that the customer understands the terms and conditions of the margin loan and allow the customer to compare available credit terms.¹⁰ A firm also is required to provide periodic (at least quarterly) written statements to the customer, which disclose such information as opening and closing balances, total interest charges, and other charges resulting from the extension of credit.

Request For Comment

NASD Regulation encourages members and other interested parties to comment on the issues discussed in this *Special Notice*, including whether adjusting NASD margin requirements for certain stocks is an appropriate means of addressing volatility in the securities markets. In addition, we seek comment on the following issues:

1. Should margin requirements applicable to a securities transaction or account differ based on the size of a customer's account? In particular, should margin requirements be more stringent for small accounts, given that the financial consequences of a margin call to the holder of a small account may be more severe? If so, should there be any exemptions to

such a heightened margin requirement for small accounts? What would be an appropriate definition of "small account"?

2. Should margin requirements be linked to volatility? If so, how should this approach work?

3. Should the ability of customers to guarantee each other's accounts for maintenance margin purposes be eliminated or restricted? For instance, should rules require that cross-guaranteed accounts be owned or controlled by the same customer in order to receive special maintenance margin treatment? What would be the effect of any such revisions? Should the five percent maintenance margin treatment for perfectly offsetting long and short positions between cross-guaranteed accounts be eliminated or revised?

4. How important is margin to day-trading activities? Are the current margin requirements applicable to day-trading accounts appropriate? If not, how should the current requirements be revised?

5. Should customers be required to make margin deposits during the day in order to account for intra-day risk exposure? If so, what should those margin requirements be, and should margin deposits be made prior to additional trading taking place?

6. Are customers receiving adequate disclosure of the credit terms of margin transactions? When a firm arranges loans for customers from other sources, are customers receiving adequate disclosure of the credit terms of the loans? Are the persons or entities making the loans receiving adequate disclosure of the risks and terms of the loans?

Comments should be mailed to:

Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com

Important Note: The only comments that will be considered are those submitted in writing or via e-mail.

Comments must be received no later than **May 31, 1999**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission.

Endnotes

¹NASD Notice to Members 99-11, NASD Regulation Issues Guidance Regarding Stock Volatility (Feb. 1999).

²NASD Notice to Members 99-12, NASD Regulation Issues Guidance Concerning The Operation Of Automated Order Execution Systems During Turbulent Market Conditions (Feb. 1999).

³See NASD Notice to Members 99-11 (Feb. 1999) for additional discussion of margin requirements for volatile stocks.

⁴NASD Regulation also recently issued investor guidance on the use of margin accounts and the risks involved with trading securities on margin. See NASD Regulation's Web Site at www.nasdr.com.

⁵While often thought of as a "maintenance" margin rule, Rule 2520 also contains initial margin requirements. Initial margin is the greater of the amount specified in Regulation T or the maintenance margin specified in Rule 2520.

⁶See NASD Notice to Members 98-102, Calculating Margin For Day-Trading And Cross-Guaranteed Accounts (Dec. 1998), for further discussion of margin requirements for cross-guaranteed accounts. When calculating Regulation T margin, cross guarantees have no effect.

⁷See *id.* for further discussion of margin requirements for day-trading accounts.

⁸The relative daily return of a stock can be derived from the closing price (or the bid-ask mid-point) of an issue each day during the specified time period. Using the closing price, the daily relative return would be the percent price change between the most recent closing price and the previous day's closing price. For example, a stock that closes at \$10 on Monday and at \$11 on Tuesday has a relative daily return for Tuesday of 10 percent. Once this daily relative return has been calculated for each of the trading days during the specified time period, a firm can calculate the standard deviation (or dispersion) of these returns to determine the volatility of the issue.

⁹See Rule 10b-16 under the Securities Exchange Act of 1934. Brokers also are subject to the general anti-fraud provisions of the federal securities laws.

¹⁰See Securities Exchange Act Release No. 8773 (Dec. 8, 1969) (adopting Rule 10b-16).

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NASD Regulation Press Release - 1/26/99



NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Press Release

For Release: Tuesday, January 26, 1999
Media Contact: Nancy A. Condon
(202) 728-8379

NASD Issues Guidance to Brokerage Firms Regarding Sales Practices and Order Execution During Turbulent Market Conditions

Washington, D.C.—NASD Regulation, Inc., today issued two *Notices to Members* of the National Association of Securities Dealers, Inc. (NASD®) addressing the recent turbulent market conditions. Recent increased volatility and volume present new issues for investors, regardless of the method of trading. In *Notice to Members 99-11*, NASD Regulation suggests disclosures that brokerage firms should make to investors to educate them about the risks of price and volume volatility. *Notice to Members 99-12* provides firms with guidance on the operation of their order execution systems and procedures during extreme market conditions. A companion bulletin for investors is available on the NASD Regulation Web site www.nasdr.com.

Notice to Members 99-11 encourages firms to ensure that investors are knowledgeable about firm procedures for handling securities transactions during volatile market conditions. NASD Regulation has suggested disclosures that firms should consider making to educate investors:

- **Delays.** Firms should consider disclosing that high volumes of trading at market opening and at various points during the day may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was entered. This disclosure is particularly important to investors who have come to expect quick executions at or near the quotes displayed on their computer screens and may not understand that Market Makers may execute orders manually or reduce their size guarantees during periods of volatility, possibly resulting in delays in order execution and losses.
- **Types of Orders.** Firms should consider explaining, in detail, the differences between market and limit orders and the benefits and risks of each. It is important for investors to understand that firms are required to execute a market order fully and promptly without regard to price. That execution may be at a price significantly different from the current price quoted for the security. Limit orders are executed only at a specified price or better and while the investor receives price protection, there is the possibility that the order may not be executed.

Firms should consider additional disclosure for customers who place market orders for initial public offerings (IPOs) — particularly those trading at a price significantly higher than their offering price or in 'hot stocks', those that have recently traded under 'fast market' conditions in which the price changes so quickly that quotes for the stock cannot keep pace with its trading price.

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- **Access.** Firms should consider alerting investors that there may be periods of time when they may be unable to access their accounts due to high volume. Customers trading through on-line accounts may have difficulty accessing their accounts due to high Internet traffic or because of systems capacity limitations. Customers trading through brokers at full-service or discount firms or through representatives of on-line firms when on-line trading has been disabled or is not available may have difficulty reaching account representatives on the telephone during periods of high volume. Firms should make investors aware that they may suffer losses during periods of volatility due to delays in effecting buy and sell orders. They should also explain their procedures for responding to these access problems.
- **Communications with the Public.** When on-line trading firms use advertisements or sales literature to make claims about the speed and reliability of their services, they may not exaggerate the firm's capabilities or omit material information about the risks associated with on-line trading and the possibilities of delayed executions. These broker/dealers should have the systems capacity to support any claims they make about their trading services.

The *Notice* also describes a number of steps broker/dealers have taken to respond to volatility. These procedures, when clearly disclosed to customers, may be appropriate responses to price and volume volatility.

Notice to Members 99-12 provides broker/dealers guidance concerning the operation of their order execution systems and procedures for handling customer orders and obtaining best execution for them in light of the recent dramatic intraday volatility and surges in trading volume. 'Best execution' is the obligation of broker/dealers, Market Makers, and others to execute customer orders at the best prevailing market price.

Recent market conditions have raised questions about the proper handling of customer orders and resulted in requests for guidance on best execution under these market conditions. Under non-turbulent market conditions, order execution systems should be designed to process and execute a reasonably anticipated order volume in an efficient, fair, and consistent manner. During extreme market conditions, when large order imbalances and price volatility may result, many firms implement procedures that are designed to preserve uninterrupted execution of customers' orders while lessening the firms' exposure to extraordinary market risk.

NASD Regulation has indicated that firms should consider the following when evaluating whether order execution procedures are appropriate during turbulent market conditions:

- Procedures for handling of customer orders must be fair, consistent, and reasonable.
- Disclosure to customers (and order entry firms) should be made when the firm's order execution procedures differ during turbulent market conditions. Disclosing alternative order procedures, however, does not insulate the broker/dealer from potential best execution violations – the alternative procedures must also be fair.
- Modified order execution procedures should be implemented only when warranted by market conditions. Firms are required to document the basis for activating alternative procedures.
- The SEC has stated that firms must take steps to prevent their systems from being overwhelmed during periodic spikes in systems 'message traffic' due to high volume so that they are equipped to handle exceptional loads. Best execution concerns may

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be raised if a firm frequently activates alternative order execution procedures to compensate for inadequate systems.

- To the extent that broker/dealers execute orders manually during extreme market conditions, firms are reminded that NASD rules provide that failure to adequately staff an order execution department is not justification for "executing away from the best available market".

Both *Notices to Member, 99-11* and *99-12*, can be viewed in full via the NASD Regulation Web site, www.nasdr.com.

NASD Regulation oversees all U.S. stockbrokers and brokerage firms. NASD Regulation, along with The Nasdaq-Amex Market Group, are subsidiaries of the National Association of Securities Dealers, Inc. (NASD®), the largest securities-industry self-regulatory organization in the United States.

NASD Notice to Members 98-102

Calculating Margin For Day-Trading And Cross- Guaranteed Accounts

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☐ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☒ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☐ Registered Representatives
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

Federal Reserve Board Regulation T governs the extension of credit to customers by broker/dealers. Among the provisions of Regulation T are requirements governing the initial margin requirements for certain securities transactions. In addition, National Association of Securities Dealers, Inc. (NASD*) Rule 2520 requires NASD members to impose additional margin requirements on customer accounts.¹ The purpose of this *Notice* is to communicate the opinion of the NASD on the margin requirements under Regulation T and Rule 2520 for day-trading and cross-guaranteed accounts with the expectation that members will calculate margin for such accounts in a manner that is consistent with Regulation T and Rule 2520.

The NASD believes that some members are calculating margin for day-traders and cross-guaranteed accounts in a manner that is not consistent with the requirements of Regulation T and Rule 2520. Accordingly, members are advised to review their margin calculation practices to ensure that they conform to the requirements of these rules. Adherence to the margin requirements is in the best interest of the investing public and serves to protect the financial security of members that extend credit.

Finally, the NASD believes that some members may be failing to take certain account-related charges when computing their net capital pursuant to Securities and Exchange Commission (SEC) Rule 15c3-1. These charges include those specified in Rule 2520(f)(4) for certain guaranteed accounts. Members should review the requirements of SEC Rule 15c3-1 and Rule 2520 to determine whether they are in compliance with these rules.

Members should be aware that the NASD believes compliance with the

margin and net capital requirements is of paramount importance and intends to examine member firms for compliance with these rules.

Questions concerning this *Notice* may be directed to Samuel Luque, Associate Director, Member Regulation, NASD Regulation, Inc. (NASD Regulation™), at (202) 728-8472, or Susan DeMando, Regional Compliance Supervisor, Member Regulation, NASD Regulation, at (202) 728-8411.

Discussion

This *Notice* addresses some of the most frequently asked questions regarding the application of Regulation T and Rule 2520 to day-trading and cross-guaranteed accounts. In addition, this *Notice* addresses only common scenarios and questions relating to marginable equity securities and is not meant to be a complete discussion of the application of Regulation T and Rule 2520 to all possible trading strategies utilized by day-trading and/or cross-guaranteed accounts.

In order to clarify member understanding of the requirements relating to day-trading and cross-guaranteed accounts, highlighted below in plain English are some of the fundamental requirements and provisions of these rules.

General

• Members must perform two separate margin calculations for each account each day; one for Regulation T and one for Rule 2520. The calculations should be performed at the end of each trade date; intra-day calculations are not permitted. Members must comply with the requirements of both rules at all times.

• "Day-trading" means buying and selling the same security on the same day. A "day-trader" is any cus-

former whose trading shows a pattern of day-trading (see Rule 2520(f)(8)(B)). (See also the Securities Industry Association's *Credit Division Manual's* definition of "day-trading" as "selling first and then repurchasing" the same security on the same day.)

- Day-trades should occur only in margin accounts. Day-trading in a cash account may amount to free riding (*i.e.*, purchasing a security and then selling it without having paid for the purchase).

- Regulation T requires initial margin of 50 percent for new purchases and 150 percent for short sales (of which 100 percent can come from the proceeds of the short sale, with the customer depositing the remaining 50 percent). (See Regulation T, Sections 220.12(a) and (c)(1).)

- Rule 2520 requires maintenance margin of 25 percent of the current market value for all long positions, and \$5 per share or 30 percent of the current market value, whichever amount is greater, of each stock "short" in the account selling at \$5 per share or above (see Rule 2520(c)(1) and (c)(3)). *If a customer's account is both "long" and "short" the same security, Rule 2520(e)(1) requires five percent maintenance margin of the current market value of the long security. The short position must be marked to the market.*

- If two accounts are cross-guaranteed and one is long the same security that the other is short the same number of securities, the maintenance margin requirement on the combined positions is five percent. This five percent maintenance margin requirement in no way eliminates the requirement to comply with the initial margin requirements of Regulation T on the original purchase and short sale.

- When calculating Regulation T margin, cross guarantees have *no* effect (see Regulation T, Section 3(d)). Therefore, members must apply Regulation T to each account separately, notwithstanding the fact that Rule 2520 permits certain special maintenance margin treatment for transactions in cross-guaranteed accounts.

- Rule 2520(f)(4) permits cross guarantees for maintenance margin purposes so that the amount of maintenance margin excess in one account may be used to offset a maintenance margin deficit in the other cross-guaranteed account. In any given situation, the account with the maintenance margin excess is considered the guaranteeing account and the account with the maintenance margin deficit is considered the guaranteed account.

- The fact that Regulation T margin is calculated at the end of the business day only does not mean that broker/dealers can disregard intra-day risk. Reliance on the proceeds of anticipated sales to pay for purchases exposes the broker/dealer to risk.

Regulation T

- Margin is required for each long or short securities position unless an exception or special provision is available (see Regulation T, Section 4(b)). The required margin is set forth in Section 12 (the Supplement).

- Regulation T margin is calculated at the end of the business day. All transactions on the same day are combined to determine the Regulation T requirement. Therefore, Regulation T does not distinguish between day-trading and other forms of trading (see Regulation T, Section 4(c)(1)).

- A Regulation T margin requirement may be satisfied by a transfer from

the Special Memorandum Account (SMA), or by a deposit of cash, margin securities, or exempted securities, in any combination (see Regulation T, Section 4(c)(2)).

- Regulation T treats a short sale "against the box" as a long sale (see Regulation T, Section 4(b)(2)). As a result, there is no Regulation T requirement on the transaction; however, Rule 2520(e)(1) imposes a five percent margin requirement on the market value of the long position and requires the short position to be marked to the market.

- A sale cannot be treated as a short sale "against the box," nor can it be treated as a long sale, if the account making the sale is not long the same number of shares of the same security, even if another cross-guaranteeing account is long the security. Because cross guarantees have no effect under Regulation T, the fact that another cross-guaranteeing account is long the security is meaningless for Regulation T purposes and the sale must be regarded as a short sale subject to a margin requirement of 150 percent (see Regulation T, Section 12(c)(1)).

- Regulation T has no margin requirements for day-trading *per se*. Regulation T margin is calculated on the position in the account at the end of the day. Therefore, if a day-trader engages in numerous day-trades throughout the day, but ends the day with no securities position, Regulation T requires margin equal to the net loss in the account at the end of the day. A Regulation T call must be issued for the entire amount of the loss. The call may be met by a deposit of cash or securities (margin or exempted), a transfer from SMA, or any combination (see Regulation T, Section 4(c)(2)).

Rule 2520

• While often thought of as a "maintenance" margin rule, Rule 2520 also contains initial margin requirements (see paragraph (b)). Initial margin is always the greater of the amount specified in Regulation T or the maintenance margin specified in paragraph (c). This requirement applies to both non day-traders (see paragraph (B)) and day-traders (see paragraph (f)(8)(B)).

• Rule 2520 was created to work in tandem with Regulation T. Therefore, because Regulation T calculations are made only at the end of the day, Rule 2520 maintenance margin calculations must be made only at the end of the day.

Although firms may calculate margin intra-day for risk assessment and risk avoidance purposes, and may impose margin calls based on such intra-day calculations, members may not grant additional buying power² to a customer on the basis of such intra-day calculations. Buying power may only be based on the preceding day's end-of-the-day margin calculations.

• A maintenance margin call may be satisfied by a deposit of cash, margin securities, or exempted securities, in any combination. A maintenance margin call *may not* be satisfied by a transfer from the SMA.

• Rule 2520(f)(4) permits special margin treatment for transactions in cross-guaranteed accounts if certain conditions are met. Since Regulation T does not recognize cross guarantees, nothing in Rule 2520 is intended to grant guaranteed accounts any benefit that would circumvent the provisions of Regulation T.

• Day-trading is recognized by Rule 2520 through the definitions of "day-trading," "day-trader" and the margin

requirements specified in Rule 2520 (f)(8)(B). The paragraph states:

Whenever day-trading occurs in a customer's margin account the margin to be maintained shall be the margin on the "long" or "short" transaction, whichever occurred first, as required pursuant to the other provisions of this Rule. When day-trading occurs in the account of a "day-trader" the margin to be maintained shall be the margin on the "long" or "short" transaction, whichever occurred first, as required by Regulation T of the Board of Governors of the Federal Reserve System or as required pursuant to the other provisions of this Rule, whichever amount is greater.

**Questions And Answers
Relating To The Calculation Of
Initial And Maintenance
Margin On Day-Trading And
Cross-Guaranteed Accounts**

For the purpose of the illustrations contained in this *Notice*, the examples assume: 1) that the securities discussed are marginable equity securities; 2) that unless otherwise noted the maintenance margin requirement on short transactions is 30 percent of the current market value of the security; 3) the customer intends to meet his/her requirement with a deposit of cash; and 4) that each of the customers has a history of day-trading, whether or not the trades in a specific example are day-trades.

1.

Q. Customer A and Customer B cross guarantee each other's accounts. Customer A buys \$1,000,000 of securities on Day 1 and is long the securities at the end of the day. Customer B sells short

\$1,000,000 of different securities on Day 1 and is short the securities at the end of the day. What are the Regulation T and maintenance margin requirements for each customer?

A. Since Regulation T does not acknowledge the existence of the cross guarantee, Regulation T would require Customer A to put up margin of 50 percent or \$500,000 in payment for the securities purchased in Customer A's account (see Regulation T, Section 220.12(a)). Regulation T would require Customer B to put up margin of 150 percent or \$1,500,000 in payment for the securities sold short in Customer B's account, of which \$1,000,000 could come from the proceeds of the short sale (see Regulation T, Section 220.12(c)(1)).

Rule 2520 requires maintenance margin for Customer A of \$250,000 (25 percent of the market value long and maintenance margin for Customer B of \$300,000 (30 percent of the market value short). (See Rule 2520, paragraphs (c)(1) and (c)(3) respectively.)

2.

Q. Considering the facts in Question 1 again, would the answer be different if the securities bought by Customer A and sold short by Customer B were the same securities, i.e., because of the cross guarantee the accounts were fully hedged?

A. Again, since Regulation T does not acknowledge the existence of the cross guarantee, Regulation T would require Customer A to put up margin of 50 percent or \$500,000 in payment for the securities purchased in Customer A's account (see Regulation T, Section 220.12(a)). Regulation T would require Customer B to put up margin of 150 percent or \$1,500,000 in payment for the securities sold short in Customer B's

account, of which \$1,000,000 could come from the proceeds of the short sale (see Regulation T, Section 220.12(c)(1)).

Rule 2520 (e)(1) permits maintenance margin of five percent of the current market value of the long securities for "Offsetting 'Long' and 'Short' Positions" where the same security is carried long and short for the same customer. Given the existence of the cross guarantee, Rule 2520(f)(4) allows any account guaranteed by another account to be consolidated with the other account, and the margin to be maintained may be determined on the net positions on both accounts. In this case, since Customer A and Customer B are long and short the same securities, and since they cross guarantee each other's accounts, they may utilize the five percent maintenance margin requirement outlined in paragraph (e)(1) on the offsetting positions. Therefore, the required maintenance margin for the combined position would be \$50,000.

3.

Q. On Day 1, Customer C purchases \$400,000 of securities. The Regulation T margin required is \$200,000. The customer deposits \$250,000 cash in the account and, as a result, has received a margin loan of \$150,000 from the broker/dealer to complete the transaction. What is the customer's Regulation T buying power for Day 2? What is the customer's day-trading buying power for Day 2?

A. Going into Day 2, Customer C has Regulation T buying power of \$100,000 because the previous day's Regulation T excess of \$50,000 would provide \$100,000 in buying power. Thus, if Customer C purchases securities on Day 2 that he does not sell on Day 2, he can make such purchases up to

\$100,000 without incurring a Regulation T call. Buying power is calculated as follows: $(\$250,000 - (\$400,000 \times 50\%)) \times 2 = \$100,000$.

Going into Day 2, the customer has day-trading buying power of \$300,000 because the maintenance margin excess of \$150,000 provides day-trading buying power of \$300,000. If Customer C purchases securities on Day 2 which he subsequently sells on Day 2, i.e., he engages in day-trading, he can make such purchases up to \$300,000 without incurring a day-trading call. This is calculated as follows: $(\$250,000 - (\$400,000 \times 25\%)) \times 2 = \$300,000$.

The above answer presumes Customer C did not incur a loss on the day-trades (i.e., made a profit or broke even). If Customer C were to buy \$300,000 of securities and sell them the same day for \$280,000, he would have a Regulation T call for \$20,000, or 100 percent of the loss. Regulation T requires additional margin when a transaction creates or increases a margin deficiency in an amount equal to the deficiency created or increased (see Regulation T, Section 220.4(c)(1)).

4.

Q. Customer D makes one purchase for \$2,000,000 in the morning of Day 1 and then sells the securities at a profit in the afternoon of Day 1 for the same account ending the day with no securities position. What is the customer's margin requirement?

A. Regulation T margin is calculated on the end of the day position. Because the customer has no securities position at the end of the day, and did not incur a loss, there is no Regulation T requirement. However, there is a required day-trading maintenance margin requirement of \$1,000,000. The margin call would be classified as a Rule 2520 Call (not

a Regulation T call) since it is Rule 2520 (b) that sets the margin for the trade.

5.

Q. On Day 1, Customer E buys 100 ABCD at \$88 in an existing margin account that has no SMA, and deposits \$4,400, which is the Regulation T requirement, into the account. She carries the position over into Day 2. On Day 2, she sells 100 ABCD at \$89 at 11 a.m. What is impact of the sale on the customer's Regulation T buying power or day-trading buying power for the remainder of Day 2?

A. Going into Day 2, the customer has zero Regulation T buying power since she deposited the exact amount of the Regulation T requirement into her account on Day 1, i.e., $\$8,800 \times 50\% = \$4,400$. Per Regulation T, Section 220.4(c)(1), buying power for Day 2 is based on the status of the account at the end of Day 1. Intra-day sales on Day 2 cannot be used to increase Regulation T buying power for Day 2. Therefore, Customer E's Regulation T buying power for Day 2 remains at zero, irrespective of the sale on Day 2.

Going into Day 2, the customer has day-trading buying power of \$4,400. If Customer E chooses to purchase securities on Day 2 that she subsequently sells on Day 2, i.e., she engages in day-trading, she can make such purchases up to \$4,400 without incurring a day-trading call. This is calculated as follows: $(\$4,400 - (\$8,800 \times 25\%)) \times 2 = \$4,400$. The customer's day-trading buying power is set at \$4,400 for Day 2. It can not be adjusted by intra-day activity.

6.

Q. On Day 1, Customer F has an account containing equity securities with a market value of \$100,000, a

debit balance of \$70,000, equity of \$30,000, and maintenance margin excess of \$5,000. On Day 2, the customer purchases \$100,000 in equity securities and later in the same day sells them for \$105,000. What is the Regulation T requirement for Day 2?

A. Regulation T margin is calculated on the end of the day position. Since the customer has no securities position at the end of Day 2 resulting from Day 2 transactions and earned a profit on the sale, there is no Regulation T requirement for Day 2.

However, there is a Rule 2520 requirement. Going into Day 2, the customer may use the maintenance margin excess carried over from Day 1 to day-trade additional securities.

Customer F has a maintenance margin excess of \$5,000 (\$30,000 - (\$100,000 x 25%)). She could use this excess to day-trade \$10,000 (\$5,000 x 2) in equity securities on Day 2 without having to deposit any additional margin as long as she incurs no loss (*i.e.*, she makes a profit or breaks even) on the Day 2 day-trades. Taking the above into account, the customer should receive a Rule 2520 day-trading margin call of \$45,000 representing half of the purchase price not covered by the day-trading buying power.

Endnotes

¹Several years ago, the NASD amended Rule 2520 to make it substantially the same as New York Stock Exchange (NYSE) Rule

431, including paragraph numbering. Thus, for example, paragraph 2520(f)(4) is the same as NYSE Rule 431(f)(4). The NASD has also customized Rule 2520 in a few places in recognition of certain differences between the NASD and NYSE in rules, jurisdiction, and market structure. Members should be familiar with the requirements of either NASD Rule 2520 or NYSE Rule 431, depending upon which one applies to them.

²Buying power - either Regulation T or day-trading - represents the dollar value of securities that can be purchased with a given amount of Regulation T or maintenance margin excess respectively (usually twice the amount of the excess).

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NASD Notice to Members 99-12

NASD Regulation Issues
Guidance Concerning
The Operation Of
Automated Order
Execution Systems
During Turbulent Market
Conditions

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☒ Executive Representatives
- ☐ Government Securities
- ☒ Institutional
- ☐ Insurance
- ☒ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☒ Registered Representatives
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☒ Systems
- ☒ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

In light of the recent dramatic intraday volatility and significant surges in trading volume with respect to certain issues traded on The Nasdaq Stock Market, Inc. ("Nasdaq"), particularly Internet-based issues, NASD Regulation, Inc. ("NASD Regulation") is issuing this *Notice to Members* to provide members guidance concerning the operation of their order execution systems and procedures during extreme market conditions. In sum, while National Association of Securities Dealers, Inc. ("NASD") and Securities and Exchange Commission (SEC) rules and regulations do not specify or mandate a particular order execution algorithm or procedure for the execution of customer orders (aside from requirements imposed by the NASD's limit order protection interpretation), NASD Regulation believes that members' best execution obligations require that such algorithms and procedures treat customer orders in a fair, consistent, and reasonable manner. In addition, to the extent that members (particularly wholesale firms) deviate from or alter their execution algorithms or procedures during turbulent market conditions, NASD Regulation believes that firms should consider disclosing such altered procedures and the basis for activating such altered procedures to their customers and firms sending them order flow.¹

Questions or comments concerning this *Notice* may be directed to the Legal Section of NASD Regulation's Market Regulation Department, at (301) 590-6410.

Discussion

The recent extraordinary volatility and volume in particular stocks, particularly Internet-based stocks, has led to questions as to whether customer orders in these stocks are han-

dled properly, and requests for guidance on best execution under these circumstances. In a companion *Notice to Members* issued today, *Notice to Members 99-11*, NASD Regulation is providing guidance to firms that deal directly with customers with respect to disclosure firms should consider making to inform investors of the increased risks associated with trading during turbulent market conditions. *Notice to Members 99-11* also lists some of the steps on-line firms have taken to respond to volatility. With this *Notice*, NASD Regulation is providing guidance as to the factors Market Makers should consider in evaluating whether modifications to their order execution algorithms or procedures during turbulent market conditions are consistent with the best execution of customer orders.

Given the high trade volume and share volume of the Nasdaq market, as well as competitive pressures to provide swift executions, wholesale firms (*i.e.*, those firms that principally execute orders routed to them from other firms) and integrated firms (*i.e.*, firms with a large retail business that also engage in market making and other activities) have developed their own automated order execution systems for smaller customer orders, generally 3,000 shares or less. During non-turbulent market conditions, these systems, which are by no means uniform, typically execute orders on a first-in-first-out basis and afford priced orders priority on a price/time basis, in addition to complying with applicable SEC and NASD rules, such as the SEC's limit order display rule and the NASD's limit order protection rule. As a general matter, these systems should be designed to process and execute orders during non-turbulent market conditions in a fair, consistent, and reasonable manner and have a capacity that is adequate to handle reasonably anticipated trading volume in an efficient manner.

During extreme market conditions, where there are large order imbalances and/or significant price volatility, however, many firms implement procedures that are designed to preserve the continuous execution of customers' orders while also lessening the exposure of the firm to extraordinary market risk. For example, some firms switch from an automated order execution mode to a manual execution mode in which orders are generally routed through SelectNet™ to execute against another Market Maker, passing on those prices to the customer. Other firms provide partial executions up to a certain size and, if applicable, place the remainder of the order in a queue that is then processed on a first-in-first-out basis.² These are but two examples of the procedures firms have adopted during extreme market conditions and are not intended to reflect preferred procedures.

Some firms have asked NASD Regulation whether their procedures during extreme market conditions are consistent with the best execution of customer orders. Accordingly, NASD Regulation is issuing this *Notice* to provide guidance in this area. Specifically, NASD Regulation believes firms should consider the following guidelines when evaluating whether their order execution algorithms or procedures are appropriate during turbulent market conditions. Nothing in the following guidelines is intended to suggest that firms are restricted from revising their execution algorithms for business reasons unrelated to market turbulence.

1. The treatment of customer orders under any order execution algorithm or procedure must remain fair, consistent, and reasonable.

2. To the extent that a firm's order execution algorithm or procedures are different during turbulent market conditions, the firm should disclose to its order entry firms (and customers if applicable) the differences in the procedures from normal market conditions and the circumstances in which the firm may generally activate these procedures. In this connection, however, NASD Regulation notes that the disclosure of alternative order handling procedures that are unfair or otherwise inconsistent with the firm's best execution obligations would neither correct the deficiencies with such procedures nor absolve the firm of potential best execution violations.

3. Modifications to order execution algorithms or procedures designed to respond to turbulent market conditions may be implemented only when warranted by market conditions. Excessive activation of modified procedures on the grounds of turbulent market conditions could raise best execution concerns. Accordingly, firms should document the basis for activation of their modified procedures.

4. As noted above, and as the SEC has stated, "[b]roker-dealers therefore need to take steps to prevent their operational systems from being overwhelmed by periodic spikes in systems message traffic due to high volume. In particular, broker-dealers should not merely have sufficient systems capacity to handle average-to-heavy loads."³ Frequent activation of modified order execution algorithms or procedures because a firm has failed to maintain adequate system capacity to

handle exceptional loads may raise best execution concerns.

5. To the extent firms execute orders manually during extreme market conditions, NASD Regulation reminds firms that NASD Rule 2320(d) provides that "[f]ailure to maintain or adequately staff an over-the-counter order room or other department assigned to execute customers' orders cannot be considered justification for executing away from the best available market"

Ultimately, it necessarily involves a facts and circumstances analysis to determine whether actions taken by a firm during turbulent market conditions are consistent with the duty of best execution. Accordingly, NASD Regulation cannot provide specific guidance that a particular order execution algorithm or order handling procedure during turbulent market conditions is always consistent with best execution. Nevertheless, NASD Regulation believes the guidelines set forth above provide useful direction for firms.

Endnotes

¹Firms that direct order flow likewise have a best execution obligation to conduct regular and rigorous review of the quality of executions of orders sent to correspondent Market Makers.

²Firms also have reduced their size guarantee on individual stocks or groups of stocks (i.e., Internet stocks) on a going-forward basis, irrespective of market conditions at any given time.

³See SEC Staff Legal Bulletin No. 8 (September 9, 1998).

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NASD Notice to Members 99-11

NASD Regulation Issues Guidance Regarding Stock Volatility

Suggested Routing

- ☒ Senior Management
- ☒ Advertising
- ☒ Continuing Education
- ☐ Corporate Finance
- ☒ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☒ Mutual Fund
- ☐ Operations
- ☐ Options
- ☒ Registered Representatives
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☒ Systems
- ☒ Trading
- ☒ Training
- ☐ Variable Contracts

Executive Summary

In recent months, there has been a sharp increase in price volatility and volume in many stocks, particularly of companies that sell products or services via the Internet (Internet issuers). NASD Regulation, Inc. (NASD Regulation[™]) is issuing this *Notice to Members* to suggest disclosures that firms can make to retail customers to educate them about the risks of price and volume volatility. This *Notice* also describes steps taken by some on-line brokers to respond to volatility. A companion *Notice to Members* issued today, *Notice to Members 99-12*, provides members with guidance concerning the operation of their order execution systems and procedures during extreme market conditions.

Questions or comments concerning this *Notice* may be directed to Mary Revell, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8203.

Discussion

Recently, there has been a marked increase in the price volatility of many stocks, particularly those of Internet issuers. This volatility has been coupled with record trading volume in many of these stocks. Customers eager to trade Internet stocks have flooded their brokers with large numbers of orders, leading to large order imbalances, systems queues, and backlogs. During these extreme market conditions, many firms implemented procedures that are designed to preserve the continuous execution of customers' orders while also lessening the exposure of the firm to extraordinary market risk. For example, some Market Maker firms temporarily discontinued normal automatic order executions and handled orders manually. Firms also reduced their size guarantees on individual stocks or groups of stocks (i.e., stocks of Internet issuers) on a going-forward basis. Delays in order

executions and executions at prices significantly away from the market price quoted at the time the order was entered then occurred, which in turn led to market losses caused by executions at prices higher or lower than customers expected, especially with respect to orders placed over the Internet.

First and foremost, NASD Regulation reminds member firms of their obligations under Securities and Exchange Commission (SEC) Staff Legal Bulletin No. 8 to ensure that they have adequate systems capacity to handle high volume or high volatility trading days.¹ In this connection, we note that the SEC staff's position relates to all firms handling orders and is premised on a legal obligation to treat customers fairly.² Second, firms should provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner. This *Notice* describes the types of disclosure we deem appropriate.

We also have spoken to several order entry firms that provide on-line trading services about the steps they are taking to respond to volatility. This *Notice* provides members with information about these steps.³

Disclosure

Recent events show that the way some stocks are traded is changing dramatically, and the change in trading methods may affect price volatility and cause increased trading volume. This price volatility and increased volume present new hazards to investors, regardless of whether trading occurs on-line or otherwise. Firms are reminded that their procedures for handling customer orders must be fair, consistent, and reasonable during volatile market conditions and otherwise. To ensure that cus-

customers are knowledgeable about these procedures, we suggest that all firms, both order entry firms (*i.e.*, firms with a retail business that route orders to other firms for execution) and integrated firms (*i.e.*, firms with a large retail business that also engage in market making and other activities), whether they offer on-line trading services or not, consider making the following types of disclosures to educate retail customers about their procedures for handling the execution of a securities transaction, particularly during volatile market conditions, along with any additional disclosures they deem appropriate. NASD Regulation notes, however, that disclosure of procedures that are unfair, inconsistent, or unreasonable would not correct deficiencies with these procedures.

Delays

Firms should consider disclosing that high volumes of trading at the market opening or intra-day may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was entered. Firms should consider explaining to customers how order executions are handled by Market Makers, and explain that Market Makers may execute orders manually or reduce their size guarantees during periods of volatility, resulting in possible delays in order execution and losses. This disclosure is particularly important with respect to on-line investors, who have come to expect quick executions at prices at or near the quotes displayed on their computer screens.

Types Of Orders

Firms should consider explaining in detail the difference between market and limit orders and the benefits and risks of each. In particular, firms should consider disclosing that they are required to execute a market order fully and promptly without

regard to price and that, while a customer may receive a prompt execution of a market order, the execution may be at a price significantly different from the current quoted price of that security. Firms should tell customers that limit orders will be executed only at a specified price or better and that, while the customer receives price protection, there is the possibility that the order will not be executed.

As a related matter, firms should consider additional disclosure for customers who place market orders for initial public offering (IPO) securities trading in the secondary market, particularly those that trade at a much higher price than their offering price, or in "hot stocks" (those that have recently traded for a period of time under what is known as "fast market conditions," in which the price of the security changes so quickly that quotes for a stock do not keep pace with the trading price of the stock). Firms may disclose that in such cases customers' risk of receiving an execution substantially away from the market price at the time they place the order may be significantly reduced if they also include a cap (or floor) with the order above (or below) which the order is not to be executed, by placing a limit order.

Access

Firms should consider alerting customers that they may suffer market losses during periods of volatility in the price and volume of a particular stock when systems problems result in inability to place buy or sell orders. Customers trading on-line may have difficulty accessing their accounts due to high Internet traffic or because of systems capacity limitations. Customers trading through brokers at full-service or discount brokerage firms or through representatives of on-line firms when on-line trading has been disabled or is not available because of systems limita-

tions may have difficulty reaching account representatives on the telephone during periods of high volume. Firms should explain their procedures for responding to these access problems.

Communications With The Public

Firms may use advertisements or sales literature to make claims about the speed and reliability of their trading services. These communications with the public must not exaggerate the members' capabilities or omit material information about the risks of trading and the possibilities of delayed executions. Moreover, members should have the systems capacity to support any claims they make about their trading services. Misrepresentations or omissions of material facts in public communications violate National Association of Securities Dealers, Inc. (NASD*) Rule 2210 as well as Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade.

Current Practices

As stated above, on-line firms have described to us steps they have taken to respond to volatility. These procedures are detailed below. While NASD Regulation believes that these actions, when clearly disclosed to customers, may be appropriate responses to trading in securities experiencing extraordinary volatility, they may not be sufficient or appropriate responses in all circumstances. Each action provides protection to the firm and obviously also impacts a firm's customers wishing to trade those securities.

Hot IPOs And Hot Stocks

There recently has been significant volatility during the period of time when certain IPOs have opened for secondary market trading,

particularly the IPOs of Internet issuers. When some of these IPOs started trading on an exchange or on The Nasdaq Stock Market, Inc., after going public, they initially have traded at a much higher price than their IPO offering price. The prices of some of these "hot" IPOs have doubled or more in initial trading (one increased more than tenfold in price), only to fall sharply in subsequent trading. This price volatility has been accompanied by significant trading volume. Certain non-IPO stocks of Internet issuers also recently have traded for a period of time under fast market conditions.

The extraordinary volume of orders and cancellations entered on-line and otherwise during those periods caused queues and backlogs for many order entry and Market Maker firms. As a result of the level of market volatility and volume of orders, a number of Market Makers discontinued their normal automatic execution of orders and began handling orders manually. Firms also reduced their size guarantees on individual stocks or groups of stocks. This in turn led to delays in order executions, executions at prices significantly away from the market quoted at the time the order was entered, and delays in execution confirmations and cancellation reports.

Order entry firms responded to this price volatility and to changes in Market Maker order handling procedures in several ways. One firm has halted on-line trading of hot IPOs and stocks, requiring customers to purchase these securities through a registered representative, either in person or via the telephone. When contacted, representatives can explain, for example, the difference between market and limit orders and the benefits and risks of each, and encourage customers whose primary

goal is to achieve a target price and protect against sudden price moves, and who understand that there is a possibility that the order will not be executed, to enter limit orders. When used, this halt has been implemented only for a short period of time, typically one day.

Other firms do not accept market orders for hot IPOs, requiring customers who wish to buy these stocks to enter a limit order specifying the highest price they would pay for these issues. Still other firms do not accept any orders for certain IPOs that are forecast to be hot until the IPO begins trading in the secondary market. Finally, some firms call clients back who have placed orders on IPOs that look to be volatile. The firms alert customers to restrictions they impose by placing a notice on their Web sites.

Margin

All firms, whether on-line or otherwise, may raise margin requirements for volatile stocks. Some firms that permit on-line trading have raised the amount of equity that must be maintained in margin accounts (maintenance margin) for long positions in certain volatile stocks to between 40 percent and 100 percent.⁴ The rationale for raising maintenance margin is to help ensure that the equity in a customer's margin account is sufficient to cover large changes in the price of a stock. Increasing maintenance margin requirements protects both the firm and customers by ensuring that investors have more equity in their margin accounts as protection in case of a large change in the value of a stock, which reduces the likelihood that the firm will have to liquidate assets in the customer's account to meet a margin call. Firms evaluate stocks for more stringent maintenance margin requirements by examining price

fluctuations, market capitalization, and volatility.

On-line firms also have responded to recent volatility by prohibiting the use of margin to purchase certain securities. Some securities have been designated as "not marginable," requiring customers to purchase the securities with 100 percent initial margin, allowing payment to be made within three days of settlement. Firms also have designated certain securities as "cash on hand," requiring customers to have 100 percent of the purchase price of the security in the account before the transaction can be executed.

Investor Education

Many firms provide some kind of investor education on issues related to market volatility on their Web sites. This education may be found in a part of the Web site devoted generally to investor education and in firm newsletters. It may include definitions of market and limit orders, an explanation of the difference between the two types of orders, and the risks and benefits of each. Some firms encourage customers to use limit orders when they are more concerned about achieving a desired target price for a trade than an immediate execution. Investor education also can be found in some firms' account-opening documents and cash- and margin-account opening documents. Finally, many firms have customer help desks and support agents, both of which provide answers to customer questions.

Pop-up Or Splash Screens

Certain firms have added a page that a customer must view when entering the customer account pages of their Web sites indicating, for example, that maintenance margin has been

raised for certain listed securities; trade reports may be delayed; only limit orders will be accepted for certain securities; and the latest "real-time" quotes viewed on the site may not be reflective of the current trading price of a stock.

Some firms use these pages to discuss what happens when customers attempt to cancel market orders and enter replacement orders. Because of delays in receiving trade reports on volatile trading days, some customers, fearing that their orders have not been executed, have attempted to cancel their initial market orders and enter new orders. Because market orders must be executed as promptly as possible, firms explain that it may not be feasible to cancel a market order, since it may already have been executed, even if a customer has not yet received a trade report confirming the execution. Customers are told that entering a cancel order and a separate replacement order may result in the customer being responsible for the execution of

duplicate orders, if the cancellation order cannot be processed in a timely fashion. Firms advise customers instead to place limit orders to reduce the risk of placing a duplicate order and ensure that the price received is within acceptable limits. One firm has created another category of order called "cancel and replace": the firm will execute the second or "replace order" only if it can confirm that the initial order was in fact canceled.

Member firms are exploring the feasibility of creating more of these screens on a stock-specific or trade-specific basis. This could include, for example, a "pop-up" screen explaining that a particular stock is trading in a fast market condition when a customer seeks to place an order in the stock.

Endnotes

¹Staff Legal Bulletin No. 8 (MR), published on September 8, 1998, states the views of the SEC's Division of Market Regulation about the need for broker/dealers to maintain enough internal systems capacity to

operate properly when trading volume is high. This Bulletin is available on the SEC's Web site at:
<http://www.sec.gov/rules/other/slbmr8.htm>

²The Legal Bulletin cites an SEC Release in support of its position. See note 8, citing Securities Exchange Act Release No. 8363 (July 29, 1968), 33 FR 11150 (August 7, 1968).

³This Notice addresses possible responses to recent stock price volatility, particularly in stocks traded through on-line brokerage firms. While it does not address firms' suitability obligations in connection with recommended transactions or their know-your-customer obligations, firms are reminded that the existence of these obligations does not depend upon whether a trade is executed on-line or otherwise.

⁴This increase is from the 25 percent maintenance margin required by NASD and stock exchange rules or the 30 percent to 35 percent maintenance margin required by many firms.

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COMPLAINT:

NASDR Department of Enforcement

v.

Lakeside Trading and Thomas G. Russell.

Note: The issuance of a disciplinary complaint represents the initiation of a formal proceeding by the Association in which findings as to the allegations in the complaint have not been made and does not represent a decision as to any of the allegations contained in the complaint. Because this complaint is unadjudicated, you may wish to contact the respondent before drawing any conclusions regarding the allegations in the complaint.

**NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS**

Department of Enforcement,
Complainant,

v.

Lakeside Trading, Respondent
[CRD No. 39418]

and

Thomas G. Russell, Registered
General Securities Principal and
Registered Financial and Operations
Principal
[CRD No. 2669033]

Respondents.

Disciplinary Proceeding
No. C05990018

Hearing Officer _____

COMPLAINT

Upon information and belief, Complainant alleges as follows:

1. Respondent Member Lakeside Trading ("Lakeside Trading") became a member of the Association in 1996. Lakeside Trading, during all periods mentioned herein, was a registered broker/dealer with the Securities and Exchange Commission and a member of the Association, which registration and membership remain currently in effect.
2. Individual Respondent Thomas G. Russell ("Respondent Russell") entered the securities industry in December 1995 as a General Securities Representative of Lakeside Trading, a member of this Association. Respondent Russell, during all periods mentioned herein, was associated with member firm Lakeside Trading, and was registered with the Association under Article V of the By-Laws as a General Securities Principal, and as a Financial and Operations Principal, which registrations remain currently in effect.

Complaint
Case No. C05990018
Lakeside Trading, et al.
Page No. 2

FIRST CAUSE OF COMPLAINT

NASD Conduct Rules 2110, 2330(a), and 2510(b): Misuse of Customer Funds
Against Lakeside Trading and Thomas G. Russell

3. During the period from on or about October 12, 1998, through on or about December 1, 1998, Lakeside Trading, acting through Thomas G. Russell, its president and sole principal, improperly used customer funds, in that Respondent Russell executed approximately 788 transactions in the account of a public customer IV, account no. 62823861, then directed the trading profits from the customer's account to the firm by placing excessive commissions on certain trades equaling approximately 95% of the total trading profits earned in the account during that period.
4. During this period, Respondent Russell effected 788 discretionary trades in the account of public customer IV, and failed to obtain written discretionary authority from the affected public customer.
5. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 2110, 2330(a), and 2510(b) by Lakeside Trading and Thomas G. Russell, each separately.

Complaint
Case No. C05990018
Lakeside Trading, et al.
Page No. 3

SECOND CAUSE OF COMPLAINT

NASD Conduct Rules 2110 and 2330(e): Guaranteed Customer Against Loss
Against Thomas G. Russell

6. In September 1998, Thomas G. Russell guaranteed public customer IV against losses in a securities account maintained by IV at Lakeside Trading, account no. 62823861, by telling IV that only profitable transactions would be placed in his account.
7. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 2110 and 2330(e) by Thomas G. Russell.

THIRD CAUSE OF COMPLAINT

Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder,
and Conduct Rules 2110 and 2520(f)(7): Regulation T Violations; Effecting Transactions
Beyond Financial Means, Against Thomas G. Russell

8. On or about November 30, 1998, Thomas G. Russell, by the use of means or instrumentality of interstate commerce, or of the mails, or of a facility of a national securities exchange, caused the execution of transactions in his personal account, account no. 62711000, which he maintained at Lakeside Trading's clearing firm JB Oxford & Company, for which transactions he knowingly did not have the financial resources to settle, nor the ability to meet the initial margin requirements of Federal Reserve Board Regulation T. Specifically, on trade date November 30, 1998, Respondent Russell purchased shares in

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Lakeside Trading, et al.
Page No. 4

the stock of Books-a-Million and OnSale Inc., costing \$1,739,986.84 in his personal account, while maintaining no more than a \$25,000.00 cash balance in the account. Respondent Russell failed to disclose to JB Oxford & Company his inability to pay for these transactions. These activities resulted in eventual realized losses to JB Oxford & Company of approximately \$218,797.00.

9. In addition, on or about December 1, 1998, Thomas G. Russell effected unauthorized transactions in the stock of Books-a-Million and OnSale Inc., totaling approximately \$275,225.00 in the account of public customer IV, with the intention of transferring gains in that account to his own account. These transactions resulted in eventual realized losses in the account of public customer IV of approximately \$97,430.00.
10. Such acts, practices, and conduct constitute separate and distinct violations of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2520(f)(7) by Thomas G. Russell.

FOURTH CAUSE OF COMPLAINT

NASD Conduct Rule 2110: Misrepresentations Against Thomas G. Russell

11. In connection with the activities detailed in the Third Cause of Complaint, on or about December 1, 1998, Thomas G. Russell willfully misled representatives of his clearing firm, JB Oxford & Company, by misrepresenting in a telephone conversation that he had sold

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Lakeside Trading, et al.
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over \$1.7 million in unsecured positions in the stock of Books-a-Million and OnSale Inc. in his personal account. By so doing, Respondent Russell prevented JB Oxford & Company from taking action to limit losses in the account, so that he could continue to maintain the positions in anticipation that the values would increase.

12. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rule 2110 by Thomas G. Russell.

FIFTH CAUSE OF COMPLAINT

SEC Rules 17a-5(a)(2)(iii) and 17a-5(d), and NASD Conduct Rule 2110:
Failure to File FOCUS Report and Audited Financial Statements
Against Lakeside Trading and Thomas G. Russell

13. For the month-ending period of December 31, 1998, Lakeside Trading, acting through Thomas G. Russell, in contravention of SEC Rule 17a-5(a)(2)(iii), failed to file its FOCUS Part IIA and Schedule I with the Association within 17 business days, as required by said Rule.
14. In addition, for the year-ending period of December 31, 1998, Lakeside Trading, acting through Thomas G. Russell, in contravention of SEC Rule 17a-5(d), failed to file audited financial statements.
15. Such acts, practices, and conduct constitute separate and distinct violations of SEC Rules 17a-5(a)(2)(iii) and 17a-5(d), and NASD Conduct Rule 2110, by Lakeside Trading and Thomas G. Russell, each separately.

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SIXTH CAUSE OF COMPLAINT

NASD Conduct Rules 2110 and 2210(c)(3)(A):
Failure to Obtain Prior Approval of Initial Advertisement and the Revisions thereto on Website
Against Lakeside Trading and Thomas G. Russell

16. On or about June 1, 1998, Lakeside Trading, acting through Thomas G. Russell, employed its initial advertisement, in the form of an internet web-site, without having previously filed such material with the Association ten days prior to use, as required by NASD Conduct Rule 2210(c)(3)(A). Lakeside Trading, acting through Thomas G. Russell, failed to file its initial advertisement until July 23, 1998.
17. In addition, during the period from on or about July 24, 1998, through on or about November 30, 1998, the firm, acting through Respondent Russell, continuously revised such advertisements without filing ten days prior to use, as required by the Association.
18. Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 2110 and 2210(c)(3)(A), by Lakeside Trading and Thomas G. Russell, each separately.

SEVENTH CAUSE OF COMPLAINT

NASD Conduct Rules 2110, 2210(d)(1)(A) and 2210(d)(1)(B): Misleading Advertising
Against Lakeside Trading and Thomas G. Russell

19. During the period from on or about June 1, 1998, through on or about November 30, 1998, Lakeside Trading, acting through Thomas G. Russell, employed advertising, in the form of

Complaint
Case No. C05990018
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Page No. 7

an internet web-site, that failed to provide a sound basis for evaluating the services provided by the firm and included exaggerated and unwarranted statements that were potentially misleading. Specifically, the firm, acting through Russell, included on the internet web-site:

- a. misleading statements that implied that individuals accessing the firm's trading systems on-line had direct access to the markets;
- b. material that failed to clarify that investors must place trades for the purchase and sale of securities through Lakeside Trading as intermediary;
- c. statements that exaggerated customers' ability to access the markets;
- d. material that failed to disclose that customers' transactions were subject to market fluctuation risks, and that trades may not be executed at all; and
- e. material that failed to provide a balanced and complete presentation by omitting disclosure concerning the risks associated with day trading.

20. Such acts, practices and conduct constitute separate and distinct violations of NASD Conduct Rules 2110, 2210(d)(1)(A), and 2210(d)(1)(B) by Lakeside Trading and Thomas G. Russell, each separately.

EIGHTH CAUSE OF COMPLAINT

NASD Conduct Rule 2110 and Procedural Rule 8210: Failure to Respond
Against Thomas G. Russell

21. By letters dated March 9, 1999, April 26, 1999, April 28, 1999 and May 12, 1999, the District staff requested that Respondent Thomas G. Russell provide certain information to the staff. These requests for information were sent pursuant to, and in accordance with, the provisions of Procedural Rule 8210, all as more fully detailed on Exhibit "A," attached hereto.

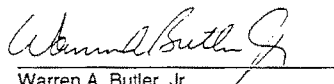
Complaint
Case No. C05990018
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22. Respondent Thomas G. Russell failed to respond to the above requests.
23. Such acts, practices and conduct constitute separate and distinct violations of NASD Conduct Rule 2110 and Procedural Rule 8210 by Thomas G. Russell.

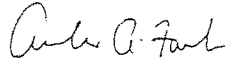
PRAYER FOR RELIEF

WHEREFORE, Complainant respectfully requests:

- A. Findings of fact and conclusions of law that Respondents committed the violations charged and alleged herein;
- B. An order imposing sanctions upon the Respondents in accordance with NASD Rule 8310;
- C. An order requiring Respondents to disgorge fully any and all ill-gotten gains and/or make full and complete restitution, together with interest;
- D. An order imposing such costs of any proceeding as are deemed fair and appropriate under the circumstances in accordance with NASD Rule 8330; and
- E. An order imposing any other fitting sanction.


Warren A. Butler, Jr.
Vice President and District Director
NASD Regulation, Inc., District No. 5
1100 Poydras Street, Suite 850
New Orleans, Louisiana 70163-0802
(504) 522-6527

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Andrew A. Favret, Chief Counsel
NASD Regulation, Inc., District No. 5
1100 Poydras Street, Suite 850
New Orleans, Louisiana 70163-0802
Phone: 504/522-6527
FAX: 504/522-4077

Rory C. Flynn, Of Counsel
Department of Enforcement
NASD Regulation, Inc.
1801 K Street, N.W., Suite 800
Washington, D.C. 20006
Phone: 202/974-2874
FAX: 202/974-2805

NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

Department of Enforcement,	
Complainant	Disciplinary Proceeding No. C05990018
v.	Hearing Officer _____
Lakeside Trading, Respondent CRD No. 39418	CERTIFICATE OF SERVICE
and	Date: May 26, 1999
Thomas G. Russell, Respondent Registered General Securities Principal and Registered Financial and Operations Principal CRD No. 2669033	
Respondents	

I hereby certify that on this 26th day of May, 1999, I caused a copy of the foregoing Complaint and Notice of Complaint to be sent by first class certified mail to Thomas G. Russell, 218 West Livingston Place, Metairie, Louisiana 70005 (Receipt No. Z 431 858 010); and to Thomas G. Russell, c/o Lakeside Trading, 3850 North Causeway Boulevard, Metairie, Louisiana 70002 (Receipt No. Z 431 858 011).


Andrew A. Favret, Chief Counsel
NASD Regulation, Inc., District No. 5
1100 Poydras Street, Suite 850
New Orleans, Louisiana 70163-0802
Phone: 504/522-6527
FAX: 504/522-4077

CHRONOLOGY OF THE ASSOCIATION'S REQUESTS FOR INFORMATION
 SENT TO THOMAS G. RUSSELL, UNDER THE PROVISIONS OF NASD PROCEDURAL RULE 8210
 LAKESIDE TRADING: E05990101

DATE	ADDRESS	METHOD	INFORMATION REQUESTED	DUE DATE	DATE RECEIVED BY RUSSELL	DATE RESPONSE RECEIVED	REGULAR MAIL RETURNED
09-Mar-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	via facsimile (504) 834-9729	Financial airtels for January 31, 1999 (previously due in District Office by February 24, 1999).	upon receipt	Facsimile confirmation 10:59am, 3/9/99	none	n/a
26-Apr-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	Regular and Certified Mail receipt No.: P 119 330 123	All items previously requested during on-site exam dated 4/19/99. Also documents requested previously in 3/9/99 letter above.	upon receipt	Signed for by Thomas Russell on 4/30/1999	none	no
28-Apr-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	Regular and Certified Mail receipt No.: Z 431 858 020	Written statement detailing trading activity engaged in.	upon receipt	Signed for by Thomas Russell on 4/30/1999	none	no
12-May-99	3850 N. Causeway Blvd., Ste. 710 Metairie, LA 70002	Regular, facsimile (504) 834-9729 and Certified Mail receipt No.: P 119 330 124	All documents requested previously in 3/9/99, 4/26/99, and 4/28/99 letters above.	upon receipt	Facsimile confirmation 9:51am, 5/12/99	none	no

NASD Regulation Press Release - 07/07/99



NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1530

Press Release

For Release: Wednesday, July 7, 1999
Media Contact: Nancy A. Condon
(202) 728-8379
Other Contact: Barry Goldsmith
202-974-2850

NASD Regulation Censures and Fines On-Site Trading, Inc. For Registration Violations

Washington, D.C.—NASD Regulation Inc., announced today that it censured and fined On-Site Trading, Inc., of Great Neck, NY, \$25,000 for failure to properly qualify and register 14 individuals.

In addition to proprietary traders employed by the firm at its main trading floor in Great Neck, On-Site provides services to day-trading customers who effect trades from 10 On-Site branch offices and other remote locations around the country.

The censure and fine mark the first disciplinary action by NASD Regulation for violations of the NASD's Series 55 registration rule. The rule prohibits equity traders from trading in the Nasdaq® and over-the-counter markets without first passing a qualification examination for trading and market making and registering with NASD Regulation.

Without admitting or denying the charges, On-Site consented to the entry of findings that 14 employees who acted as equity traders between May 1, 1998 and January 31, 1999 failed to comply with the Series 55 registration rule. During that period, those 14 traders effected approximately 3700 trades in 250 Nasdaq securities.

On-Site also consented to findings that it lacked adequate oversight to ensure proper registration of its traders. As part of the settlement, On-Site agreed to implement new compliance procedures to prevent future violations.

The Series 55 registration rule became effective in April 1998. It applies to market makers, agency traders, proprietary traders, and persons who supervise these activities. The rule was developed in response to concerns about rule violations by traders conducting market-making and principal trading functions in both the Nasdaq and over-the-counter markets.

In addition to the specialized Series 55 examination, equity traders must also have passed either the General Securities Registered Representative Examination (Series 7) or the Corporate Securities Limited Representative Examination (Series 62). The Series 55 examination includes questions regarding the Nasdaq market and market-maker activities, automated execution and trading systems, trade reporting, and other industry regulations.

This matter resulted from an investigation conducted by NASD Regulation's New York District Office.

NASD Regulation oversees all U.S. stockbrokers and brokerage firms with public customers. NASD Regulation and The Nasdaq-Amex Market Group, Inc., are subsidiaries of the National Association of Securities Dealers, Inc., the largest securities-industry self-regulatory organization in the United States.

For more information on NASD Regulation, visit its Web Site, www.nasdr.com.

**NASD REGULATION, INC.
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. CAF990009**

TO: Department of Enforcement
NASD Regulation, Inc.

RE: On-Site Trading, Inc. - MEMBER
CRD No. 30271

Pursuant to Rule 9216 of the National Association of Securities Dealers, Inc. ("NASD") Code of Procedure, we submit this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD Regulation, Inc. will not bring any future actions against us alleging violations based on the same factual findings.

We understand that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by both the Office of Disciplinary Affairs and the National Adjudicatory Council ("NAC") of NASD Regulation, Inc.;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against us; and
3. If accepted:
 - a. this AWC will become part of our permanent disciplinary record and may be considered in any future actions brought by NASD against us;
 - b. this AWC will be made available through NASD Regulation, Inc.'s public disclosure program in response to public inquiries about our disciplinary record;
 - c. NASD Regulation, Inc. may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and
 - d. We may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any allegation in this AWC or create the impression that the AWC is without factual basis. Nothing in this provision affects our testimonial obligations or right to take legal positions in litigation in which the NASD is not a party.

We also understand that our experience in the securities industry and disciplinary history may be factors which will be considered in deciding whether to accept this AWC. That experience and history are as follows:

On-Site Trading, Inc., during all periods mentioned herein, was a registered broker/dealer with the Securities and Exchange Commission and a member of the Association, which

registration and membership remain currently in effect. On-Site Trading, Inc. has not been subject to any formal disciplinary action by the Association.

I.

WAIVER OF PROCEDURAL RIGHTS

We specifically and voluntarily waive the following rights granted under the NASD's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against us;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, we specifically and voluntarily waive any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

We further specifically and voluntarily waive any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

II.

ACCEPTANCE AND CONSENT

- A. We hereby accept and consent, without admitting or denying the alleged violations, to the entry of the following findings by NASD Regulation, Inc.:

At various times during the period of May 1, 1998 to January 31, 1999, On-Site Trading, Inc. failed to ensure that 14 persons who were actively engaged in the trading of securities in the Nasdaq and OTC markets were properly registered as equity traders in accordance with the Association's Series 55 rule requirements.

During the aforementioned time period, those 14 equity traders effected approximately 3700 trades involving approximately 250 Nasdaq securities.

Additionally, On-Site Trading, Inc. failed to establish, maintain, and enforce written supervisory procedures that would ensure the proper registration of persons who traded securities in the Nasdaq or OTC markets.

Such acts, practices and conduct constitute separate and distinct violations of NASD Membership and Registration Rules 1032 and NASD Conduct Rules 2110 and 3010 by On-Site Trading, Inc..

B. We also consent to the imposition, at a maximum, of the following sanctions:

1. A censure;
2. A monetary fine in the amount of \$25,000.00;
3. An undertaking requiring On-Site Trading, Inc. within 90 days of the date of acceptance of this Letter of Acceptance, Waiver, and Consent to conduct a review, in a manner acceptable to the Association, of its supervisory procedures regarding registration of personnel engaged in the activity of equity trading. Thereafter, upon completion of the review, On-Site Trading, Inc. will implement such changes to its supervisory procedures necessary to ensure that all persons in the firm engaged in equity trading are properly registered with the Association. On-Site Trading, Inc. will be required to prepare and submit to the District No. 10 staff a written report detailing its review procedures and revised supervisory procedures no later than 90 days from the date of acceptance of this Letter of Acceptance, Waiver, and Consent.

The sanctions imposed herein shall be effective on a date set by the Association staff.

III.

OTHER MATTERS

- A. We understand that we may attach a Corrective Action Statement to this AWC which is a statement by us of demonstrable corrective steps taken to prevent future misconduct. We may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD Regulation, Inc. nor does it reflect the views of NASD Regulation, Inc. or its staff.
- B. We agree to pay any monetary sanctions imposed on us upon notice that this AWC has been accepted and that such payments are due and payable, and

have attached the election of payment form showing the method by which we propose to pay any fine imposed.

We certify that we have read and understand all of the provisions of this AWC and have been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce us to submit it.

6/17/99
Date

Reviewed by:

[Signature]
Counsel for On-Site Trading, Inc.

On-Site Trading, Inc.
[Signature]
A duly authorized officer of the firm

Accepted by NASD Regulation, Inc.:

July 2, 1999
Date accepted BY NAC

[Signature]
Roger B. Sherman
Vice-President

Attachments:
Standard Election of Payment Form

Attachment

ELECTION OF PAYMENT FORM

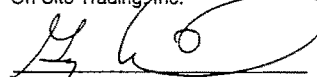
We intend to pay the fine proposed in Section II of the Letter of Acceptance, Waiver and Consent by the following method (check one):

- ☒ A personal check or bank check for the full amount;
- ☐ Credit card authorization for the full amount;¹
- ☐ The installment payment plan (only if approved by NASDR staff and the National Adjudicatory Council).²

Respectfully submitted,

6/21/99
Date

On-Site Trading, Inc.


A duly authorized officer of the firm

¹ Only Mastercard and Visa are accepted for payment by credit card. If this option is chosen, the appropriate forms will be mailed to you, with an invoice, by the NASD Regulation's Finance Department. Do not include your credit card number on this form.

² The installment payment plan is only available for fines of \$5,000 or more. Certain interest payments, minimum initial and monthly payments, and other requirements apply. You must discuss these terms with the NASD staff prior to requesting this method of payment.

NASD Regulation <i>In the Matter of On-Site Trading, Inc.</i> <i>(ENF0328)</i>	Submission of Proposed Letter of Acceptance, Waiver and Consent CORRECTIVE ACTION STATEMENT June 21, 1999
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On-Site Trading, Inc. ("OST") submits this Corrective Action Statement in support of the proposed Letter of Acceptance, Waiver and Consent ("AWC"). It does not constitute factual or legal findings by NASD Regulation, Inc., nor does it reflect the views of NASD Regulation, Inc., or its staff:

Background

In February 1998 the NASD published Notice to Members 98-17 ("NTM 98-17"), which announced that effective April 1, 1998, the Limited Representative Equity Trader Exam ("Series 55") would be required for certain traders. NTM 98-17 explained the operation of a two-year grace period for current traders pursuant to the filing of a formal application by May 1, 1998.

In July 1998 the NASD published Notice to Members 98-60 ("NTM 98-60"), which acknowledged that the earlier NTM 98-17 May 1 application date had previously been extended to May 15, and further stated in relevant part:

To be eligible for this extended qualification period, equity traders had to submit applications to NASD Regulation before May 1, 1998. The NASD now has amended its Registration Rules to extend the filing period to August 31, 1998, for persons who were functioning as equity traders before May 1, 1998, and who missed that cut-off date for filing their applications for the Series 55 Examination.

Consequently, in implementing the new Series 55 rule, NASD provided for three different filing dates.

Explanation

During the period of time the NTMs were published, OST was engaged in several ongoing regulatory matters requiring significant allocation of its staff resources and time. Further, OST's staff was required to attend to the daily demands of its business. As a result, OST staff charged with implementing the new rule change apparently failed to fully understand key aspects of the Series 55. In specific, OST staff misinterpreted the rule and believed that the extensions granted to *functioning* equity traders included *new* traders. Compounding this inadvertent error, OST staff mistakenly believed that there was a 90 grace period attached to the taking of the qualifying examination. As a result of the above referenced confusion, 14 equity traders effected trades without having been registered in a Series 55 capacity.

Corrective Action Taken

When the deficiency was brought to OST's attention it promptly reacted and prohibited further trading until such time as the exam requirement was met. All individuals requiring Series 55 examinations have either passed the test or are prohibited from functioning in that registered capacity.

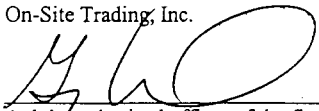
Additionally, OST recently expanded its compliance staff and back-office, and has implemented a revised "SECTION IV - REGISTRATION" in its written supervisory procedures ("WSP"). (See attachment A). Section 4.1 "Registration Requirement" of the revised WSP succinctly explains the new Series 55 requirements and details the procedure required to ensure compliance for those traders functioning under the two-year grace period.

OST also prepared a written outline entitled "PROCEDURES FOR SETTING UP NEW FIRM TRADER" which was disseminated to the firm's registration staff. (See Attachment B) This document sets out in 12 steps the process required at the firm to open a new trader's trading account and to issue an ID to that new trader. Paragraph 2 states in pertinent part that "No person can be assigned an account number or user id unless they are fully registered with a Series 7 or 62, Series 63, and a Series 55."

As to the element of human error that largely caused this problem, OST is satisfied that the steps it has taken to memorialize the rule change and the guidelines now in place to verify registration status, will limit further errors. However, the compliance and registration departments of the firm will attempt to further coordinate their efforts and will seek to more closely review future rule changes involving similar issues.

Dated: June 21, 1999

On-Site Trading, Inc.


A duly authorized officer of the firm



National Association of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Press Release

For Release: Thursday, July 29, 1999

Contact: Nancy A. Condon
(202) 728-8379

NASD Board Approves Proposed Rule for Opening Day-Trading Accounts

Washington, D.C.—The National Association of Securities Dealers, Inc. (NASD®) Board of Governors today approved a rule that would require firms that promote day-trading strategies to disclose to customers, prior to opening accounts, the risks associated with that type of trading. In addition, those firms would have to make a threshold determination that day trading is appropriate for the customer. The rule will not become effective until approved by the Securities and Exchange Commission, after public comment.

As Internet trading has become more popular, more brokerage firms have begun to promote day-trading activities for individual investors. The growth of day-trading activities raises unique investor protection issues and concerns. Day trading requires not only sufficient capital, but also a sophisticated understanding of the markets and market dynamics, and sophistication in identifying securities to trade and in accurately timing buys and sells.

In response to these issues and concerns, the Board agreed that firms promoting day-trading strategies must:

- **Disclose Risk** – A firm promoting day trading will be required to deliver a disclosure statement to the customer discussing the unique risks posed by day trading. The disclosure will include several points for customers to consider before engaging in day trading, including that they should be prepared to lose all of the funds used for day trading and that day trading on margin may result in losses beyond their initial investment. Firms will be permitted to develop an alternative disclosure statement as long as it is substantially similar to the mandated statement and is approved by NASD Regulation's Advertising Department prior to use.
- **Approve the Account for Day Trading** – To approve an account for day trading, the firm must have reasonable grounds for believing that a day-trading strategy is appropriate for a customer by gathering the essential facts relative to the customer. A firm need not make this determination if it obtains from the customer a written agreement that the customer does not intend to use the account for day-trading purposes. If a firm later discovers that a customer who provided this written agreement is using the account for day trading, the firm will be required to approve the account for day trading within 10 days of the date of discovery.

"It is important for a firm that is actively promoting a day-trading strategy to be responsible for assessing whether the strategy is appropriate for an individual who opens a day-trading account at the firm. Today's action by the Board of Governors will go a long way to better

protect investors in an increasingly more sophisticated technological environment," said Mary L. Schapiro, President of NASD Regulation, Inc.

Individuals seeking to establish day-trading accounts at these types of firms would be covered by the proposed rule, regardless of whether they engage in day-trading activities in their own names or under partnership or corporate names. The rule would apply only to accounts that are opened after the effective date of the rule.

The National Association of Securities Dealers, Inc. (NASD[®]), is the largest securities-industry, self-regulatory organization in the United States. It is the parent organization of The Nasdaq-Amex Market Group, Inc., and NASD Regulation, Inc. Through its regulatory subsidiary, the NASD develops rules and regulations, provides a dispute resolution forum, and conducts regulatory reviews of member activities for the protection and benefit of investors. The NASD oversees the nation's 5,600 brokerage firms and more than 600,000 registered brokers.

For more information about the NASD and its subsidiaries, please visit the following Web Sites: www.nasd.com; www.nasdaq-amex.com; www.nasdr.com; or the Nasdaq-Amex NewsroomSM at www.nasdaq-amexnews.com.



NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500
202 728 8000

August 20, 1999

Richard C. Strasser, Esq.
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

Re: **File No. SR-NASD-99-41**
Approval Procedures for Day-Trading Accounts

Dear Mr. Strasser:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Patrice Gliniecki, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8014; e-mail Patrice.Gliniecki@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Alden S. Adkins
Sr. Vice President
and General Counsel

Enclosure

File No. SR-NASD-99-41
Consists of 195 Pages
August 20, 1999

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend the Rule 2300 Series of the NASD Rules to include new Rules 2360 and 2361. The proposed rule change would require a member firm that is promoting a day-trading strategy to furnish a risk disclosure statement to a non-institutional customer prior to opening an account for the customer and either to (1) approve the customer's account for a day-trading strategy or (2) obtain from the customer a written agreement that the customer does not intend to use the account for day-trading purposes. As part of the account approval process, the firm would be required to make a threshold determination that day trading is appropriate for the customer. Below is the text of the proposed rule change. Proposed new language is underlined.

Rule 2360. Approval Procedures for Day-Trading Accounts

(a) No member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer, unless, prior to opening the account, the member has furnished to the customer the risk disclosure statement set forth in Rule 2361 and has:

(1) approved the customer's account for a day-trading strategy in accordance with the procedures set forth in paragraph (b) and prepared a record setting forth the basis on which the member has approved the customer's account; or

(2) received from the customer a written agreement that the customer does not intend to use the account for the purpose of engaging in a day-trading strategy, except that the member may not rely on such agreement if the member knows that the customer intends to use the account for the purpose of engaging in a day-trading strategy.

(b) In order to approve a customer's account for a day-trading strategy, a member shall have reasonable grounds for believing that the day-trading strategy is appropriate for the customer. In making this determination, the member shall exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her financial situation, tax status, prior investment and trading experience, and investment objectives.

(c) If a member that is promoting a day-trading strategy opens an account for a non-institutional customer in reliance on a written agreement from the customer pursuant to paragraph (a)(2) and, following the opening of the account, knows that the customer is using the account for a day-trading strategy, then the member shall be required to approve the customer's account for a day-trading strategy in accordance with paragraph (a)(1) as soon as practicable, but in no event later than 10 days following the date that such member knows that the customer is using the account for such a strategy.

(d) Any record or written statement prepared or obtained by a member pursuant to this rule shall be preserved in accordance with Rule 3110(a).

(e) For purposes of this rule, the term "day-trading strategy" means an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.

(f) 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).

Rule 2361. Day-Trading Risk Disclosure Statement

(a) Except as provided in paragraph (b), no member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer unless, prior to opening the account, the member has furnished to the customer, in writing or electronically, the following disclosure statement:

You should consider the following points before engaging in a day-trading strategy.

For purposes of this notice, a "day-trading strategy" means a strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.

- **Day trading can be extremely risky.** Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day-trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses.
- **Be cautious of claims of large profits from day trading.** You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead to large and immediate financial losses.

- **Day trading requires knowledge of securities markets.** Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.
- **Day trading requires knowledge of a firm's operations.** You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures.
- **Day trading may result in your paying large commissions.** Day trading may require you to trade your account aggressively, and you may pay commissions on each trade. The total daily commissions that you pay on your trades may add to your losses or significantly reduce your earnings.
- **Day trading on margin or short selling may result in losses beyond your initial investment.** When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day-trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

(b) In lieu of providing the disclosure statement specified in paragraph (a), a member that is promoting a day-trading strategy may provide to the customer, in writing or

electronically, prior to opening the account, an alternative disclosure statement, provided that:

(1) The alternative disclosure statement shall be substantially similar to the disclosure statement specified in paragraph (a); and

(2) The alternative disclosure statement shall be filed with the Association's Advertising Department (Department) for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changes are recommended by the Association, shall be withheld from use until any changes specified by the Association have been made or, if expressly disapproved, until the alternative disclosure statement has been refiled for, and has received, Association approval. The member must provide with each filing the anticipated date of first use.

(c) For purposes of this rule, the term "day-trading strategy" shall have the meaning provided in Rule 2360(e).

(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).

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on July 28, 1999, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with

respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors reviewed the proposed rule change at its meeting on July 29, 1999. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt new NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Patrice M. Gliniecki, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8014.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Introduction

Certain brokerage firms focus primarily, or even exclusively, on promoting day-trading strategies to individuals. These firms generally advertise on the Internet and elsewhere as "day-trading" firms or otherwise promote their execution and other services as desirable for "serious" or "professional" traders. In addition, many of these firms offer training on day-trading techniques, as well as provide computer facilities and software packages specifically designed to support and accommodate day trading.

Day trading, however, raises unique investor protection concerns. In general, day traders seek to profit from very small movements in the price of a security. Such a strategy often requires aggressive trading of a brokerage account. As a result, day trading generally requires a significant amount of capital, a sophisticated understanding of securities markets and trading techniques, and high risk tolerance. Even experienced day traders with in-depth knowledge of the securities markets may suffer severe and unexpected financial losses.

The Proposal in Special Notice to Members 99-32

To address investor protection concerns arising from day-trading activities, on April 15, 1999, NASD Regulation issued Special Notice to Members 99-32 soliciting comment on proposed rules regarding approval procedures for day-trading accounts. The proposal set forth in the Notice required a firm that had recommended an intra-day trading strategy to an individual to approve the individual's account for day trading. The proposal also required the firm, as part of the account approval process, to determine that the strategy was appropriate for the customer and to provide a disclosure statement to the customer discussing the risks associated with day-trading activities. As further discussed below, NASD Regulation received 39 comment letters in response to Notice to Members 99-32.

The Revised Proposed Rule Change

Based on the comments received in response to the Notice and input provided by the various NASD standing-committees, NASD Regulation has revised the proposed rule change concerning the opening of day-trading accounts. The proposed rule change, similar to its predecessor in Notice to Members 99-32, focuses on disclosing the basic risks of engaging in

a day-trading strategy and assessing the appropriateness of day-trading strategies for individuals.

In particular, the proposed rule change would require a firm that is promoting a day-trading strategy, directly or indirectly, to deliver a specified risk disclosure statement to a non-institutional customer prior to opening an account for the customer. In addition, the firm would be required to (1) approve the customer's account for day trading or (2) obtain a written agreement from the customer stating that the customer does not intend to use the account for day-trading activities. A firm would not be permitted to rely on the written agreement from the customer if the firm knows that the customer intends to use the account for day trading. In addition, if a customer who provides such an agreement later engages in a day-trading strategy, the firm would be required to approve the account for day-trading.

As part of the account approval process, a firm would be required to have reasonable grounds for believing that the day-trading strategy is appropriate for the customer. In making this determination, the firm would be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her financial situation, tax status, prior investment and trading experience, and investment objectives. The firm also would be required to prepare a record setting forth the basis on which the firm has approved the customer's account. Any record or written statement prepared or obtained by the firm pursuant to the proposed rule change would have to be preserved in accordance with NASD Rule 3110(a).

Requirement to Approve the Account for Day TradingElimination of the Term "Recommend"

As noted above, the proposal articulated in Notice to Members 99-32 applied to firms that had recommended an intra-day trading strategy to individual investors. Many commenters raised serious concerns with the proposal's use of the term "recommend." While the proposed rules did not define "recommendation" in the context of day trading, Notice to Members 99-32 provided general guidance on the types of activities that would constitute a recommendation in this context. The Notice stated that in general, a member would be recommending a day-trading strategy for purposes of the proposed rules if it affirmatively promoted day trading through advertising, training seminars, or direct outreach programs, and an individual engaged in day trading in response to those solicitations.

Many commenters voiced concerns that the Notice adopted an overly broad view of "recommendation," and feared that this broader view would be applied in other contexts. In particular, these commenters were concerned that advertisements or other promotions alone would be deemed to trigger a firm's duty to customers under the NASD's general suitability rule, Rule 2310. In this regard, one commenter stated its belief that the historical understanding that a recommendation is a specific communication from a broker to a customer at a specific time must be maintained. A second commenter suggested that the rules include a clear statement that "recommendation" for purposes of the rules shall mean "recommendation" as that term is commonly used throughout NASD rules, other Notices to Members, and NASD interpretative letters. This same commenter believed the rules should

explicitly state that advertising does not constitute a recommendation for purposes of the proposed rules.

Several commenters suggested specific interpretations of the term “recommendation” in the day-trading context. For instance, one commenter expressed the view that the types of conduct that constituted “recommending” involved actively reaching out to the investing public with the goal of reaping financial benefits from the recommendation being made. The commenter also believed that the definition of recommendation should expressly exclude conduct such as solely operating a Web site that provided general financial information and news. A second commenter suggested exempting from the proposed rules those Internet-based firms that do not provide individualized instructions or guidance with respect to day trading, and that do not promote or endorse particular investment strategies to customers on an individual basis. Many commenters, after addressing issues raised by the proposal’s use of the term “recommendation,” suggested that the proposal be limited to a risk disclosure requirement.

In contrast, several commenters believed that the proposed rules should apply to a broader scope of firms and firm activities, such as to any firm that permits or accepts intra-day trading transactions. In this regard, one commenter opined that all firms promoting, advertising, recommending, or providing their customers with the opportunity to day trade should be required to comply with the rules. Another commenter suggested that the proposed rules should apply to all firms that promote or advertise day-trading activities or that have more than a certain percentage of day-trading accounts.

After considering the comments, NASD Regulation has revised the proposed rule change to apply to those firms that are “promoting a day-trading strategy.” This revision should address commenters’ concerns that the interpretation of the term “recommendation” in the day-trading context could obfuscate use of the term in the general suitability area. By using the concept of “promoting a day-trading strategy,” the proposed rule change also would more clearly apply to those situations where a member firm either solicits a person on an individual basis or advertises to the general public.

NASD Regulation has determined not to define “promoting a day-trading strategy” for purposes of the proposed rule change. However, NASD Regulation believes that the promotion by a member of efficient execution services or lower execution costs based on multiple trades alone would not trigger the requirements under the proposed rule change. In addition, merely providing general investment research or advertising the high quality or prompt availability of such general research would not constitute the promotion of day trading under the proposal. Similarly, merely having a Web site that provides general financial information or news or that allows the multiple entry of intra-day purchases and sales of the same securities would not constitute the promotion of day trading.

However, a member would be subject to the proposed rule change if it affirmatively promotes or touts day-trading activities or strategies through advertising, training seminars, or direct outreach programs. For instance, a firm generally would be subject to the proposed rule change if its advertisements address the benefits of day trading, rapid-fire trading, or momentum trading, or encourage persons to trade or profit like a professional trader. A firm also would be subject to the proposed rule change if it promotes its day-trading services

through a third party. Moreover, the fact that many of a firm's customers are engaging in a day-trading strategy would be relevant in determining whether a firm has promoted itself in this way.

Notably, while the proposed rule change does not define the term "promoting a day-trading strategy," firms could submit their advertisements to NASD Regulation's Advertising Department for review and guidance on whether the content of the advertisement constitutes such activity for purposes of the rule change. As a result, the proposed rule change, as revised, should both limit concerns about any effect of the proposal on the NASD's general suitability rule and allow firms to better determine whether a particular advertisement would trigger the rule prior to publication or distribution of the advertisement.

Persons Covered by the Proposed Rules

Comments also were varied regarding whether any proposed day-trading rules should reach a broader range of customers. One commenter stated that the application of the rules should not be limited to natural persons, but should include "non-institutional customers" as defined by NASD Rules. This commenter noted that many day traders have opened accounts under partnership or corporate names and that these customers typically are no more sophisticated than customers who open accounts in their own names. Several commenters also believed that all existing customers should be covered by day-trading rules or, at a minimum, receive a risk disclosure statement. One individual suggested that any proposed day-trading rules should apply to all new day-trading accounts, rather than to new customers.

In response to commenters' concerns, NASD Regulation has determined to revise the proposal to apply to all non-institutional customers. For purposes of the proposed rule

change, the term “non-institutional customer” would mean a customer that does not qualify as an “institutional account” under NASD Rule 3110(c)(4). 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 SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million. Applying the proposed rule change to non-institutional customers would ensure that most individuals would be covered by the proposed rule change, regardless of whether they engage in day-trading activities in their own name or in the name of a corporation or partnership. As revised, the proposed rule change would not apply to an existing customer unless the customer opens a new account at a firm that is promoting a day-trading strategy.

Accounts Used For Purposes Other Than Day-Trading Activities

As an alternative to approving an account for a day-trading strategy, the proposed rule change would permit a firm that is promoting a day-trading strategy to obtain from the customer a written agreement that the customer does not intend to use the account for the purposes of day trading (“other-use agreement”). In addition, the firm would be required to provide a risk disclosure statement to the customer even if the firm obtains an other-use agreement. A firm would not be permitted to rely on an other-use agreement if it knows that the customer intends to use the account for day trading. Moreover, if a firm opens an account for a customer in reliance on an other-use agreement, but later knows that the customer is

using the account for day-trading activities, then the firm would be required to approve the customer's account for day trading in accordance with the rule as soon as practicable, but in no event later than ten days from the date of discovery.

Elements to Consider in Making Appropriateness Determinations

Commenters also suggested additional elements that a firm should consider in order to assess the appropriateness of a day-trading strategy for an individual. For example, several commenters believed that firms should be required to determine the source of funds that an individual intends to use for day-trading activities. Other commenters, however, voiced concerns that any such requirement would be an invasion of privacy or questioned why this requirement would not apply to all types of brokerage accounts. One individual believed that all persons should be required to meet a minimum net worth standard in order to engage in day trading.

After considering the comments, NASD Regulation has revised the proposed rule change to require a firm that is promoting a day-trading strategy to have reasonable grounds for believing that the strategy is appropriate for the customer and to exercise reasonable diligence to ascertain the essential facts relative to the customer. The proposed rule change continues to require a firm to review the customer's financial situation, prior investment and trading experience, and investment objectives. A firm also would be expressly required to review the customer's tax status. The proposed rule change, however, would not require firms to determine the source of funds, primarily because of concerns with defining the scope of any such obligation and the risks of imposing disproportionate burdens on firms.

Definition of an Intra-Day Trading Strategy

The proposal set forth in Notice to Members 99-32 defined “intra-day trading strategy” to mean “an overall trading strategy characterized by the regular transmission by a customer of multiple intra-day electronic orders to effect both purchase and sale transactions in the same security or securities.” Several commenters suggested a broader definition of the term. For example, one commenter stated that the term should include a person who regularly makes only one buy and one sale of a particular security or group of securities on a daily basis. A second commenter believed that the term should include short-term trading strategies that could occur over, for example, a two-day period. Another commenter suggested that the definition include any offer and sale of the same security if the offer and sale are accomplished prior to settlement.

In contrast, one commenter emphasized its belief that the long-standing historical definition of a day trader requires a pattern of day trades, noting that there are legitimate reasons to buy and sell a single security in a single day that are not premised on a day-trading strategy. This commenter suggested that the proposal apply only when a clearly defined and easily identified pattern of activity exists over a considerable period of time. Another commenter expressed a general view that the definition of day trading lacked sufficient clarity, and raised a series of questions regarding the scope of the term, including whether it should include the transmission of orders in a non-electronic environment.

In light of the comments, NASD Regulation has revised the proposed definition of “day-trading strategy” to mean “an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in

the same security or securities." NASD Regulation believes that the revised definition would include those instances where an individual regularly transmits one or more purchase and sale (i.e., "round-trip") transactions in a single day. In addition, although as a practical matter, day trading typically requires electronic delivery of orders, the proposed definition of "day-trading strategy" has been revised to include orders transmitted by non-electronic means, such as by telephone.

Requirement to Provide Day-Trading Risk Disclosure Statement

As discussed above, the proposed rule change would require a firm that is promoting a day-trading strategy to deliver a disclosure statement to the customer discussing the unique risks posed by day trading. The disclosure statement would include several factors that a customer should consider before engaging in day trading, including that the customer should be prepared to lose all of the funds that he or she uses for day trading and that day trading on margin may result in losses beyond the initial investment. The firm would be permitted to develop an alternative risk disclosure statement, provided that the alternative statement was substantially similar to the mandated statement and was filed with, and approved by, NASD Regulation's Advertising Department.

Many commenters agreed that customers should receive additional information on the risks of day-trading or other on-line trading activities. One commenter suggested that firms be required to provide a risk disclosure statement to all new individual customers, rather than limit dissemination to individuals to whom firms have recommended a day-trading strategy. In contrast, another commenter believed that it was more effective for the NASD to provide risk disclosures to potential customers in an educational atmosphere, such as the NASD's

Web site. Some commenters suggested specific revisions to the proposed risk disclosure statement. In this regard, one commenter proposed that the statement include the language from the text of the Notice that day trading generally would not be appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. Another commenter expressed concern that the suggestion in the disclosure statement that persons inquire as to a firm's capacity to permit customers to engage in day trading might place an unrealistic obligation on the customer.

Comments generally were divided as to whether customers should be required to acknowledge receipt of the disclosure statement. One commenter believed that a firm should be able to provide a copy of the statement on its Web site or in an initial mailing to the customer at the time of account opening. The commenter stated that the document was a disclosure of risks and not an agreement between the parties. Another commenter asserted that firms should have flexibility in deciding whether to require a customer to sign the statement. In contrast, one commenter emphasized that requiring customers to acknowledge receipt of the statement would protect both the customer and the firm. In addition, one individual suggested that the proposed rules require customers to sign the statement and to wait three days prior to trading to allow for additional reflection and consideration.

After considering the comments, NASD Regulation has modified the proposed rule change to require firms promoting a day-trading strategy to deliver the risk disclosure statement to all non-institutional customers prior to opening an account for such customers. NASD Regulation is not recommending that all firms be required to disseminate the disclosure statement to all new customers because the benefits of such a requirement are

unclear. However, NASD Regulation will continue to monitor the growth of day-trading activities to determine whether, in the future, such a requirement might be justified. In addition, NASD Regulation encourages all firms, particularly firms that provide on-line trading capability, to provide the mandated risk disclosure statement or a substantially similar disclosure statement to their customers.

The disclosure statement also has been revised to include the additional key point that day trading generally is not appropriate for persons of limited resources and limited investment or trading experience and low risk tolerance. The provision in the proposed statement that an individual should confirm that a firm has adequate capacity to support day-trading activities has been deleted, in light of concerns that the provision might place undue burdens on the customer.

Comments Suggesting No or Minimal Regulatory Response

Those commenters that opposed any action in the area of day trading generally questioned why day-trading activities merited special regulation. For example, two commenters emphasized that many investments were risky and generally believed that the proposed rules inappropriately targeted day-trading firms. Some commenters also suggested that the proposed rules were paternalistic. Another commenter raised concerns that the proposal unfairly suggested to investors that on-line trading is somehow less scrupulous and more risky than trading through a traditional broker/dealer. This commenter also believed that the existing regulatory framework provides ample means to combat abuses associated with day trading. In addition, one commenter generally stated that it was premature to attempt regulation of day-trading practices. Several individual commenters, in opposing

regulation of day trading, emphasized the benefits of electronic trading and their ability to protect themselves.

As noted above, however, NASD Regulation believes that the proposed rule change focuses on the promotion of trading strategies that present very high risk to individuals and, as revised, should be easier for firms to apply to their activities. Firms that are actively promoting a day-trading strategy should be responsible for assessing whether the strategy is appropriate for an individual who opens a day-trading account at that firm. These firms also should be required to disclose the risks of engaging in a day-trading strategy to an individual prior to opening an account for that individual.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be 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. The NASD believes that the proposed rule change codifying the obligation of firms promoting day-trading strategies to disclose the risks of these strategies to non-institutional customers and to determine whether the strategy is appropriate for a customer will help to protect investors and the public interest in an increasingly more sophisticated trading environment.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Special Notice to Members 99-32 (April 15, 1999). The comment period expired on May 31, 1999. Thirty-nine comment letters were received in response to the Notice. A copy of Notice to Members 99-32 is attached as Exhibit 2. A summary of the comment letters received in response to the Notice is attached as Exhibit 3. Copies of the comment letters are attached as Exhibit 4. Of the 39 comment letters received, approximately 13 were in favor of the proposed rule change, 8 supported risk disclosure only, 12 were opposed to the proposed rule change, and 6 expressed no opinion or addressed broader issues.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. NASD Special Notice to Members 99-32 (April 15, 1999).
3. Summary of Comment Letters received in response to Special Notice to Members 99-32.
4. Comment Letters received in response to Special Notice to Members 99-32.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: 
Alden S. Adkins, Sr. Vice President and General Counsel

Date: August 20, 1999



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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

President: Peter C. Hildreth (New Hampshire) • President-elect: Bradley W. Skolnik (Indiana) • Secretary: Patricia D. Struck (Wisconsin) • Treasurer: Joseph P. Borg (Alabama)
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Executive Director: Philip A. Feigin
Ombudsman: Robert M. Lam (Pennsylvania)

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 action⁴. 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.

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.

NASAA Recommends:



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**



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."



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 ...

Statement of Electronic Traders Association
1800 Bering, Suite 750
Houston, Texas 77057

Hearing Before the Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate
Washington, D.C.

September 16, 1999

I.

Introduction

The Electronic Traders Association ("ETA"), a non-profit trade association of on-site day trading firms,¹ is grateful to the Permanent Subcommittee on Investigations ("Subcommittee") for this opportunity to dispel various misconceptions which have arisen concerning day trading. Knowing of the Subcommittee's interest in promoting the interests of small investors we appreciate also the chance to inform the investing public of the many benefits small investors derive from other individuals willing to accept the responsibility of risking their personal capital in day trading.

¹ETA, founded in 1996, has approximately 15 supporting organizations, including six of the ten largest on-site day trading firms. ETA members service customers who are a majority of active day traders and execute a majority of day trading transactions.

In common with all innovators, electronic day trading has been considered a threat to the established order, and has been under attack for years. In the nineteen eighties the handful of firms involved were maligned by market makers and regulators as "SOES Bandits". Today, the charges are, alternatively, that day trading is gambling or that (presumably to even up the odds) day traders routinely violate the securities laws.² Day trading is not gambling, it requires skill, state of the art technology and hard work.³ And, from published decisions, it is clear that the record of day trading firms complying with securities laws is better than that of the 100 largest broker-dealers (see Appendix A).

Although on-site day trading has developed greatly, electronic day trading firms are by securities industry standards, tiny. ETA estimates that there are 62 on-site firms, of which 10 do 80% of the business, and somewhat less 5,000 full-time professional on-site day traders (including a small number of individuals who trade remotely through on-site firms locations via dedicated telephone lines). However, ETA also estimates that these individuals, trading an average of 700 shares, 35 times a day and almost entirely in the most liquid Nasdaq stocks, trade the equivalent of 15% of Nasdaq volume daily, and comprise the largest portion of retail limit orders in the major Nasdaq stocks.

²"[D]ay trading firms... need to play by the same rules the rest of Wall Street follows. If they don't get their act together they will be under increasing regulatory pressure." Peter C. Hildreth, NASAA Press Release, August 9, 1999.

³"Dan Ripoll is sick of reading stories criticizing his career of choice. 'The people writing [these stories] don't have any idea of what we do,' he says. 'This isn't gambling.' " [HTTP://CNMNF.COM/1999/09/01/INVESTING/DAYTRADE_DAYINLIFE/](http://CNMNF.COM/1999/09/01/INVESTING/DAYTRADE_DAYINLIFE/).

Day traders understand that they are accountable for their decisions. Those decisions and the trades they make are theirs alone. And they are therefore accountable for the money they make or lose. ETA members however, emphasize that day trading is not for everyone. And ETA believes its members are both responsible for informing day traders about the risks of such trading and avoiding all hype about possible rewards. It has apparently not been recognized that the vast majority of ETA members' day trading prospects are references from customers, only a small fraction of whom are accepted. In fact, as the New York Times reported, "many former professional traders, brokers and financial service professionals are quitting their jobs to work full time as day traders..."⁴ Nearly all day traders are college graduates and many hold graduate degrees.

On-line day trading differs from on-site trading. On-line traders, estimated to number more than 250,000 individuals, using firms such as Charles Schwab, Fidelity, E*Trade, et al., trade 1 to 3 times per day. They have been insightfully referred to by Chairman Levitt as "Day Traders Lite". The business of on-line traders is eagerly competed for by the major on-line discounters. As a consulting group recently reported, "on-line leaders... are about to enter a bloody fight for customers".⁵

⁴The New York Times, August 13, 1999; also see footnote 3 "Ripoll quit Merrill Lynch's market-maker training program a year and a half ago to day trade."

⁵Forrester Research, May 11, 1999. See also, among many, advertisement in New York Times, Discover Brokerage, "Gordon Gekko Eat Your Heart Out", August 1, 1999, Business Section, page 9 (reproduced as Exhibit B). (On-line firms are expected to spend over \$1.5 billion for marketing in 2000.)

Although the technology available to on-line traders continues to improve, it is not the equal of technology available to on-site traders. Please note three important differences between on-line and on-site day traders:

First, at an on-site firm, the customer is connected directly to the firm's order router; trading through an on-line firm the customer's PC has no direct connection to the firm's order-router. This adds perhaps a second to the order entry process; in day trading seconds are expensive.

Second, because of on-line brokers preferencing arrangement with market makers, on-line traders do not have the opportunity to receive price improvement on their orders; on-site firms' technology offer access to all ECNs and markets.

Third, on-line traders trade in isolation from other traders; thus they can not access the intellectual capital provided by other day traders which is available at on-site firms.

The growth of on-site day trading and day traders is, at this point, almost primarily due to: a stock market with consistently high volume; extraordinary technology which is equal to or in advance of that available to securities industry professionals, the SEC's recently enacted order handling and alternative trading systems rules and the entrepreneurial culture, emphasizing personal responsibility, which has renewed its strength in this country over the past two decades.

II.

Day Trading Business Standards

ETA members are SEC and state registered broker-dealers; nearly all are members of the NASD which introduce their business to clearing firm members of the New York Stock Exchange and NASD. ETA members are reviewed regularly by the NASD; most have been visited by the SEC in its "sweep" of day trading firms. So far as we are aware, only one ETA member has ever been the subject of SEC or NASD discipline (which resulted in a \$7,500 fine for order entry violations), and no ETA member is a subject of an SEC or NASD proceeding. Given the fact that most on-site day trading firms have only been in existence for a few years, their procedures are continually being refined. Whatever failings a few state securities regulators may cite are relatively minor, and these failings, as Exhibit A shows, are certainly not unique to the day trading business.

On a positive note, ETA members seek to meet all regulatory requirements. They seek to foster high standards of ethics. Thus for example, ETA's risk disclosure statement (Exhibit C) adopted in February 1999 not only reflects the risk disclosures proposed currently by the NASD, but also points out such additional risks as the possibility of loss through systems failures, inability to liquidate positions because of market conditions and the lack of ultimate safety in stop-loss type orders. The ETA form also requires, as the NASD proposal does not, that the

prospective day trader execute the risk disclosure form acknowledging his awareness of the risks of day trading. Disclosure of risk is simply not an issue.

ETA members promote the importance of being fully forthcoming regarding each firm's traders' successes and failures, and offering prospects access to those traders to conduct their own due diligence. As a matter of business ethics, ETA's Statement of Principles (Appendix D), does not permit exaggerated statements regarding possible trading results.

The NASAA report characterizes day trading in the view of on-site firms as a program or strategy of investing. Better said, day trading is an approach to the market characterized by multiple trading strategies. Under such circumstances, where traders hold positions for four minutes and make their own decisions, the concept of suitability, even repackaged as appropriateness, has no meaning. A day trader, in thirty market days, will make more than 2,000 buy/sell decisions; in ten days, 500 trading decisions. At what point is the day trader considered sophisticated enough so that suitability can not possibly be an issue? After all, most investors, including those deemed sophisticated, do not make 500 trading decisions in a lifetime, let alone 2,000 decisions. Accordingly ETA believes that the NASD proposal currently before the SEC is too general in nature to be useful to regulators, firms or customers. However, while, as noted, ETA does not believe in a suitability standard for on-site day trades, if in fact there is to be such a standard ETA for the reasons described below considers that NASD Rule 2860, which governs procedures used for opening retail option accounts, furnishes a better model.

Option trading, like day trading, is an approach to the market composed of many possible strategies bearing lesser and greater degrees of risk. Under Rule 2860, an individual trading options, receives a risk disclosure statement, signs a new account form verifying that the information he has provided regarding his finances and market experience is accurate, and then based on this information is initially allowed to trade, as suitable, the spectrum of available strategies. This sensibly is a one time analysis, and under the Rule (§19) suitability applies only to recommended transactions. At ETA members, beginning day traders, without previous experience generally are limited to strategies such as trading on news or momentum, with limited size and leverage, as compared to experienced traders who can accept the riskiest strategies of leverage and positioning.

III.

Misconceptions About Day Trading And The NASAA Report

Rather than burden the body of this statement with a point by point refutation of a number of misconceptions promoted by the NASAA Report about day trading we address these misconceptions in Appendix E. However, two causally related misconceptions, that day trading firms advertise falsely to obtain customers and that all, but a tiny fraction of day trading customers will lose all their money, demand immediate response even though the educational level of the prospect and customer base noted above should be in itself enough to show their absurdity. With deference, we believe that without these claims it is unlikely that this Subcommittee would consider these hearings useful.

The first claim, deceptive advertising, endlessly repeated, appeared most recently in a statement by Matthew Nestor, the Massachusetts Securities Division's Director, who noted that Massachusetts' investigations did not stem "from customer complaints but from concerns about on-site firm advertising".⁶ The second, the allegation that there is an extremely high percentage of customer losses, appears in its most recent formulation in the NASAA press release concerning its August 9 1999 report:⁷

These related themes of losses hidden from customers have been pervasive in NASAA's approach to this issue.⁸ That this approach is driven by NASAA's desire for publicity was clearly stated by NASAA President Peter C. Hildredth in his remarks to NASAA's winter enforcement conference.

"I think we need to reposition ourselves... Another way to tell our story is to ... be more visible... by cultivating media contacts. The news media is hungry for good crime stories - and with a little imagination we can find them stories to write about."⁹ (Emphasis added.)

⁶The Atlanta Constitution, August 18, 1999.

⁷Report of the Day Trading Project Group (hereinafter "NASAA Report").

⁸We note NASAA, but in actuality, it is a task force of states; in fact, only four states have brought actions against day trading firms, and only one state, Massachusetts, the author of the NASAA Task Force Report, has for whatever reason conducted a major campaign against on-site firms. Conspicuously absent are major financial states such as New York, California, Illinois and Florida. New York, the most sophisticated of the blue sky regulators, as a result of on-line customer complaints, has focused entirely on on-line firms.

⁹Remarks, Miami, Florida, January 11, 1999.

Thus NASAA's "imagination" that day traders lose money in wholesale numbers. Lacking analytical proof NASAA commissioned a "study" of day trading results. That study, is hardly convincing. Despite NASAA's claim that its analysis "was resource intensive", with "thousands of entities" reviewed, the analysis itself is based on only 17 accounts, which on average traded for four months, at one office of one (now ETA) firm, at least two years ago. It does not add to the strength of the study that it has been conducted by a retired commodity trader operating out of his apartment who makes his living as a witness for plaintiffs in commodity cases. Nor does it add to the "expert's" credibility that his resume (See Exhibit F) lists with pride both that he "published daily hot line trading recommendations" and that as an investment advisor (apparently unregistered) he "developed [a] low price stock strategy that returned over 30%".

The NASAA report is also the home of a number of contradictory thoughts: one example, is a discussion of a study by two California business professors ("Short Term Trading is Injurious To Your Wealth"), which, in fact, shows that short term traders while they underperform the Dow-Jones Index (in common with mutual funds, as the study points out), make, rather than lose money; however, the period studied is 1991 - 1997 and the commissions charged to customers were ten times those now prevailing. If such present commission structure were factored in, the accounts presumably would well outperform the Dow-Jones. Another example, the claim that there is an inherent flaw in day trading theory since, as NASAA views it, only by letting profits run can traders make money, a claim that is contradicted by its expert's report which adopts the opposite view that it is the holding of positions overnight that leads to the "risk of ruin".

It is interesting to note that the NASAA Report ignores a study of Professor Paul Schultz (the individual almost single handedly responsible for exposing collusion in the Nasdaq market place) which found day trading to be a successful market approach. His comment about day traders was that: "On average, they made money, but because of the reaction time of a trader is very rapid, it's a game best left to young people with good memories."¹⁰

However, much of the NASAA Report's this mumbo jumbo would be unnecessary if NASAA had accepted ETA's March 1999 offer to provide current trading information. (NASAA's response was that it would "reserve comment on the proposed survey".) Apparently recognizing that it is undisputed that a high percentage of accounts lose money as they advance on the trading learning curve (which ETA believes runs three to five months), the NASAA study followed the principle that these accounts, would not profit from experience, but merely by day trading would have a "risk of ruin". One needn't be a graduate in statistics to understand that the study's results, and the NASAA claims (depending on the occasion) that 7 or 8 or 9 out of 10 on-site day trading customers lose money, are absurd.¹¹

The NASAA Report also claims that there is a high turn over of customers. If in fact 3,500 - 4,500 of the 5,000 day traders were wiped out every six months or so, there would be by

¹⁰Quoted in article cited in footnote 3. On the other hand, one ETA member surveying its customers, found their average age to be 37. (The survey also found previous customer average income of \$120,000 and net worth of \$600,000.)

¹¹"[R]egulators say that nine out of every ten trades lost money." Newsweek, August 8, 1999, p. 30.

now at least 20,000 individuals who had lost in the aggregate hundreds of millions if not billions of dollars. One would therefore expect complaints by the hundreds if not thousands. That few or none have been brought to Mr. Nestor's office, nor, judging from the silence of the NASAA report on the subject, anywhere else, is the clearest evidence that the NASAA loss numbers are unconvincing and that disclosure of risk is not an issue. Presumably it also explains why there have been no regulatory actions brought against day trading firms by the vast majority of NASAA members (including such giants as California, New York, Illinois and Florida).

Earlier this year ETA informally surveyed certain of its members to obtain a rough estimate of customer profitability. These estimates were that after an initial period of three to five months of losses 60 - 65% netted in the range of \$28,000 per month, with the balance of customers losing \$6,000 - \$8,000 per month. In August, ETA's Executive Committee members considered these numbers still to be representative. Please note that these are only estimates, unlike the NASAA Report, they do not purport to be scientific. To put the matter to rest, ETA is in the process of retaining KPMG to conduct a day trading profitability study; this study is expected to be completed in the next two months.

IV.

How Day Trading Benefits The Investing Public

These are the ways the average investor - who may never short term trade, let alone day trade - benefits from the activities of on-site day traders.

Transparency

Until a Justice Department investigation and action by that Department and the SEC, there was substantial evidence that market makers conspired to keep price quotations artificially wide. ECNs, the trading systems fostered by day trading, have forced competition upon market makers. Quoting Traders Magazine: "The number of ECNs exploded on Wall Street soon after the implementation of the order handling rules. This caused market makers to make their price quote information more transparent and to improve their handling of retail size limit orders." Most importantly, ECN prices are driven by actual orders, while Nasdaq is a market of quotes by dealers. There is, as a result, more competition now for market makers than has ever existed before.

Until 1998, Instinet, an ECN which, as its name implies, is aimed at institutions, had a virtual monopoly on trading in this third market. Thus, institutions (and market makers laying off excess positions) could deal anonymously through this back door to Nasdaq receiving better prices than were generally available to individuals. All attempts over the years to create other successful ECNs had failed for lack of liquidity. Only when on-line discount and day trading blossomed did ECN competition become meaningful. By December 1998, the volume of one ECN, Island, was nearly equal to Instinet's. A key factor behind Island's success is the order flow of the major day trading firms. Thus day traders helped break the market maker trading monopoly and provide an obvious public good to all investors.

Liquidity

The New York Stock Exchange has found that individual investors have greatly increased their presence in stock market activity, and that for the first time in a generation individuals rather than institutions were the major traders in such well known stocks as Dell Computer, Cisco Systems, Lucent Technologies and Compaq Computer. Forbes Magazine, looking back at 1998, reported that block trades (10,000 shares or more) had dropped below 50% of market volume. A large part of the reason is given by an institutional trader: "Individual traders now have a lot of the same tools we institutions do; real-time quotes, push button executions..." Day traders add prodigiously to the depth of the market and its liquidity. Liquidity benefits every investor.

Reduced Spreads

ETA estimates that limit orders constitute nearly one-half of day trader orders. Since the vast majority of all customer orders are at the market, these limit orders disproportionately improve prices. Limit orders provide price competition to market maker quotes, shrinking price spreads and thus reducing trading costs for the benefit of all investors. In simple terms, if a market maker is quoting a stock at 50-50-1/4, a customer limit order at 50-1/8 will efficiently narrow that spread.

In addition to reducing spreads the SEC correctly believes that limit orders would benefit the public by increasing quote competition, thus enhancing the price discovery process. Please note that beyond executions, the key consideration is to present to the public an accurate picture

of trading interest. In fact, it has been noted that, since the National Best Bid and Offer (NBBO) is the starting point in negotiating execution prices with institutional investors, narrowing the quoted NBBO improves the quality of executions for both retail and institutional investors (who are, of course, proxies for individual investors).

Other Benefits

The fostering of new hardware to transmit information and accelerate executions, whether in the form of broadened telephone lines or more efficient servers and routers, results in technological benefits to the larger economy. Perhaps most importantly, removing the middleman broker in choosing securities, and pressing competition on self-regulatory organizations, means an enormous reduction of the need for ethical sales practice regulation, eliminating traditional concerns about churning, mark-ups, trading ahead of customers and the like. In fact, the savings should even allow blue sky regulators to focus on the real problem of Internet fraud, rather than imagined problem of day trading.

V.

Day Trading Firms are a Desirable and Integral Part of the Securities Industry.

For the above reasons, major financial interests have invested in day trading firms and those who provide services to them. Softbank Corp. (which owns 26% of E*Trade and is the largest shareholder of Yahoo) and J. W. Childs have taken large stakes in Tradescape, a day

trading software firm which is acquiring Momentum Securities, one of the largest day trading firms. The Texas based Bass family invested \$40 million in TradeCast, a firm that makes day trading software, and a Bass representative will sit on the Board of TradeCast.¹²

These investments provide a number of insights to the Subcommittee: first, the investments reflect the restructuring of financial markets now taking place; second, each investment was made after considerable due diligence by the investors - had such review shown violative conduct the investments would not have been made; and third, the investments indicate, that day trading is in fact just another (albeit growing) facet of the securities industry.

Further evidence of the above appears in an August 13, 1999 New York Times report that Fidelity Investments, Lehman Brothers and Instinet are considering "adopting the software platforms of day trading firms, forming alliances with them or making outright acquisitions..." These firms' interest is in technology and transaction volume.¹³ As the article puts it, "Electronic Communication Networks are gobbling up a growing share of the marketplace and firms want to make sure they do not miss out".

¹²Dow Jones News Service, August 25, 1999.

¹³See also: "Wall Street Warms Up to Day-Trading Brokerages", the Los Angeles Times, July 14, 1999.

Two points derive from this.

1. As we have noted in the preceding section, volume is necessary to make ECNs effective (each of the firms named in the New York Times article has an interest in an ECN). A recent article in "The Industry Standard", a publication which follows Internet developments, notes:

"You can't run a stock market without people who want to trade. That issue confronts the growing group of ECNs, which offer active stock traders an alternative to the big stock exchanges. Theoretically, ECNs offer a more efficient way to trade stocks. For the systems to gain traction, however, they need to attract a critical mass of users. It's a chicken and egg problem: it takes liquidity to attract liquidity."¹⁴

2. Wall Street firms exist in a world of myriad regulations; they expect regulation and discipline. As noted in Appendix A, from January 1, 1998 forward no fewer than 50 of the SIA's 100 most well capitalized broker-dealers, including such well known firms as Merrill Lynch, NationsSecurities, Piper Jaffray, Hambrecht & Quist and Prudential Securities, et al. have been disciplined by regulators (some more than once) for the kinds of violations which are the inevitable detritus of brokerage activities. The charges are exactly the kinds of allegations against day

¹⁴The Industry Standard, July 12, 1999.

trading firms made (in magnified fashion) by the NASAA Report; that is, order entry matters, short sale, margin and books and records violations, as well as failures to monitor trading practices and register personnel; even omissions as to the risks of investment losses and false marketing. The institutions investing in day trading firms realize that the alleged violations are within the pattern of regulatory discipline; that is, fines reflecting the seriousness of the offense and the firm's capital, and measures which stress the importance of corrective actions, proper supervision and compliance.

Summary

All participants in the securities industry respect securities regulators. In this regard, ETA believes that it is significant that to this point, neither the Securities & Exchange Commission, nor the NASD, have initiated disciplinary action of any extraordinary nature against on-site day trading firms. Thus the evidence is convincing that the attempt to demonize day traders has been orchestrated by a small group of NASAA officials for their own purposes.

Day trading is not gambling. The majority of those who day trade after training do not lose money. The individuals who day trade represent the democratization of securities trading. They neither seek nor need the protection of regulators. Their lack of complaints in itself speaks volumes.

More importantly, day trading provides great benefits to the economy and to small investors everywhere. If it were not for day traders, history tells us that competition by ECNs with market makers would either be weak or non-existent. If it were not for day traders market maker spreads would be higher than they are at present. If it were not for day traders, the technology of the securities industry would not have advanced to its present level.

Day trading firms are part of the securities industry. That fact is recognized by the large investments in them made by institutional investors. Those investments would not be made if day trading firms were wantonly violating securities regulations. Current regulatory cases show that the majority of major broker-dealers have been the subject of discipline by regulators for activities similar to those alleged of day trading firms.

ETA members seek to be in compliance with all regulations; they promote risk disclosure and avoid hype. While ETA believes suitability standards are out of place in a business where investment decisions are made dozens of times a day independently by customers, it also considers that if there is to be a suitability standard, the option rules provide a useful model.

Appendix A

Disciplinary Actions

January 1, 1998 - August 31, 1999

(SIA Top 100 Firms By Capital)

<u>Date</u>	<u>Firm</u>	<u>Violations</u>	<u>Penalty</u>	<u>Regulator</u>
02/98	Raymond James	Books/Records Sup.	\$ 35,000	NYSE
02/98	Mayer & Schweitzer (Schwab)	Trading Violations	29,000	NASD
02/98	Troster Singer (Spear Leeds)	Customer Order Violations	198,000	NASD
03/98	Raymond James	Trade Reporting	17,500	NASD
03/98	Ernst & Co.	Order Entry	12,000	NASD
04/98	Piper, Jaffray	Short Sale & SOES Violations	20,897	NASD
04/98	Deutsche Morgan Grenfell	Trade Reporting	12,500	NASD
05/98	Alex Brown	Trading Violations	90,000	NYSE
05/98	J. Hancock Clearing	Books & Records	60,000	NYSE
05/98	NationsSecurities and NationsBank	Books & Records/ Inadequate Monitoring for Improper Trading/	4,000,000 (Plus 2,000,000 to NASD)	SEC
05/98	ABN Amro	Trade Violations	15,000	NASD
05/98	Everen	Trade Reporting	18,500	NASD
06/98	Troster Singer (Spear Leeds)	Trade Reporting	12,000	NASD
06/98	Fahnestock	Margin, etc.	100,000	NYSE
07/98	Dean Witter	Failure to Provide Information	10,000	NASD

<u>Date</u>	<u>Firm</u>	<u>Violations</u>	<u>Penalty</u>	<u>Regulator</u>
07/98	NationsBanc	Registration Failures	16,000	NASD
08/98	Cowen	Margin Failures, etc.	380,000	NYSE
08/98	Merrill Lynch	As Underwriter sold Notes Through Official Statements that Omitted Material Facts & the Risks of Investment Losses.	2,000,000	SEC
08/98	Nikko Securities	Failure to Supervise/ Inadequate Procedures/ Books & Records	2,500,000	SEC
09/98	Piper Jaffray	Order Entry Violations	12,500	NASD
09/98	Herzog Heine	Order Execution	10,000	NASD
09/98	Mayer & Schweitzer	Quotes	10,000	NASD
09/98	Bear, Stearns	Best Execution	34,584	NASD
09/98	CS First Boston	Delayed Investigation of Improper Activity by Branch Manager	500,000	SEC
10/98	Prudential Securities	Inaccurate Mark to Market in Customer Accounts, False Marketing Information Regarding CMOs	500,000	NYSE
10/98	Merrill Lynch	Order Entry	85,000	NYSE
11/98	Schroder	Regulation T Violations	25,000	NYSE
11/98	John Hancock Distribs.	Misleading Sales Material and Presentation	100,000	NASD
11/98	Paribas	Order Entry	20,000	NASD
01/99	Morgan Stanley	Order Execution	60,000	NASD
01/99	Salomon Smith Barney	Failure to Supervise/ Order Execution/ Books & Records/ Unlawful Profits & Gains	735,000 & Disgorge- ment of 24,766	SEC

<u>Date</u>	<u>Firm</u>	<u>Violations</u>	<u>Penalty</u>	<u>Regulator</u>
01/99	Prudential Securities	Failure to Supervise/ Books & Records/ Unlawful Profits & Gains	1,000,000	SEC
01/99	Morgan Stanley	Fictitious Quotations/ Unlawful Profits & Gains	350,000 & Disgorge- ment of 4,170	SEC
01/99	CIBC Oppenheimer	Failure to Supervise/ Fictitious Quotations/	225,000	SEC
01/99	Lehman Brothers	Fictitious Quotations/ Unlawful Profits & Gains	212,500	SEC
01/99	Bear, Stearns	Failure to Supervise	225,000	SEC
02/99	Smith Barney	Trade Execution	17,000	NASD
04/99	Hilliard Lyons	Registration	32,500	NASD
04/99	ABN Amro	Confirmations	13,500	NASD
04/99	Everen	Limit Orders	13,000	NASD
05/99	Hambrecht & Quist	Regulation T	35,000	NYSE
05/99	HSBC Securities	Books & Records, etc.	50,000	NYSE
05/99	Merrill Lynch	Order Execution	15,000	NASD
05/99	Warburg Dillon Read	Limit Orders	17,500	NASD
06/99	NationsBanc	Best Execution	15,968	NASD
07/99	Legg Mason	Confirmations	16,500	NASD
07/99	Spear Leeds	Trading	275,000	NYSE
08/99	Crowell, Weeden	Books & Records	50,000	NYSE
08/99	Everen	Order Entry	120,000	NYSE
08/99	Donaldson Lufkin & Jenrette	Trade Reporting	11,000	NASD
08/99	Tucker, Anthony	Trade Reporting	16,497	NASD
08/99	McDonald & Co.	Best Execution	15,431	NASD
08/99	Bear, Stearns	Clearing Failures	3,500,000	SEC

APPENDIX B

THE NEW YORK TIMES, SUNDAY, AUGUST 1, 1999

**GORDON
GEKKO
EAT YOUR
HEART OUT.**

Wall Street used to be about greed. Now it's about brains. About taking control of your money. So go ahead. Buy stocks. Mutual funds. Even government bonds. Online or over the phone. Want more? How about market quotes and portfolio updates. Yup. Just a mouse click away. So welcome to the world of investing. And hey. Check your cufflinks at the door.

DISCOVER BROKERAGE
A MORGAN STANLEY DEAN WITTER COMPANY

www.DISCOVERBROKERAGE.COM

APPENDIX C**ETA MODEL RISK DISCLOSURE STATEMENT**

 Customer Name (Please Print)

 Account Number

THE RISK OF LOSS IN ELECTRONIC DAY TRADING CAN BE SUBSTANTIAL. YOU SHOULD, THEREFORE, CAREFULLY CONSIDER WHETHER SUCH TRADING IS SUITABLE FOR YOU IN LIGHT OF YOUR CIRCUMSTANCES AND FINANCIAL RESOURCES. IN CONSIDERING WHETHER TO TRADE, YOU SHOULD BE AWARE OF THE FOLLOWING POINTS:

- (1) The national securities markets are extremely efficient and competitive. Successful Electronic Day Trading typically requires skill and discipline as well as experience and knowledge of the capital markets. There is no guarantee that you will be successful in implementing your investment strategy. A substantial number of Electronic Day Traders will not be successful. Moreover, changes in market structure and competitive conditions also may affect your continued success. Only risk capital should be used for trading. Market structure and competitive changes in the markets may cause formerly successful traders to become less successful.
- (2) Electronic Day Trading involves a high volume of trading activity — the number of transactions in an account may exceed 100 per day. Each trade generates a commission and the total daily commission on such a high volume of trading can be in excess of any earnings.
- (3) Persons who are new to Electronic Day trading should strictly limit both the number of trades they do and the size of their trades to reduce the risk of large dollar losses during the learning process.
- (4) Electronic Day Trading is designed to produce short-term profits. However, the activity also may result in losses that can exceed more than 100% of your initial capital. You are solely responsible for any losses in your account.
- (5) Placing contingent orders, such as "stop-loss" or "stop-limit" orders, will not necessarily limit your losses to the intended amounts, since market conditions on the NASDAQ or any Alternative Trading System on which the order is placed may make it impossible to execute such orders. Similarly, using "market orders" can be very risky, since large gaps can occur in price movements of active stocks. You are urged in most instances to use "limit orders."
- (6) Under certain market conditions, you may find it difficult or impossible to liquidate a position quickly at a reasonable price. This can occur, for example, when the market for a stock suddenly drops, or if trading is halted due to recent news events or unusual trading

activity. The more volatile a stock is, the greater the likelihood that problems may be encountered in executing a transaction.

(7) In addition to normal market risks, you may experience losses due to system failures. The firm and its clearing broker rely upon sophisticated computer software and hardware to execute transactions, which are subject to failure due to a variety of factors. In addition, NASDAQ and the Alternative Trading Systems have computer systems that often malfunction. Among other events, you may experience losses due to: system crashes during both peak and low volume periods; the loss of orders on both SOES and Select Net; and, delayed, conflicting and inaccurate confirmations on orders or cancellations that you initiate.

(8) The use of any margin or leverage in an account can work against you as well as for you. Leverage can lead to large losses as well as gains. You may sustain a total loss of the initial margin funds and any additional funds that you deposit with your broker to establish or maintain a position, and you may incur losses beyond your initial investment. If the market moves against your position, you may be called upon to deposit a substantial amount of additional margin funds, on short notice, in order to maintain your position. If you do not provide the required funds within the time required, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account.

(9) You should consult your broker concerning the nature of the protections available to safeguard funds or property deposited in your account.

ALL OF THE POINTS NOTED ABOVE APPLY TO ELECTRONIC DAY TRADING OF DOMESTIC EQUITY SECURITIES. IF YOU ARE CONTEMPLATING TRADING FUTURES OR OPTIONS CONTRACTS, YOU SHOULD BE AWARE THAT THESE INSTRUMENTS POSSESS ADDITIONAL RISKS.

THE RISK OF ELECTRONIC DAY TRADING MAY BE SUBSTANTIAL. THIS BRIEF STATEMENT CANNOT, OF COURSE, DISCLOSE ALL THE RISKS AND OTHER ASPECTS OF ELECTRONIC DAY TRADING. ONLY RISK CAPITAL SHOULD BE USED FOR SUCH TRADING.

I hereby acknowledge that I have received and understood this risk disclosure statement.

x _____

Signature

x _____

Joint Owner Signature, if any

x _____

Date

APPENDIX DELECTRONIC TRADERS ASSOCIATION
STATEMENT OF ETHICAL PRINCIPLES

Electronic Traders Association (ETA) is an association of broker-dealers that provide individuals, who day trade, with technology at a level generally available to institutions and securities dealers. ETA seeks to encourage education and awareness regarding the opportunities and risks of day trading, to promote price competition in all securities markets, and to be a resource for law, guidance and regulation in these areas.

Changes in technology now allow individuals direct access to the securities markets without the assistance of intermediaries or professional advice. These changes require day trading firms to meet high standards of ethical business conduct. As ETA members we pledge to observe these principles:

I. Responsibility to Promote Reasonable Regulation in the
Interests of Our Customers and the Securities Markets

We will cooperate with lawmakers and regulators to encourage appropriate regulation to protect day traders and to make securities markets more efficient.

We are dedicated to establishing and following appropriate policies and procedures to effect full compliance with the letter and spirit of the laws and regulations which govern our activities, maintaining all appropriate state and federal licenses.

II. Responsibility to the Prospective Customer

We will be truthful in all communications with prospective customers, seeking to make sure that our communications are complete in all material respects.

We will not make misleading or exaggerated claims about our services, or the benefits of day trading, and will provide a balanced perspective in our advertisements and presentations.

We will disclose fully and candidly, orally and in writing, the risks of day trading -- knowing that successful day trading requires knowledge of the securities markets, skill, and commitment. We will not obscure the reality that most people lose money in their initial

trading period and that many will not ultimately become successful day traders.

We will not make false statements, provide erroneous information, or fail to inform prospective customers of the limitations, conditions or constraints of our own systems or those of our vendors.

We will be candid in our assessment of any prospective customer's skills and potential for success. We will not open accounts for customers who do not appear to have the ability to sustain losses, or intend to trade with retirement assets, or assets necessary for daily living.

III. Responsibility to Our Customers and Our Commitment to Their Success

We will be frank and honest in our communications with customers, providing to each a statement explaining the risks of day trading, including the fact that many persons will not be successful and may lose money.

We recognize that customers' skills and potential for success will vary, and therefore we pledge to be candid in our appraisal of their individual abilities as they become apparent.

We will maintain facilities to enable customers to execute transactions efficiently -- continually developing and refining systems and vendor relationships to promote customer success.

We will uphold each customer's right to privacy and confidentiality.

IV. Responsibility to Promote Best Practices

We will promote fair and open access to the securities markets and will resist discriminatory policies and practices. We will work with lawmakers and regulators to assure fair treatment of our customers and to promote efficient markets.

We will improve continually the training we offer customers and encourage them to learn.

We will treat all persons fairly, regardless of race, religion, sex, age or national origin. We will not tolerate on our premises individuals who engage in offensive behavior.

We recognize that the markets continually change and that

regulatory requirements change accordingly. We will not be satisfied with ethical standards as they were but will promote principles and practices that reflect the nature of the day trading industry as it may change.

Unanimously approved by the ETA Board of Governors, July 28, 1999.

Andover Brokerage, LLC
Mount Pleasant Brokerage Services, LP
Momentum Securities, Inc.
On-Line Investment Services, Inc.
Tradescape.Com, Inc.

The Electronic Traders Association is an association of order entry and proprietary trading firms and other vendors, affiliated companies and individuals across the United States. ETA was formed to encourage education and awareness regarding the opportunities and risks of day trading, to promote access to the NASDAQ market for all investors, to promote price competition in the NASDAQ market, and to promote investor fairness and confidence in the NASDAQ market.

APPENDIX ECommon Misconceptions About Day Trading1. Day Trading is a New Phenomenon.

Day traders have existed as long as there have been markets. Specialists and market makers are given regulatory and informational advantages to day trade. However, individuals have been engaged in professional day trading on the floors of our national stock and commodity exchanges since their formation in the 18th century. Individuals have traded "upstairs" in brokerage offices at least since Edison invented the stock ticker more than 100 years ago. History shows that whenever anyone believes he has an informational edge, through proximity (being on the floor) or technology (the ticker) he trades securities for a living. What is new is that changes in technology and recent SEC regulations governing the securities markets now make it possible for on-site day traders to have virtually the same access to market information, execution and order exposure as the professionals.

2. Day Trading Firms are Entities Apart From the Rest of the Securities Industry.

Day trading firms service customers who intend to trade full time as a vocation. Trading customers have always been welcomed at brokerage firms. On-line discount firms like Schwab, E*Trade and Fidelity compete actively for active traders' business by offering them preferential technology and commission rates. Various firms share profits with their registered and unregistered traders. A clear example that day trading firms are just another part of the securities

industry is seen in the Securities Industry Association's June, 1999 letter opposing the NASD's "appropriateness" proposal. In addition to speaking for SIA's membership the letter states that it reflects comments of "The Federal Regulation Committee (Chairman, the General Counsel of Prudential Securities), the Discount Brokerage Committee and committee on Technology and Regulation (Chairman, counsel of Fidelity Securities)". As noted in the text, it has been reported that larger members of the securities industry are actively seeking to purchase day trading firms, just as they have been investing in ECNs.

3. Day Traders Offer No Benefits to the Securities Markets and Investors.

Day traders provide multiple benefits to the markets and the customers who use them. Perhaps the most obvious benefits result directly from limit orders and indirectly through orders placed on ECNs. These orders foster important competition to market makers, narrowing market maker spreads (the major cost to retail investors) and providing alternatives allowing price improvement to all market participants, including institutions. An example: assume the spread on a given stock is 20-20-1/4; a day trader's limit order to buy 1,000 shares at 20-1/8, will provide an additional \$125 to the proverbial Aunt Sally in Portland who is selling stock to pay for her favorite niece's freshman year at Orano. This effect is exactly what Congress had in mind in enacting the National Market System and the SEC intended in promulgating its order handling rules in 1997.

4. Day Traders Add to the Volatility of the Market.

Professor Burton Malkiel's studies show that volatility is more closely correlated with institutional ownership than day trading. But the other side of the volatility coin is liquidity. One Alternative Trading System, Optimark, claiming that day traders added approximately 100 basis points to the execution cost of a large institutional order masks such orders from public view. However, institutions, the system's intended customers, simply do not use it. Institutions understand the volatility argument is overstated; they prefer the depth and liquidity of the market, the increasing quote competition and enhanced price discovery mechanism which are strengthened by day traders. As Professor Samuelson in his classic textbook on economics wrote regarding day traders (circa 1955) "Traders make the market less thin. Because of them, any investor can liquidate his market holdings at any time at some price... liquidity enhances the attractiveness of securities..." In fact, to service day traders various ECNs - unlike Exchange specialists and market makers - now make available their entire book of orders. Thus the average customer can see all the prices. As one fund manager wrote recently in the New York Times: "The Internet takes out the middlemen who are not creating value. John Q. Investor should care because if he wants to get a maximum return on his investment dollar, he does not want to pay anyone any more than he has to." Day traders are a key instrument for pre and post transparency. (Providing meaningful pricing data for all investors and transparency reduces "gaming" by market makers, especially at the opening of trading.

5. Day Traders are Not Informed of the Risks of Day Trading.

ETA not only supports the NASD's risk disclosure proposal, ETA believes it does not go far enough. ETA members already require that prospective customers sign a statement containing risk disclosures significantly beyond what the NASD proposes. But disclosure or not it is simply impossible for on-site day traders not to be aware of their trading risks. In a typical on-site office the traders are in close proximity to each other, if they have been trained at the firm they will have seen numerous examples of failed trades and strategies. In simple terms, no day trader could possibly be unaware of these risks. If as one blue sky commissioner's reported, 67 of 68 day traders in an office lost money, traders would be fleeing the office screaming "plague". More particularly, for those who do lose money the understanding and acceptance of the risks, and their own market decisions, explains why the NASAA Report cited no customer complaints. In fact, the Atlanta Constitution reported in August that the director of the Massachusetts Securities Division admitted that the Division's investigations did not stem from customer complaints.

6. Seven, Eight or Nine Out of Ten Day Traders Lose (All) of Their Money.

The keystone of the attempted demonization of day trading firms by the NASAA Report is its claim that a high percentage of day traders lose money. When offered the opportunity by ETA to conduct an impartial study of the subject NASAA refused. When the NASAA Report was released the numbers provided by its "expert" were notably incredible: 17, the number of accounts sampled, was small; the accounts came from one office of one non-ETA firm; the sampling was of two year old account information; the period focused on covered four months;

the percentage of alleged losers had dropped from previous references of 8 or 9 out of 10 to 65%; and, most bogus of all, the standard for testing was not, as one would expect, traders who had lost all of their money, but traders who if they continued trading would realize a "Risk of Ruin", that is, against all common sense they were destined at some point in the future to lose all their money. ETA has determined to put these fantasy figures to rest. It expects to commission KPMG to do a study based on thousands of day trading accounts, over a considerable period of time at a number of firms. ETA believes that study will bear out its members' estimates of day trading profitability; that is, approximately 60% of day traders lose money in their three to five month learning period, thereafter well over 60% make money, averaging \$25,000 or more in monthly profits, while the balance lose \$6,000 - \$8,000 monthly.

7. Day Traders are at a Trading Disadvantage to Market "Professionals".

The technology platforms utilized by day traders are the state of the trading art. That they are beyond the existing technology at many firms was reported in an August 13, 1999 New York Times article, which wrote that Fidelity Investments, Lehman Brothers and Instinet are considering "adopting the software platforms of day trading firms..."

One institutional trader has stated: "Individual traders now have a lot of the same tools we institutions do; real-time quotes, push button executions..." Five months of training and experience puts customers at the same level of market knowledge skills as the traders at market making desks. In fact, the knowledge level of the day traders may be higher given the advanced level of education of day traders compared to traders employed by market makers. Market

makers recognize that there is at least a level playing field in skills and technology. To quote the President of a major market maker, "The genie is out of the bottle and it ain't going back in."

8. . Day Traders Routinely Violate Securities Regulations.

Forgery, false advertising, evasion of margin regulations, improperly executing short sales, promoting unregistered investment advisors, are the most sensational charges leveled by the NASAA task force against day trading firms. But, as the NASAA Report shows, neither the SEC nor NYSE has ever brought a case aimed at day trading practices, while the NASD, which annually examines all day trading firms, has fined one firm \$25,000 for failure to register certain employees (and another \$7,500 for order entry violations). And this is in a period in which the SEC, NYSE and NASD have brought numerous actions against household name brokerage firms for infractions of the myriad securities regulations. Thus in August alone the NYSE and NASD disciplined such firms as Everen Securities, McDonald Investments, Inc., Donaldson Lufkin and Jenrette and Tucker, Anthony, Inc. In fact, other than Massachusetts, which wrote the NASAA Report and is the home of its chairman, only a handful of states have taken action. These have brought in all four cases for failures to file broker-dealer reports or register; one state, apparently finding no securities law violations, claimed the firm involved had violated the state's franchise law. That the NASAA effort is in reality driven by one state is put in further context by the fact that the nation's five most populous states, California, New York, Illinois, Florida and Pennsylvania have taken no action. Day trading is used by the NASAA leadership to promote its position in the regulatory world. As NASAA President Hildredth stated "to reposition ourselves... with a little imagination we can find [the news media] stories to write about". It is

clear that most regulators do not agree that a customer's authorization (in writing) of a firm employee to sign the customer's name when he is unavailable to sign is "forgery", or that one customer's trading his parents' money amounts to his being an unregistered investment advisor; or that there have been violations of short sale regulations. As a matter of fact even the NASAA Report admits that the states have no regulatory role in securities credit matters. Thus what the NASAA Report pumps up beyond all recognition are brokerages' common failings regarding books and records, sales practices and order entry and execution.

APPENDIX F**RONALD L. JOHNSON**

3624 Dana Shores Drive, Tampa, FL 33634
 Business: (813) 884-0331 Fax: (813) 884-0779

EXPERIENCE:**CONSULTANT (FUTURES & SECURITIES)****1986- PRESENT**

Provide investment analyses, damage calculations; and consulting services for securities and commodity disputes. Special expertise in options and commodities. Knowledgeable in all aspects of these markets including theory, practice, compliance and suitability. Expert in trading risk assessment and statistical expectations. Insightful analyses based on professional trading experience, advanced analytical background, and quantitative analyses techniques.

Consulted with numerous law firms, individuals, and the State of Florida. Represented clients in California, Michigan, Ohio, Louisiana, Florida, Virginia, Pennsylvania, and Massachusetts. Provided expert testimony in Federal Court, State Court, CFTC Reparations, and arbitration proceedings of the National Association of Securities Dealers, National Futures Association, American Arbitration Association, and New York Stock Exchange.

PUBLISHER, COMMODITY TRADING SERVICE**1985-1986**

Edited and published "TRADING POINTS," a national futures trading service. Published daily hot line trading recommendations and biweekly reports on index futures and options markets based on proprietary computer models and indicators developed as a professional trader.

PROFESSIONAL TRADER**1982-1985**

Traded managed option and futures accounts for suitable clients. Developed new technical trading indicators and trading systems based on market research and quantitative, analytical background. Honed trading skills in professional trading contests.

INVESTMENT ADVISOR**1978-1985**

Edited and published the "ROI ADVISOR," an investment letter on the stock, bond, and gold markets. Developed low price stock strategy that returned over 30% per annum during this period. Developed client base through referrals. Served as investment consultant to individuals, trusts, and pension funds.

Adult Education

MSAD #11

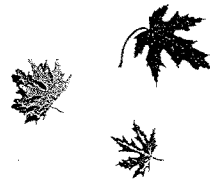
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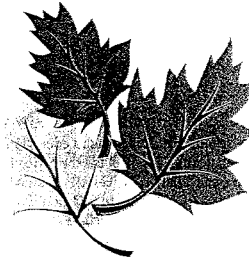
Oct

Nov

Dec




1999
Fall Program



Registration Begins August 23rd



Home & Community	
<p>Putting Your Garden to Bed <i>Jeffrey Quirion</i> Proper fall care is the key to your garden's health and survival. In this course learn proper storage of summer bulbs, soil conditioning, caring for perennials, planting fall bulbs for spring color and what to do with all those leaves. Jeff will also discuss tips for cultivating plants that will brighten up your home in the winter months. High School Room 343. Begins: Thursday, September 23 Time: 6:00-8:00 pm, 6 weeks Fee: \$20 res./\$25 non-res</p>	<p>Day Trading for Beginners <i>Ory Canal</i> Day trading, especially on-line, is a hot topic these days. Learn what is involved, what are the risks and benefits and why it is becoming so popular. Topics will include an examination of different types of investments, stock market terminology, characteristics of common stocks, how to analyze common stock performance and how to get started in day trading. Please bring a Wall Street Journal to class with you. High School Room 204. Session A: Thursday, September 23 Session B: Thursday, October 28 Time: 7:00-9:00 pm, 1 night Fee: \$5 res./\$7.50 non-res.</p>
<p>Dried Floral Arranging <i>Ap</i> Those participating in the designs in creating wall basket, pot, etc.). Direct used will be available in ment in the drying process a wreath from eucalyptus be arranging to complete of \$3 per class includes rolled will be responsible and wire cutters. Student Begins: Thursday, October 28 Time: 6:30-9:00 pm Fee: \$20 res./\$25 non-res \$3 lab fee paid</p>	<p>Holiday Floral Arranging Participants will create first week will be design students will be responsible for individual decorations (small pine cones, holly berries, garland, colored balls, tree top, etc.). The tree will be approximately 15-18" tall and is a nice gift for a shut-in, or for someone who may not have a full-size tree. The second class we will create a boxwood and holly centerpiece. The approximate fee for the container foam, boxwood, candle, holly and velvet bow is \$7. Students may decorate the centerpiece as they want with decorations, pine cones, berries, etc. Students should bring scissors, wire cutters, decorations for tree and centerpiece. Student limit 10. High School Room 313. Begins: Thursday, December 2 Time: 6:30-9:00 pm, 2 weeks Fee: \$30 res./\$12.50 non-res. \$13 lab fee paid to instructor-1st class \$10 lab fee paid to instructor-2nd class</p>
<p>Christmas Wreath <i>Jeffrey Quirion</i> Celebrate the Season! Make a single sided balsam and pine wreath just in time for the holidays. Some supplies will be provided by instructor (\$10). Bring decorations to add. High School Cafeteria. Begins: Monday, November 29 Time: 6:00-9:00 pm, 1 week Fee: \$5 res./\$7.50 non-res. \$10 lab fee paid to instructor</p>	<p>Pre-Retirement Seminar <i>Laurie Gagnon</i> Sponsored by the Social Security Administration, this informative presentation is for anyone planning for retirement-no matter what your age. Topics will include obtaining benefits, disability and Medicare application information, how divorce and remarriage effect benefits and much more. To receive your personal printout of estimated benefits, give us your date of birth and social security number when registering. Free, but you must call 582-3774 to pre-register. High School Conference Room. Begins: Tuesday, September 28 Time: 6:30-8:30 pm, 1 week</p>
	<p>Getting Started in Family Childcare <i>Rita Fullerton, Childcare Options</i> This two evening course will fulfill the six hours of orientation required by DHS for childcare certification. We will cover health & safety standards and business management. A packet of materials will be given to each participant. High School Rm 344. Begins: Wednesday, October 20 Time: 6:00-9:00 pm, 2 weeks Fee: \$10 registration fee</p>






Computerized Day Trading


S&P 500 Index, Stock Market, Currency Markets,
 and Institutional Trading of Debt Instruments
**A POWERFUL HIGH-PROFILE INCOME
 OPPORTUNITY**

 (Potential 6 to 7 Figure Income Per Year) 


- Earning Potential
- S&P 500 Performance Charts
- Stock Performance Charts
- Our Locations
- Institutional Trading
- Corporate Philosophy
- Guestbook
- Brokerage Services


 **The absolute best trading system in the financial market**


You are just about to be introduced to one of the most powerful trading systems ever developed. By learning our trading method, you will be taking a big step away from the crowd of amateurs and on your way to becoming a successful professional trader. Our sophisticated trading system is the absolute best in the financial market -- and we couple this with state-of-the-art training facilities and the best on-going support system.



 **Requirements needed for this phenomenal opportunity**

NO experience, NO selling, NO boss, NO employees, NO inventory, NO traveling and NO invoice collection. All you need is a computer and a small amount of start up capital (for start-up cost information, click on the "Earning Potential" button to the left).

 **Click below to learn more about the exciting opportunity of Institutional Trading of Debt Instruments**



	<h2 style="text-align: center;">Computerized Day Trading</h2> <p style="text-align: center;">Learn how to become a professional trader...</p> <ul style="list-style-type: none"> ✓ Day trading and long-term trading <ul style="list-style-type: none"> ✓ Futures market and Stock markets ✓ S&P500 - E-mini - Currency - Stocks <p style="text-align: center;">POWERFUL HIGH-PROFILE INCOME OPPORTUNITY</p>
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"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 to leave for the day on a whim."

All-Tech Investment Group Online <<http://www.attain.com/faq.html>>.
See NASAA Report, p. 13 (visited July 26, 1999).

**"We have a success rate
of around 85% with
customer traders, meaning
people who come here and
actually make money doing
this over time."**

On-Line Investment Services, Inc. <<http://www.onli.com>>
See NASAA Report, p. 11. Cited information is no longer found on web site.

“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.”

On-Line Investment Services, Inc. <<http://www.onli.com>>
See NASAA Report, p. 12. Cited information is no longer found on web site.



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 6

September 21, 1999

The Honorable Susan M. Collins
Chairman
Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510-6250

Dear Chairman Collins:

I would like to congratulate you on the success of your hearings on day trading last week. Your leadership in this area is important. By focusing attention on the extraordinary risks that day traders take on and the unbalanced and questionable marketing used to lure potential day traders, I believe that many more individuals will think twice before using their hard earned money for day trading. Arming individuals with the information they need to make informed decisions is, I believe, the most effective form of investor protection.

I have enclosed a response to Senator Levin's question on margin, which was prepared by the staff. We would be happy to answer any additional questions you may have on this or other matters.

Sincerely,

Arthur Levitt

Enclosure

cc: The Honorable Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations

MEMORANDUM

To: Chairman Levitt

From: Robert L.D. Colby *RC*
Deputy Director
Division of Market Regulation

Re: Day Trading Margin Requirements

Date: September 20, 1999

This memorandum responds to the margin question that Senator Levin posed to you at the day trading hearing on September 16, 1999. Specifically, Senator Levin asked what the margin requirements are when a customer has \$50,000 in cash in his margin account at a broker-dealer, and during the day, the customer purchases \$120,000 of stock. The customer sells this stock before the end of the day and, after commissions, there is no loss or gain in the account.

In this example, only the margin rules of the self-regulatory organizations ("SROs") would apply. There would be no obligation under Regulation T to post margin because margin requirements under this rule are calculated at the end of the day when, in this example, the customer has no securities and there were no losses in the account.¹

However, the broker-dealer has extended the customer credit for the intra-day positions, and is therefore at risk. Accordingly, the SROs have adopted a special maintenance margin requirement for day trading² that, in effect, requires a customer to demonstrate that he could meet a margin call if he did not unwind the positions by the end of the day.

Specifically, paragraph (f)(8) of the New York Stock Exchange, Inc.'s ("NYSE") margin rule, Rule 431, provides that when day trading occurs in the account of a day trader, a customer's margin requirement is calculated at the end of the day based on the total cost of all the day trades made during that day. The purpose of this provision of Rule 431 is to require margin on the day trader's greatest exposure during the day, rather than -- as under Regulation T -- the day trader's position at the end of the day. Because,

¹ Regulation T is the rule, promulgated by the Board of Governors of the Federal Reserve, that governs lending by broker-dealers in connection with the purchase of securities. 12 CFR 220.4(c)(1).

² Under the SROs' margin rules, a day trader is any customer whose trading shows a pattern of day trading. Industry practice is to presume that a customer is a day trader if the customer conducts three or more day trades in one calendar year.

in this example, the day trader purchased stock,³ the SRO rules would require margin in the customer's account equal to 50% of the total cost of all the day trades, or \$60,000 (50% of \$120,000).⁴ In this example, the broker-dealer would issue a margin call to the customer for \$10,000.

The NYSE has issued an interpretation of Rule 431 that provides that, if the broker-dealer keeps a record showing the "time and tick" of each trade as evidence of the sequence of the day trades, the customer may maintain margin based on the largest aggregate open position during that day.⁵ Under this interpretation, a day trader that purchases and sells small blocks of stock during the day would have a lower day trading margin requirement than a day trader that accumulated a large block of stock before selling the position. Under the time and tick interpretation, if the day trader had purchased then sold \$100,000 of stock, then purchased and sold another \$20,000 of stock, his day trading margin requirement would be 50% of the total cost of the largest aggregate open position, or \$50,000 (50% of \$100,000). Under these circumstances, the broker-dealer would not issue a margin call to the customer.

SRO rules require that the broker-dealer receive any additional margin within seven business days of the trade date.⁶ Many broker-dealers, however, require customers to meet any margin call within less than seven days. After only five business days, the Commission's net capital rule⁷ requires a broker-dealer to take a capital charge equal to the amount of any unmet margin call. This penalty against a broker-dealer's capital provides an incentive to firms not to expand credit beyond that permitted by SRO rules.

³ Some stocks must be paid for in full and cannot be purchased on margin. Among other types of securities, Regulation T provides that any equity security registered or having unlisted trading privileges on a national securities exchange or any equity security listed on The Nasdaq Stock Market can be purchased on margin.

⁴ NYSE Rule 431 provides that the margin required in a day trader's account is the greater of the percentage of total cost required under Regulation T, or the percentage required under Rule 431. For margin stock, Regulation T requires margin equal to 50% of the total cost, which is greater than the 25% required under Rule 431. For other types of securities, however, the percentage required under Rule 431 may be greater than under Regulation T. For example, for debt securities, Regulation T only requires good faith margin as determined by the broker-dealer, whereas Rule 431 requires that a customer have margin equal to a fixed percentage of the total cost of the debt securities.

⁵ The National Association of Securities Dealers, Inc.'s ("NASD") margin rule, Rule 2520, is substantially the same as NYSE Rule 431; however, the NASD has not adopted the "time and tick" interpretation regarding day trading margin.

⁶ NYSE Rule 431(f)(8)(C).

⁷ 17 CFR 240.15c3-1(c)(2)(xii).

The Commission staff is working with the NYSE on an Information Memorandum that would remind broker-dealers that they must take a capital charge for outstanding special maintenance margin calls associated with day trading accounts.

In addition, if the customer does not deposit the required margin by the seventh business day after trade date, the broker-dealer would be in violation of SRO margin rules, and the firm would be subject to appropriate disciplinary action, including censure, fine, and suspension by, and expulsion from, the SRO.

SRO rules do not require a broker-dealer to liquidate a customer's account for failing to meet a margin call. Because of the capital charges that must be taken when customers do not meet margin calls and the potential for SRO sanctions, however, most firms have internal procedures that call for the liquidation of a customer's account when the customer fails to meet a margin call. The Commission staff is discussing with the NYSE the need for an explicit requirement that broker-dealers restrict a day trading account from further day trading for 90 days if a day trading margin call is not met by the customer.



U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549 (202) 942-0020

NEWS
RELEASE

SEC INVESTOR ALERT

Issued September 16, 1999

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 7

Day Trading: Your Dollars at Risk

Day traders rapidly buy and sell stocks throughout the day in the hope that their stocks will continue climbing or falling in value for the seconds to minutes they own the stock, allowing them to lock in quick profits. Day traders usually buy on borrowed money, hoping that they will reap higher profits through leverage, but running the risk of higher losses too.

As SEC Chairman Levitt recently stated in his testimony before the U.S. Senate, "[Day trading] is neither illegal or unethical. But it is highly risky." Most individual investors do not have the wealth, the time, or the temperament to make money and to sustain the devastating losses that day trading can bring.

Here are some of the facts that every investor should know about day trading:

Be prepared to suffer severe financial losses

Day traders typically suffer severe financial losses in their first months of trading, and many never graduate to profit-making status. Given these outcomes, it's clear: day traders should only risk money they can afford to lose. They should never use money they will need for daily living expenses, retirement, take out a second mortgage, or use their student loan money for day trading.

Day traders do not "invest"

Day traders sit in front of computer screens and look for a stock that is either moving up or down in value. They want to ride the momentum of the stock and get out of the stock before it changes course. They do not know for certain how the stock will move, they are hoping that it will move in one direction, either up or down in value. True day traders do not own any stocks overnight because of the

extreme risk that prices will change radically from one day to the next, leading to large losses.

Day trading is an extremely stressful and expensive full-time job

Day traders must watch the market continuously during the day at their computer terminals. It's extremely difficult and demands great concentration to watch dozens of ticker quotes and price fluctuations to spot market trends. Day traders also have high expenses, paying their firms large amounts in commissions, for training, and for computers. Any day trader should know up front how much they need to make to cover expenses and break even.

Day traders depend heavily on borrowing money or buying stocks on margin

Borrowing money to trade in stocks is always a risky business. Day trading strategies demand using the leverage of borrowed money to make profits. This is why many day traders lose all their money and may end up in debt as well. Day traders should understand how margin works, how much time they'll have to meet a margin call, and the potential for getting in over their heads.

Don't believe claims of easy profits

Don't believe advertising claims that promise quick and sure profits from day trading. Before you start trading with a firm, make sure you know how many clients have lost money and how many have made profits. If the firm does not know, or will not tell you, think twice about the risks you take in the face of ignorance.

Watch out for "hot tips" and "expert advice" from newsletters and Web sites catering to day traders

Some Web sites have sought to profit from day traders by offering them hot tips and stock picks for a fee. Once again, don't believe any claims that trumpet the easy profits of day trading. Check out these sources thoroughly and ask them if they have been paid to make their recommendations.

Remember that “educational” seminars, classes, and books about day trading may not be objective

Find out whether a seminar speaker, an instructor teaching a class, or an author of a publication about day trading stands to profit if you start day trading.

Check out day trading firms with your state securities regulator

Like all broker-dealers, day trading firms must register with the SEC and the states in which they do business. Confirm registration by calling your state securities regulator and at the same time ask if the firm has a record of problems with regulators or their customers. You can find the telephone number for your state securities regulator in the government section of your phone book or by calling the North American Securities Administrators Association at (202) 737-0900. NASAA also provides this information on its Web site at www.nasaa.org.

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 JOYCE A. RECHTSCHAFFEN, MINORITY STAFF DIRECTOR AND COUNSEL

Senate Permanent Subcommittee
 on Investigations

United States Senate EXHIBIT # 9

COMMITTEE ON
 GOVERNMENTAL AFFAIRS
 WASHINGTON, DC 20510-6250

September 27, 1999

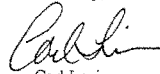
Mr. Saul Cohen, Esq.
 Consulting Counsel
 Electronic Traders Association
 Proscow Rose
 1585 Broadway
 New York, New York 10036-8299

Dear Mr. Cohen:

Thank you for testifying at our September 16, 1999, hearing on day trading. As the Ranking Member on the Permanent Subcommittee on Investigations, I have several questions to which I would appreciate your written response.

Please provide complete responses to the attached questions no later than October 8, 1999. Thank you for your assistance. If you have any questions, please contact Leslie Bell, of my staff, at (202) 224-9505.

Sincerely,



Carl Levin
 Ranking Member
 Permanent Subcommittee on Investigations

CL:ljjg
 Attachment
 cc: The Honorable Susan M. Collins, Chairman

QUESTIONS

1. How many members of the Electronic Traders Association (ETA) require their customers to sign ETA's risk disclosure form (Exhibit C in your statement from the hearing)? How many of those are on-site day trading firms?
2. You testified that day traders will lose money during the initial 3-5 months. What is the average loss per individual trader during this period of time and what is the basis for your estimate?
3. The following exchange occurred during the hearing:

Senator Levin. ... [W]e had testimony this morning that you were specifically asked for the backup information here.

Mr. Cohen. ... [W]e are talking apples and oranges.

Senator Levin. Relative to this survey of yours.

Mr. Cohen. ... So the second survey that we are talking about is one that is at a later point, that I participated in ... I think it was in August.

...

Senator Levin. So you are saying that this informal survey demonstrated that after an initial period of 3 to 5 months of losses that 65 percent netted, profited in the range of \$28,000 per month based on an average capital investment of perhaps 50- or \$100,000.

Mr. Cohen. Yes.

Senator Levin. You are going to supply us the data to support that estimate?

Mr. Cohen. I understand data regarding those estimates have been supplied to the Committee, but if they have not, I will find out from counsel who is doing it.

The Subcommittee has only the Momentum survey, not the "second survey" about which you testified. If the supporting data is in the Momentum survey, please explain where in the survey the supporting data is located, using page and paragraph references as appropriate. If the supporting data is located elsewhere, please provide the Subcommittee with a copy of any report or other document containing the data and highlighting the appropriate references.

If there is no written data for this "second survey," please provide the Subcommittee with the name and phone number of each individual you contacted; the date of each contact; the information each individual provided to you; and the justification each individual gave you, if any, for the information provided.

4. The North American Securities Administrators Association (NASAA) testified that it asked ETA for a copy of the Momentum survey as well as any others. Was a copy of this "second survey" provided to NASAA, and if not, why not?

PROSKAUER ROSE LLP

1585 Broadway
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Telephone 212.969.3000
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LOS ANGELES
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NEWARK
PARIS

Saul S. Cohen
Member of the Firm

Direct Dial 212.969.3170
sscohen@proskauer.com

October 14, 1999

VIA FEDERAL EXPRESS

Honorable Carl Levin
Ranking Member
Permanent Subcommittee on Investigation
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510-6250

Re: September 16, 1999 Hearing on Day Trading

Dear Senator Levin:

Thank you for your September 27 letter addressed to me as consulting counsel for the Electronic Traders Association ("ETA"), which posed several questions with respect to the Subcommittee's September 16, 1999 hearing. In response and adopting your enumeration, I am informed by ETA:

1. At present, the following five day trading firms are members of ETA:

Andover Brokerage, L.L.C.

Cornerstone Securities Corp.

Momentum Securities, Inc.

Mount Pleasant Brokerage Services, L.P.

On-Line Investment Services, Inc.

Other than Mount Pleasant, which is a proprietary trading firm and does not have retail customers, each of the above firms requires a customer to sign a risk disclosure form, in either the ETA or similar form. In addition, Landmark Securities, which is not an ETA member but uses software produced by Tradescape.com (which is an ETA member) also uses a risk disclosure form. (I

PROSKAUER ROSE LLP

Honorable Carl Levin
October 14, 1999
Page 2

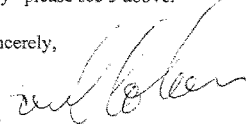
enclose copies of the risk disclosure statements for each of the above firms as they appear on the firms' Web Sites.)

2. The estimate was based on a survey conducted by Momentum Securities, Inc. ("Momentum Survey") of its Texas customers. As to customers in the five month trading period who were unprofitable, for December 1998, the Momentum Survey found that the mean and median loss was \$6,563 and \$1,996 respectively, and for January 1999, the Momentum Survey found that the mean and median loss was \$11,835 and \$3,811 respectively.
3. It appears to me that this question regarding "surveys" reflects a certain amount of confusion (which I may have inadvertently contributed to). What your letter calls the "Momentum Survey" is what the ETA written testimony (page 11) describes as the "rough estimate of client profitability" obtained "earlier this year". The reference to a "second survey" reflects another sentence of the same paragraph as follows: "In August, ETA's Executive Committee members considered these numbers to be still representative." This latter reference is not to a written survey, but rather oral responses received from the ETA on-site members participating in August 13 conference call: Andover Brokerage (David Laurent - (516) 466-1768) and Momentum Securities (James Lee - (713) 706-3300).

The confusion regarding "surveys" apparently derived from the Minority Staff and my lack of awareness that the Momentum Survey had previously been supplied to the Committee. I hope the above is now clear but it is important to note that the ETA testimony makes no attempt to claim precision as to customer profitability and, to make the point, uses such phrases in the relevant paragraph as "informally surveyed", "rough estimate", "estimates" and "do not purport to be scientific".

4. With regard to the "second survey" please see 3 above.

Sincerely,



Saul S. Cohen

SSC/lba

cc: Honorable Susan M. Collins, Chairman
Mr. William Lauderback

Disclaimer

Day trading is not investing, it is speculating. As with any form of speculation, there are risks. Day trading is considered a high-risk investment.

Day trading is fast-paced. The excitement and stimulation of day trading can be very attractive and habit forming, separate from any financial results. Your earnings/losses should be carefully monitored. Since margin accounts are used, it is possible to lose more capital than you have in the account. Any extension of credit will be charged interest at a varying rate (based upon a predetermined formula) to be determined by the clearing firm.

Andover stands responsible for honoring all executions that may occur through SOES and/or SelectNet. However, traders are subject to potential prosecution under the federal securities law for any illegal activity conducted, and the NASD will monitor all such trading activity so as to detect any such improper activity.

Past experience does not predict future results. Any success enjoyed by other day traders does not guarantee similar results for you. Only risk capital should be used, and the rigid observation of a system of stops for loss control is strongly recommended to prevent large losses from mounting rapidly. Individuals who have failed to keep tight stops while day trading have sustained substantial losses.

Commissions may add up to a substantial amount. For many successful traders, commissions take up a substantial portion of gross profits. Understand the [commission schedule](#). Andover will not reimburse any commissions collected outside of the normal volume discount schedule. Some trades may be subject to additional charges if executed by an ECN.

Other professional traders, funds, specialists, and market makers are also trading securities on a short-term basis. This will cause bids and offer prices to move, bids and offer sizes to change, and other changes in the pricing information. These changes may lead a trader to believe that certain transactions will be profitable, when, in fact, these conditions may quickly disappear, leaving the trader in an unprofitable position.

Continuing to hold positions intended for short-term speculation, after the end of the trading day introduces a new level of risk. Securities suitable for day trading are very volatile, and can open for trading the next day at prices very different from where they closed the previous day, with no intervening opportunity to exit the trade. Various regulatory bodies can halt trading in a security for various reasons. These securities can reopen at very different prices, with no intermediate opportunity to exit the trade.

News outlets can release very damaging or helpful news concerning a security that can cause very sudden, drastic price moves, with very limited opportunities to exit the trade. Andover does not make any recommendations. Your decisions to make trades are your own responsibility. Andover does not represent any trading opportunities as superior to any others which may or may not arise.

If you have filled out a trading authorization and designated someone other than yourself to trade your capital, you should be aware this opens up new risks. The trader will have discretion to trade any securities he/she deems appropriate. The trader will have no legal responsibility to report any trades or executions to you. You may not be able to monitor your capital at all times on a real time basis.

Disruptions in the electronic trading systems or lines utilized by Andover, the NASDAQ, or the NYSE could disrupt trading and the liquidity and availability of timely execution could diminish substantially. If this occurs during periods of volatility, substantial losses could be incurred. Andover will not be liable for losses that occur due to computer, line, or system failure.

As a result of increased market volatility and fast market conditions system access could be delayed. This delay may cause an execution at a price away from where the stock was trading when you entered the order.

The above comments were written to inform potential investors of the risk of day trading. There may be other factors that arise which have not been outlined. Please read recent [SEC Comments](#) on Day Trading.

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SEC COMMENTS ON DAY TRADING: 9/17/99

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Some websites have sought to profit from day traders by offering them hot tips and stock picks for a fee. Once again, don't believe any claims that trumpet the easy profits of day trading. Check out these sources thoroughly and ask them if they have been paid to make their recommendations.



Remember that "educational" seminars, classes, and books about day trading may not be objective

Find out whether a seminar speaker, an instructor teaching a class, or an author of a publication about day trading stands to profit if you start day trading.



Check out day trading firms with your state securities regulator

Like all broker-dealers, day trading firms must register with the SEC and the states in which they do business. Confirm registration by calling your state securities regulator and at the same time ask if the firm has a record of problems with regulators or their customers. You can find the telephone number for your state securities regulator in the government section of your phone book or by calling the North American Securities Administrators Association at (202) 737-0900. NASAA also provides this information on its website at www.nasaa.org.

To further enhance your understanding of the risks involved with day trading, in addition to the above comments, please read disclaimer. Andover Brokerage Disclaimer can be found on our website or at any Andover office.

If you have any additional questions please contact a representative of Andover Brokerage.

Andover Brokerage LLC

www.AndoverTrading.com

111 Great Neck Road

Suite 314

Great Neck NY 11021

(516) 466 1768

New Accounts

John Hopf

General Administration / Risk Disclosure Questions

Craig Feltz

Chief Of Operations

David Laurent

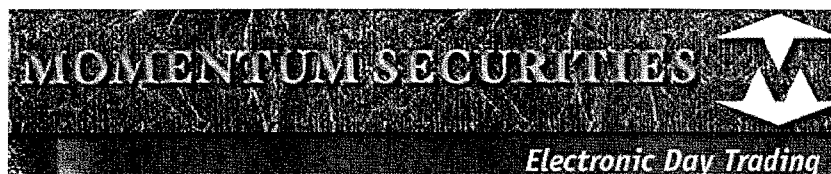
General Counsel

Dan Viola

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Understanding the Risk

MOMENTUM SECURITIES, INC. RISK DISCLOSURE STATEMENT

THE RISK OF LOSS IN ELECTRONIC DAY TRADING CAN BE SUBSTANTIAL. YOU SHOULD, THEREFORE, CAREFULLY CONSIDER WHETHER SUCH TRADING IS SUITABLE FOR YOU IN LIGHT OF YOUR CIRCUMSTANCES AND FINANCIAL RESOURCES. IN CONSIDERING WHETHER TO TRADE, YOU SHOULD BE AWARE OF THE FOLLOWING POINTS:

- (1) The national securities markets are extremely efficient and competitive. Successful Electronic Day Trading typically requires skill and discipline as well as experience and knowledge of the capital markets. There is no guarantee that you will be successful in implementing your investment strategy. A substantial number of Electronic Day Traders will not be successful. Moreover, changes in market structure and competitive conditions also may affect your continued success. Only risk capital should be used for trading. Market structure and competitive changes in the markets may cause formerly successful traders to become less successful.
- (2) Electronic Day Trading involves a high volume of trading activity - the number of transactions in an account may exceed 100 per day. Each trade generates a commission and the total daily commission on such a high volume of trading can be in excess of any earnings.
- (3) Persons who are new to Electronic Day trading should strictly limit both the number of trades they do and the size of their trades to reduce the risk of large dollar losses during the learning process.
- (4) Electronic Day Trading is designed to produce short-term profits. However, the activity also may result in losses that can exceed more than 100% of your initial capital. You are solely responsible for any losses in your account.
- (5) Placing contingent orders, such as "stop-loss" or "stop-limit" orders, will not necessarily limit your losses to the intended amounts, since market conditions on the NASDAQ or any Alternative Trading System on which the order is placed may make it impossible to execute such orders. Similarly, using "market orders" can be very risky, since large gaps can occur in price movements of active stocks. You are urged in most instances to use "limit orders."

(6) Under certain market conditions, you may find it difficult or impossible to liquidate a position quickly at a reasonable price. This can occur, for example, when the market for a stock suddenly drops, or if trading is halted due to recent news events or unusual trading activity. The more volatile a stock is, the greater the likelihood that problems may be encountered in executing a transaction.

(7) In addition to normal market risks, you may experience losses due to system failures. The firm and its clearing broker rely upon sophisticated computer software and hardware to execute transactions, which are subject to failure due to a variety of factors. In addition, NASDAQ and the Alternative Trading Systems have computer systems that often malfunction. Among other events, you may experience losses due to: system crashes during both peak and low volume periods; the loss of orders on both SOES and Select Net; and, delayed, conflicting and inaccurate confirmations on orders or cancellations that you initiate.

(8) The use of any margin or leverage in an account can work against you as well as for you. Leverage can lead to large losses as well as gains. You may sustain a total loss of the initial margin funds and any additional funds that you deposit with your broker to establish or maintain a position, and you may incur losses beyond your initial investment. If the market moves against your position, you may be called upon to deposit a substantial amount of additional margin funds, on short notice, in order to maintain your position. If you do not provide the required funds within the time required, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account.

(9) You should consult your broker concerning the nature of the protections available to safeguard funds or property deposited in your account.

ALL OF THE POINTS NOTED ABOVE APPLY TO ELECTRONIC DAY TRADING OF DOMESTIC EQUITY SECURITIES. IF YOU ARE CONTEMPLATING TRADING FUTURES OR OPTIONS CONTRACTS, YOU SHOULD BE AWARE THAT THESE INSTRUMENTS POSSESS ADDITIONAL RISKS.

THE RISK OF ELECTRONIC DAY TRADING MAY BE SUBSTANTIAL. THIS BRIEF STATEMENT CANNOT, OF COURSE, DISCLOSE ALL THE RISKS AND OTHER ASPECTS OF ELECTRONIC DAY TRADING. ONLY RISK CAPITAL SHOULD BE USED FOR SUCH TRADING.

SHOULD YOU HAVE ANY ADDITIONAL QUESTIONS OR CONCERNS REGARDING ANY ASPECTS OF THE RISKS INVOLVED IN ELECTRONIC DAY-TRADING, PLEASE CONSULT A MOMENTUM SECURITIES LICENSED BROKER.

BY MY SIGNATURE BELOW, I ACKNOWLEDGE THAT I HAVE READ AND UNDERSTAND MOMENTUM SECURITIES, INC.'S RISK DISCLOSURE STATEMENT.



U.S. SECURITIES
AND EXCHANGE
COMMISSION

**STATEMENT BY CHAIRMAN ARTHUR LEVITT
SECURITIES AND EXCHANGE COMMISSION
CONCERNING ON-LINE TRADING**

JANUARY 27, 1999

Chairman Arthur Levitt today issued the following statement to investors:

The Internet and other new technologies are in many ways transforming how our capital markets operate. There are clear benefits to these changes including lower costs and faster access to the market for investors. I believe that investors need to remember the investment basics, and not allow the ease and speed with which they can trade to lull them either into a false sense of security or encourage them to trade too quickly or too often.

Over the last two years, particularly in recent months, the SEC has been hearing concerns about retail, on-line (Internet) investing. In fact, the number of complaints concerning on-line investing has increased 330 percent in the last year. Some of the issues raised specifically relate to on-line trading, others are generic to all investing. The majority of them can be addressed through better education and investors ensuring that they have done their homework.

Every day, more and more Americans are investing in the stock market, and many of them are doing so through the Internet. On-line brokerage accounts account for approximately 25 percent of all retail stock trades. And, the number of on-line brokerage accounts is expected to exceed 10 million by the end of the year.

While the manner in which orders are executed may be changing, the time-honored principles of evaluating a stock have not. An investor's consideration of the fundamentals of a company-net earnings, P/E ratios, the products or services offered by the company-should never lose their underlying importance.

Investing in the stock market-however you do it and however easy it may be-will always entail risk. I would be very concerned if investors allow the ease with which they can make trades to shortcut or bypass the three golden rules for all investors: (1) Know what you are buying; (2) Know the ground rules under which you buy and sell a stock or bond; and (3) Know the level of risk you are undertaking. On-line investors should remember that it is just as easy, if not more, to lose money through the click of a button as it is to make it.

In recent months, we have begun to identify a number of issues every on-line investor should be aware of. First, investors must understand the issues and limitations of on-line investing. You may occasionally experience delays on these new systems. Demand has grown so quickly that many firms are racing to keep pace with it. In the meantime, you

may have trouble getting on-line or receiving timely confirmations of trade executions. You should not always expect "instantaneous" execution and reporting. There can and will be delays in electronic systems. You should investigate and understand options and alternatives to executing and confirming your orders if you encounter on-line problems.

Second, investors may sometimes be surprised at how quickly stock prices actually move. For example, many technology stocks have recently had dramatic and rapid price movements. When many investors attempt to purchase (or sell) the same stock at the same time, the price can move very quickly. Just because you see a price on your computer screen doesn't mean that you will always be able to get that price in a rapidly changing market. You should take precautions to ensure that you do not end up paying much more for a stock than you intended or can afford.

One way to do this is to use limit orders rather than market orders when submitting a trade in a "hot" stock. The result for investors that do not limit their risk can be quite surprising. Say an investor wanted to buy a stock in an IPO that was trading earlier at \$9.00 and failed to specify the maximum they were willing to pay using a limit order. That investor could end up paying whatever price the stock has moved to at the time his order reaches the market -- \$60, \$90 or even more. If, on the other hand, the investor submitted a limit order to buy the stock at \$11.00 or less, the order would only be executed if the market price had not moved past that level. Investors should understand the risk associated with trading in a rapidly moving market and make sure that they take all possible actions to control their risk.

Third, I am concerned that investors buying securities on margin may not fully understand the risks involved. In volatile markets, investors who have put up an initial margin payment for a stock may find themselves being required to provide additional cash (maintenance margin) if the price of the stock subsequently falls. If the funds are not paid in a timely manner, the brokerage firm has the right to sell the securities and charge any loss to the investor. When you buy stock on margin, you are borrowing money. And as the stock price changes, you may be required to increase the cash investment. Simply put, you should make sure that you do not over-extend.

Fourth, while new technology available to retail investors may resemble that of professional traders, retail investors should exercise caution before imitating the style of trading and risks undertaken by market professionals. For most individuals, the stock market should be used for investment not trading. Strategies such as day trading can be highly risky, and retail investors engaging in such activities should do so with funds they can afford to lose. I am very concerned when I hear of stories of student loan money, second mortgages or retirement funds being used to engage in this type of activity. Investment should be for the long-run, not for minutes or hours.

Millions of new investors have taken advantage of the unprecedented access and individual control the Internet provides. But, new opportunities present all of us with new responsibilities, challenges and risks. The SEC will do everything it can to protect and inform investors during this time of great innovation and change. But, investor protection-at its most basic and effective level-starts with the investor. I

say to all investors-whether you invest on-line, on the phone, or in-person-know what you are buying, what the ground rules are, and what level of risk you are assuming.

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THE RISK OF LOSS IN ELECTRONIC DAY TRADING CAN BE SUBSTANTIAL. YOU SHOULD, THEREFORE, CAREFULLY CONSIDER WHETHER SUCH TRADING IS SUITABLE FOR YOU IN LIGHT OF YOUR CIRCUMSTANCES AND FINANCIAL RESOURCES. IN CONSIDERING WHETHER TO TRADE, YOU SHOULD BE AWARE OF THE FOLLOWING POINTS.

(A) The national securities markets are extremely efficient and competitive. Successful Electronic Day Trading typically requires skill as well as experience and knowledge of the capital markets. There is no guarantee that a particular individual will be successful in implementing his or her investment strategy. A substantial number of Electronic Day traders will not be successful.

(B) Electronic Day Trading involves a high volume of trading activity- the number of transactions may exceed 100 per day. Each trade generates a commission and the total daily commission on such a high volume of trading can be in excess of earnings.

(C) Electronic Day Trading is designed to generate short term profits. However, the activity also may result in losses that can exceed more than 100% of the customers initial capital.

(D) Placing contingent orders, such as "stop loss" or "stop limit" orders, will not necessarily limit your losses to the intended amounts, since market conditions on the exchange where the order is placed may make it impossible to execute such orders.

(E) Under certain market conditions, you may find it difficult or impossible to liquidate a position. This can occur, for example, when the market reaches a daily price fluctuation limit.

(F) In addition to normal market risks, a customer may experience losses due to NASDAQ, ECN'S and EXCHANGE system failures. These systems often malfunction, and customers may experience losses due to : system crashes during both peak and low volume periods; the loss of live customer orders on all of the above systems; and, delayed, conflicting and inaccurate confirmations on orders or cancellations initiated by the customer.



Risk Statement

"Electronic day trading," (also referred to as "day trading," or "SOES trading"), involves intra-day buying and selling of securities, which is speculative and may pose unique and/or substantial risks to a customer. It may not be suitable for certain individuals - even if they have investing or brokerage experience.

An electronic day trader should understand the operation of a margin account under various market conditions and review his or her investment objectives, financial resources and risk tolerances to determine whether margin trading is appropriate for them. The increased leverage which margin provides may heighten risk substantially, including the risk of loss in excess of 100% of an investment.

Furthermore, day trading is often characterized by making numerous trades per day, which may result in appreciable cost to the trader and also may negate any trading profit on a particular day. On-Line Investment Services Inc. does not guarantee the success or profitability of any trader or account, and is not responsible for losses in accounts. In addition, On-Line Investment Services does not endorse any particular product regarding trading including but not limited to seminars, classes, books, strategies, techniques, or technology. All traders trade at their own risk.

Electronic day trading accounts should be considered speculative in nature with the objective being to generate short-term profits. Past trading success is not indicative of future results. Day trading involves high risk.

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Risks Of DayTrading

1. Day trading is extremely risky. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required for current income to meet your living expenses.
2. Be cautious of claims of large profits from day trading. You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead to large and immediate financial losses.
3. Day trading requires knowledge of securities markets. Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.
4. Day trading requires knowledge of a firm's operations. You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures. You should confirm that a firm has adequate systems capacity to permit customers to engage in day trading activities.
5. Day trading may result in your paying large commissions. Day trading may require you to trade your account aggressively, and you may pay commissions on each trade. The total daily commissions that you pay on your trades may add to your losses or significantly reduce your earnings.
6. Day trading on margin or short selling may result in losses beyond your initial

investment. When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

7. Day trading involves both market orders and limit orders. You should understand the difference in these type of orders before you invest. Market orders are orders that are required to execute fully and promptly without regard to price, and the execution price may be different from the current quoted price of a security. Limit orders offer you price protection, but there is the possibility that your order may not be executed.

8. Day trading is highly dependent on many advanced computer systems. Investors cannot directly access the markets or execute orders; orders are transmitted by a Broker Dealer. During periods of high volatility there may be delays in execution confirmations and cancellation reports. During periods of high volume there may be system capacity limitations.

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MEMORANDUM

TO: **PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
MEMBERSHIP LIAISONS**

FROM: **K. LEE BLALACK, II**, Chief Counsel & Staff Director *KLB*
BRIAN C. JONES, Investigator
WESLEY M. PHILLIPS, Investigator *W.P.*
 Permanent Subcommittee on Investigations

RE: **BACKGROUND MEMORANDUM FOR DAY TRADING HEARING**
"Day Trading: An Overview"
September 16, 1999, at 9:30 a.m. in SD-628

DATE: **SEPTEMBER 14, 1999**

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I. PURPOSE AND FORMAT OF THE HEARING

On June 30, 1999, Chairman Collins authorized the Permanent Subcommittee on Investigations ("PSI") staff to commence an examination of the day trading industry. Shortly after commencing the inquiry, a day trader shot and killed nine people at two day trading firms in Atlanta, Georgia. The overview hearing scheduled for September 16, 1999 will focus PSI's investigation for a subsequent, more detailed case study hearing by narrowing for the press and public the key issues associated with day trading. The Chairman of the Securities and Exchange Commission ("SEC"), Arthur Levitt; the President of the NASD Regulation, Inc. ("NASDR"), Mary L. Schapiro; the President of the North American Securities Administrators Association ("NASAA"), Peter C. Hildreth; and the Consulting Counsel for the Electronic Traders Association ("ETA"), Saul C. Cohen, have agreed to testify at the hearing.

The hearing will have three panels of witnesses. The first witness will be Chairman Levitt. Chairman Levitt will testify about the potential risks of day trading for the average investor. He will argue that, unlike securities speculation, which requires some market knowledge, day traders are in fact gambling. He also will testify that increasing numbers of people are engaging in day trading without a clear understanding of the risks attendant thereto. In addition, Chairman Levitt will summarize the SEC's preliminary findings from examinations of day trading firms and provide his perspective on NASDR's proposed rule to strengthen day trading risk disclosure and customer appropriateness standards. Finally, Chairman Levitt will discuss the potential effects of day trading on the prices of individual securities and market volatility.

The second panel will consist of the witnesses from NASDR and NASAA. Mary L. Schapiro, President of the NASDR, will testify about the day trading phenomenon in general. She will discuss the preliminary findings of NASDR's recent examinations of day trading firms as well as NASDR's recently proposed rules to strengthen disclosure and appropriateness determinations. In addition, Ms. Schapiro will discuss the potential effects of day trading on the prices of individual securities and market volatility.

Peter Hildreth, President of the NASAA and Chief of the New Hampshire State Securities Commission, will testify about the findings in NASAA's recent report on day trading, which was highly critical of the industry. He will detail the fraud and abuse that NASAA allegedly found in the day trading industry. Like Chairman Levitt, Mr. Hildreth will also testify that day trading is gambling and explain why NASAA concluded day trading is an extremely risky and unprofitable practice for the average investor.

Saul C. Cohen, Consulting Counsel for the ETA, will testify on a third panel. He will address day trading from an industry perspective. He will criticize the findings of the NASAA report on day trading, and respond to some of the allegations leveled by regulators.

II. SUMMARY OF MAJOR HEARING ISSUES

Based upon our preliminary examination of day trading, we believe that there are three major issues that will be the focus of the hearing and PST's continuing investigation:

1. Is Day Trading a Bona Fide Investment Strategy or Is It Merely Gambling? As noted above, Chairman Levitt and NASAA President Peter Hildreth have both stated that day trading is gambling. On August 9, 1999, NASAA issued a report on the day trading industry that estimated that nearly 90 percent of day traders would lose substantial amounts and perhaps all of their trading capital.¹ While ETA acknowledges that day trading is highly risky, ETA believes that NASAA's profitability study is significantly flawed and that, after a "steep learning curve," disciplined traders can make money day trading. Thus, ETA will dispute the gambling analogy.
2. Have Day Trading Firms Engaged in Deceptive and Fraudulent Practices and, If So, How Widespread Are the Abuses Within the Day Trading Industry? The NASAA study concludes that fraudulent and deceptive operating practices are pervasive within the day trading industry. These practices include deceptive advertising, forgery, unregistered investment advisory activity, unregistered trading by broker-dealers, and other questionable practices. SEC and NASDR also are concluding examinations of about 60 of the largest day trading firms. Preliminary information obtained from the SEC and NASDR suggests that these examinations also have identified questionable practices by day trading firms. ETA officials told us that there are some "marginal" firms in the industry that

¹ NASAA, *Report of the Day Trading Project Group*, (Aug. 9, 1999) [hereinafter "NASAA Report"]. The NASAA project group consisted of state securities officials from Massachusetts, Colorado, Pennsylvania, Texas, and New Jersey.

may commit fraudulent acts, but ETA contends that most day trading firms are well-run and willing to cooperate with regulators to correct any problems.

3. What Is the Impact of Day Trading on the Securities Markets? ETA and the industry claim that day trading has “democratized” the securities markets and provided average investors with the ability to make money trading in ways that previously were reserved exclusively for large securities firms. By contrast, some critics of the industry argue that day traders can manipulate the prices of individual stocks to their advantage and that day trading contributes to excessive volatility in the securities markets.

In addition to these primary points of debate, there are several other questions that are likely to be addressed during the day trading hearing:

- how day trading strategies differ from traditional investment strategies;
- how day trading firms differ from on-line, discount brokerage firms, such as E*Trade and Charles Schwab;
- what is the profile of the “typical” day trader;
- are day trading strategies suitable for ordinary investors with limited investment experience and wealth;
- have day trading firms engaged in deceptive advertising to lure unsophisticated investors into day trading;
- have day trading firms encouraged new customers to borrow funds from friends and relatives so that they can become day traders and, if so, does such “third-party” borrowing violate federal and state securities laws; and
- have day trading firms established lending programs to encourage customers to lend money to other customers who cannot meet margin calls and, if so, do these lending programs violate federal and state securities laws.

III. BACKGROUND ON DAY TRADERS AND THE DAY TRADING INDUSTRY

Media and public attention on the day trading industry has evolved over the past year from admiring to alarmist. Some press reports from early 1998 romanticized the exotic nature of day trading and the fact that young “guerrilla” day traders had given up their careers to do battle with

established Wall Street firms.² In November 1998, however, NASAA issued a press release that sharply criticized day trading and the risks that it posed to investors.³ This press release generated substantial media coverage about the risks associated with day trading. In late 1998, NASAA established a project group to study day trading and certain states — particularly Massachusetts — began to take enforcement actions against day trading firms within their jurisdiction.

Earlier this year, SEC Chairman Arthur Levitt and NASDR President Mary Schapiro gave speeches warning against the risks of day trading. Chairman Levitt actually called day trading “gambling.”⁴ The SEC and NASDR also launched examinations earlier this year to assess the operations of approximately 60 of the largest 100 day trading firms.

The public attention surrounding the risks associated with day trading reached its zenith after the recent shootings in Atlanta at the branch offices of two large day trading firms. On July 29, 1999, a day trader named Mark Barton walked into the Atlanta branch offices of All-Tech Investment Group, Inc. (“All-Tech”) and Momentum Securities, Inc. (“Momentum”) and shot nine people to death. Earlier that week, Barton killed his wife and two children. Although Barton clearly had financial and emotional problems prior to the shootings (e.g., he was suspected but not charged in the killings of his previous wife and mother-in-law), press reports suggested that his high financial losses may have prompted the shootings in Atlanta. Between April 1998 and April 1999, Barton allegedly lost about \$400,000 day trading at All-Tech. In the two months prior to the killings, Barton reportedly lost another \$105,000 day trading at Momentum.⁵

A. Day Trading Defined

Day trading typically is defined as placing multiple buy and sell orders for securities and holding positions for a very short period of time, usually minutes or a few hours but rarely longer than a day.⁶ Day traders typically seek profits in small increments from momentary fluctuations in

² Mathew Schiffrin, *Free Enterprise Comes to Wall Street*, Forbes, Apr. 6, 1998, at 114-19.

³ NASAA Press Release, “Day Trading” Craze Should Give Investors Pause, *State Securities Regulators Warn*, dated Nov. 25, 1998.

⁴ Chairman Arthur Levitt, remarks before the National Press Club (May 4, 1999).

⁵ Rebecca Buckman, *Barton Had Big Losses Months Ago: Atlanta Killer Dropped \$400,000 at All-Tech*, Wall Street Journal, Aug. 4, 1994, at C1.

⁶ Jane Bryant Quinn, *Trade by Day, Lose Sleep by Night*, Newsweek, Apr. 18, 1999, at H2. There is no standard definition of the number of trades that characterize a day trading account. Some day traders execute as few as seven buy and sell orders per day, while others may make 100 or more trades per day. See Jeffrey H. Harris and Paul H. Schultz, *The Trading Profits of SOES* [“Small Order Execution System”] *Bandits*, 50 J. Fin. Econ. 39,51 (1998).

stock prices after paying commissions, which can range from \$15 to \$25 per trade.⁷ The estimated number of “professional” day traders, who devote nearly all of their time to the activity, represents only a small fraction of the millions of investors who participate in the securities markets. The President of ETA – James Lee – told PSI staff that about 4,000 to 5,000 individuals trade from 100 or more specialized day trading firms.⁸ Although the number of day traders is relatively small, ETA estimates that day traders engage in a disproportionately high number of securities transactions, which account for ten to fifteen percent of the daily dollar volume traded on the NASDAQ exchange.⁹

Day traders do not invest in a particular security based on the fundamental strengths or weaknesses of the company. Indeed, the trading decision may have nothing whatsoever to do with the merits of a particular stock. One day trader was quoted as follows: “Wall Street’s not about investing anymore, it’s about numbers. Who cares whether [the stock] is a car company or a chemical company? Who cares what they’re going to be doing in 2000?”¹⁰ In essence, each trade is little more than a bet on the short-term price fluctuation of a particular stock. Philip Feigin, NASAA’s former President, recently said that he is fond of telling day traders that they should “[g]o to Las Vegas – the food is better.”¹¹

B. The Day Trading Industry

Day trading generally occurs at roughly 100 specialized firms. Some of these firms are large concerns with branch offices nationwide, while others are smaller operations with one or two offices in a single state. Table 1 lists the ten largest day trading firms as measured by the number of branch offices. According to NASAA and the SEC, the specialized day trading firms are generally broker-dealers registered with NASD, although a few belong to the Philadelphia Stock Exchange (“PSE”). Firms registered with the PSE typically are organized as limited partnerships in which each day trader is an agent of the firm rather than a “customer.” These “agents” trade the firms’ own capital on a highly leveraged basis through the firms’ margin privileges. The firms typically require the agents to provide a substantial security deposit or, “performance deposit” as it is called, to cover

⁷ NASAA Report at 7.

⁸ According to the Congressional Research Service (“CRS”), it is difficult to estimate the total number of day traders since many quit, due to losses, within three months of starting. See Congressional Research Service, *Day Trading*, p. 2 (1999).

⁹ Interview with Bill Lauderback, Electronic Traders Association (Sept. 7, 1999).

¹⁰ Ianthe Jeanne Dugan, *For These Day Traders, Stock Market Is One Big Casino*, Washington Post, Feb. 25, 1999, at A1.

¹¹ Id.

losses incurred by the individual agents.¹² PSE day trading firms also charge commissions to their agents.¹³

Day trading firms, whether registered with NASD or the PSE, typically provide the high-speed computer access and real-time market quotes that are necessary for day traders to rapidly take advantage of small changes in stock prices. Many of these firms also offer training seminars to individuals who wish to learn day trading strategies. These seminars generally require two to ten days to complete and cost anywhere from \$1,500 to \$5,000. Anecdotal evidence and press reports indicate that some individuals who complete these courses give up their careers to day trade full-time at these specialized firms.¹⁴

Table 1: The Ten Largest Day Trading Firms as Measured by Number of Branch Offices

Firm	Home Office Location	Number Of Branch Offices
Carlin Financial Group	New York, New York	36
All-Tech Investment	Montvale, New Jersey	23
Bright Trading, Inc.	Las Vegas, Nevada	23
Cornerstone Securities	Austin, Texas	19
Landmark Securities	Houston, Texas	15
Andover Brokerage	Montebello, New York	13
Tradescape, LLC	New York, New York	12
Terra Nova Trading	Chicago, Illinois	11
On-line Investment	Jersey City, New Jersey	10
Stock USA	San Diego, California	10

Source: PSI Analysis of NASAA data.

The second largest firm, All-Tech, is registered with the NASD and is perhaps the most famous of the specialized day trading firms in the United States. The firm's CEO is Harvey

¹² NASAA Report at 3.

¹³ Ianthe Jeanne Dugan, *For These Day Traders, Stock Market Is One Big Casino*, *Washington Post*, Feb. 25, 1999, at A1. For example, Bright Trading – a PSE firm – charges its customers a penny a share per trade.

¹⁴ *Day traders beat the clock; Practitioners of day trading live and die by eighths and sixteenths of a point*, http://www.cnnfn.com/quickenonfn/investing/9812/24/q_daytrading.

Houtkin, who is the self-proclaimed “father of electronic day trading” because he was one of the first individuals to market day trading as an investment strategy for the average investor.

According to All-Tech, approximately 1,000 of the firm’s customers day trade from one of the firm’s twenty-three branch offices throughout the nation. All-Tech also offers another 1,000 customers the ability to day trade from their homes or offices through specialized software, called Attain, that is connected to the company’s electronic trading system. The firm also offers training courses, which purport to teach new customers how to day trade. The training course is given at All-Tech’s Montvale, New Jersey headquarters, requires two to four weeks to complete, and costs \$5,000. All-Tech instructs students in the basics of the securities markets and how to use the Attain system. All-Tech also offers “boot camp” courses at its branch offices, which provide an abbreviated version of the normal training course. These boot camp courses take place over about one week and cost approximately \$3,000.¹⁵

In February, the Washington Post profiled the operations of Bright Trading Inc. (“Bright Trading”), which is the third largest day trading firm. Bright Trading is registered with the PSE and is appropriately headquartered in Las Vegas, Nevada. According to the Washington Post, the owner of the firm gambles at the casino Black Jack tables by night and runs his trading firm by day. The firm requires all of its traders to provide a \$25,000 “performance deposit.”¹⁶ In addition, day traders pay Bright Trading a \$600 per month overhead fee for use of the facility and equipment as well as a commission of one penny per share traded and 25% of all profits.¹⁷

Bright Trading, like other PSE day trading firms, differs from firms like All-Tech, which register with the NASD as broker-dealers. All-Tech and other broker-dealers generally do not require a performance deposit and do not receive a percentage of any profits achieved by its day traders, since those day traders are customers of the firms rather than limited partners. All-Tech and the broker-dealer firms make their money primarily from the commissions charged their customers on a per trade basis and from any fees that they might receive from teaching customers how to day trade. For these reasons, the day trading firms registered with the NASD may be the most likely to market themselves to, and attract, unsophisticated and potentially unsuitable investors.

C. Distinction Between Day Trading Firms and On-Line Discount Broker-Dealers

Day trading firms provide a *fundamentally different* service than traditional brokerage houses and even on-line discount brokerage firms, such as E*Trade and Charles Schwab. Neither discount on-line brokerage firms nor traditional full-service firms offer customers direct access to the trading

¹⁵ Harvey Houtkin, Remarks at an All-Tech Informational Seminar (July 21, 1999).

¹⁶ Ianthe Jeanne Dugan, *For These Day Traders, Stock Market Is One Big Casino*, Washington Post, Feb. 25, 1999, at A1. The “performance deposit” is used to offset losses that the day trader may incur.

¹⁷ Id.

floor of the type provided by day trading firms.¹⁸ On-line brokerage firms generally do not offer immediate stock order execution to their customers. Rather, on-line brokerage firms generally refer customer orders to other entities – such as market makers – for execution.¹⁹

The immediate order execution capability offered by day trading firms may serve as a marketing tool by which day trading firms attract active traders from the established on-line firms. ETA's President told PSI staff that day trading firms market their services to the estimated 250,000 individuals who make 400 or more on-line securities trades per year, since these investors would most benefit from the ability to immediately execute their stock orders. Similarly, All-Tech's CEO, Harvey Houtkin, has stated that it makes sense to market the firm's Attain trading system to individuals who actively trade through on-line brokerage accounts.²⁰

There are about 1.7 million people in the United States who are categorized as "hyper-active traders."²¹ It is estimated that hyper-active traders execute 80 to 100 stock trades per year through their online brokerage accounts.²² In addition, ETA President James Lee told PSI staff that ETA estimates that 250,000 people make more than 400 trades per year, largely through on-line brokerage firms, such as Charles Schwab and E*Trade.²³

The technology available to day trading firms has attracted the interest of several of the leading investment and securities firms.²⁴ Fidelity Investments, Lehman Brothers, and Instinet, a division of Reuters Group, reportedly have discussed adopting the software platforms of day trading firms, forming alliances with them, or making outright acquisitions. Despite concerns about the practices of day trading firms, the electronic trading boom is forcing established securities firms to consider more efficient and inexpensive trading formats. Day trading firms may now have critical

¹⁸ In addition to convenience, the basic advantage of on-line brokerage firms is that commissions are significantly lower than the commissions paid to full-service firms. For example, a *Business Week* article estimates that, to buy 200 shares on-line, it would cost \$8.00 to \$29.95. *Business Week* estimates that execution of the same trade at a full-service brokerage house would cost \$116. *Who Needs a Broker?*, *Business Week*, Feb. 22, 1999, at 113.

¹⁹ GAO, *Securities Market Operations: The Effects of Small Order Execution System ("SOES") on the NASDAQ Market*, p. 3, Aug. 31, 1998 (GAO/GGG-98-194). Market makers are NASD-member securities firms that "make markets" in particular securities by agreeing to buy and sell the securities at quoted prices. Market makers provide liquidity to the NASDAQ market.

²⁰ Harvey Houtkin, Remarks at an All-Tech Informational Seminar (July 21, 1999).

²¹ Interview with Dan Burke of Gomez Advisers (July 29, 1999). Gomez Advisers is a consulting firm located in Concord, Massachusetts that provides information about on-line broker-dealers.

²² *Id.*

²³ Telephone interview with James Lee, President of ETA (Aug. 11, 1999).

²⁴ *Why Big Firms Are Courting Day Traders*, *New York Times*, Aug. 13, 1999, at C1.

experience developing and using advanced trade routing software, systems that could someday give all investors instant access to the financial markets.²⁵

D. New Technology Is Making Day Trading More Viable from the Home or Office

PSI's preliminary inquiry also suggests that new technology is making day trading more accessible to many potential investors who have Internet access through a home or office computer. According to a recent CRS report that we requested and several other sources, more than twenty companies offer software for home computers that essentially provide the same real-time market information via the Internet, as was previously only available at specialized day trading firms.²⁶ For example, one Internet firm offers customers the opportunity to execute 600 or more trades per month for a charge of \$14.95 per trade.²⁷

In addition to PSI's ongoing investigation of the day trading firms, we also are examining the large industry that has developed to provide "educational" services to "professional" day traders or individuals who actively trade from their home or office. For example, there are now numerous day trading "how-to" books on the market, such as *How to Get Started in Electronic Day Trading* and *Electronic Day Trader's Secrets*, which were two of the top twenty selling business books in the country as of late August 1999.²⁸ Moreover, PSI has identified numerous Internet Web sites that purport to provide educational information about day trading courses. Several that we have examined contain questionable claims about the profit potential of these programs. For instance, one such educational program claims that it can provide "Explosive Winning Strategies and Secrets to Increased Profitability."²⁹

²⁵ Id.

²⁶ Congressional Research Service, *Day Trading 2* (June 15, 1999).

²⁷ CyberCorp.com, The True Costs, <http://www.cybercorp.com/fees.html>.

²⁸ A search of the Barnes and Noble Web site listed seven books about day trading as of August 30, 1999. According to the publisher, one of these books – *Day Trading On-Line* – has sold at least 55,000 copies. Barnes & Noble, <http://www.barnesandnoble.com>.

²⁹ WinningDayTraders.com, <http://www.winningdaytraders.com>.

IV. THE RISKS AND PROFITABILITY OF DAY TRADING

A. NASAA Report Claims That the Vast Majority of Average Investors Lose Money Day Trading

There have not been any comprehensive studies conducted on the profitability of securities day trading. However, information that is available -- albeit limited -- suggests that day trading is a highly risky pursuit for the average investor. The NASAA Report concluded that "70% of public traders will not only lose, but will almost certainly lose everything they invest."³⁰ In a complaint filed against the day trading firm Block Trading, Inc., Massachusetts regulators found that 67 of the 68 people who traded at the firm's Boston branch office lost money.³¹

Moreover, NASAA commissioned a financial consultant to perform a limited study of the profitability of day trading accounts for its report on the day trading industry. The consultant estimated that 70 to 88.5 percent of all day traders in the Watertown branch office of All-Tech lost money. The consultant reviewed a randomly selected sample of 26 customer accounts, which involved nearly 4,093 trades over a ten month period. The consultant found that 70 percent of the 26 accounts lost money and that most of these customers would likely lose all of the capital traded. The consultant also found that another 18.5 percent of the accounts were traded in a manner that would also likely result in losses over time. Therefore, the consultant concluded that the average public investor should refrain from day trading, since nearly 90 percent of the customer accounts traded lost money or were likely to lose money.³²

The commissions that day trading firms charge their customers appear to be a significant obstacle to profitable day trading. As discussed previously, day trading commissions range from \$15 to \$25 per trade and these commissions must be paid regardless of whether the day trader earns profits or suffers losses. According to the NASAA Report, the average day trading account must earn an average annual return of 56 percent to exceed transaction costs and achieve profitability.³³

³⁰ Ronald L. Johnson, NASAA Report Section entitled *Day Trading: Analysis of Public Day Trading at a Retail Day Trading Firm*, (1999), at 7.

³¹ *Id.* The individual who made money day trading was allegedly an unregistered investment adviser who was in a position to allocate trades, and thus profits and losses, between his account and the accounts of other customers. *Id.* As a result, NASAA found that it was questionable whether the account's profitability could be attributed solely to day trading. *Id.*

³² *Id.*

³³ According to Morgan Stanley Dean Witter, by contrast, the average annual return of the Dow Jones Industrials, between year end 1974 and year end 1998, was only 14.4%. Prospectus for the *Select 10 Industrial Portfolio 99-4*, page ix (1999).

According to All-Tech, it charges customers a commission of \$25 per trade.³⁴ The company's approximately 2,000 customers execute roughly 15,000 trades per day.³⁵ Thus, the average All-Tech customer executes 7.5 trades per day at a cost of \$187.50. Assuming twenty trading days per month, the average All-Tech customer would have to earn profits of at least \$3,750 per month, or \$45,000 per year, just to cover commissions.

According to James Lee, President of ETA, the NASAA Report's estimate of day trading profitability is significantly flawed because it is based on a small sample of day traders at just one branch office. Mr. Lee said that his firm, Momentum, conducted its own "unscientific" study of day trading of only the Texas branch offices of his firm.³⁶ Mr. Lee claims that this study found that, although highly risky, a significant number of investors who complete a "steep learning curve" make money day trading.³⁷

The Momentum study found that 56 percent of the people who begin day trading lose money during their first three months. The Momentum study also found, however, that after three months 64 percent of day traders made money and 36 percent lost money. Mr. Lee claims that the individuals who profit after five months achieve a monthly average gain of about \$26,600, while the remaining day traders lose an average of \$6,800 per month.³⁸ An ETA spokesman told PSI staff that ETA is in the process of conducting a comprehensive study of day trading's profitability, which is likely to be completed later this fall.³⁹

B. The "Suitability" or "Appropriateness" of Day Trading For The Ordinary Investor

A major issue in the debate over day trading relates to what sort of persons are engaged in day trading and whether ordinary investors are "suitable" or "appropriate" for this highly risky activity. Industry critics charge that too many ordinary investors are currently allowed -- and even encouraged -- to become a day trader even if they have no investment experience and insufficient net worth to sustain heavy losses. NASDR has responded to this criticism by proposing a new rule that will require day trading firms to screen new customers to determine their "appropriateness" for day trading. This proposed rule is discussed in more detail in Section VI of this Memorandum.

³⁴ Harvey Houtkin, Remarks at an All-Tech Informational Seminar (July 21, 1999).

³⁵ Id.

³⁶ Mr. Lee advised PSI that this study is "never used for marketing." Telephone interview with James Lee, President of Momentum Securities, Inc. (Aug. 11, 1999).

³⁷ Id.

³⁸ Preliminary Results, Momentum Securities, Inc. at 5-6.

³⁹ Interview with Bill Lauderback, Electronic Traders Association (Sept. 7, 1999).

We have not found any studies that profile the “typical” day trader. Our review of media reports and other anecdotal information suggests, however, that there may be individuals, who possessed little or no investment experience and inadequate risk capital, that lost substantial sums of money as day traders. The following examples were taken from recent press reports and/or PSI telephone interviews:

- Mark Barton had formerly worked as a chemical engineer and salesman before he opened a day trading account at All-Tech in April 1998. After losing a reported \$400,000 day trading at All-Tech between April 1998 and April 1999, Barton opened a day trading account at Momentum in May or June 1999. Barton reportedly lost another \$105,000 at Momentum in the one or two months before he committed the murders.⁴⁰
- In Chicago, an intermittently employed waiter with no investment experience became a day trader and lost an inheritance of more than \$200,000. The waiter told PSI staff that many people with whom he day traded similarly lacked basic information about investing.⁴¹
- In Boston, an elderly man with serious health problems lost about \$250,000 of his wife’s retirement money in a single afternoon at a day trading firm.⁴²
- In Fullerton, California, a 28 year-old bank employee quit his job and borrowed \$40,000 from credit cards to become a day trader. He lost all of his funds day trading within two months. The young man is now deeply in debt and living with his parents.⁴³

V. **SECURITIES REGULATORS HAVE IDENTIFIED FRAUDULENT AND DECEPTIVE PRACTICES AT SEVERAL LARGE DAY TRADING FIRMS**

Because day traders are admittedly speculating on the momentary price fluctuations of stocks, securities regulators and self-regulatory organizations recently have expressed concerns about the implications of day trading for the individual trader. NASAA’s Report alleged serious violations at

⁴⁰ Rebecca Buckman, *The Internet - Stock Frenzy, Online Trading Can Become an Addiction*, The Wall Street Journal, Feb. 1, 1999, at C1.

⁴¹ Telephone interview with John Skiersch (Aug. 5, 1999).

⁴² Telephone interview with David Schellenberger, Chief of Licensing Section, Massachusetts Securities Division.

⁴³ Rebecca Buckman, *The Internet - Stock Frenzy, Online Trading Can Become an Addiction*, The Wall Street Journal, Feb. 1, 1999, at C1.

several large day trading firms. These practices include deceptive advertising, promotion of unregistered investment advisory activities, and forgery. NASAA made several recommendations to penalize and deter these abuses.⁴⁴ Moreover, SEC and NASDR have initiated examinations into the operations of more than 60 firms that offer day trading services. The SEC and NASDR's preliminary examination results suggest several problems identified at certain day trading firms, including net capital violations, efforts to evade margin requirements, and deceptive advertising.

A. NASAA Study Identified Serious Problems in Certain Large Day Trading Firms

Since 1997, state securities regulators in Indiana, Massachusetts, Texas, and Wisconsin have initiated a total of ten enforcement actions against day trading firms. On the basis of these enforcement actions and state regulatory examinations, the NASAA report identified fraudulent and deceptive activities in several large day trading firms. The following summarizes several of the more serious abuses identified in the NASAA report:

Deceptive Marketing Practices: Deceptive advertising by a brokerage firm may violate federal and state securities laws and NASDR rules. Section 17(a) of the Securities Act of 1933 prohibits securities brokers from making material misstatements or omissions or engaging in any "transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" in the sale of securities. Similarly, Section 10(b) of the Securities Exchange Act of 1934, Section 101 of the State Uniform Securities Act of 1956, and NASDR's Rule 2120 prohibit dishonest or manipulative practices in the sale of securities.

According to the NASAA Report, four of the six administrative proceedings that Massachusetts securities regulators have initiated alleged the use of deceptive advertising. The basis of these complaints was that the firms misrepresented the profit potential of day trading, which Massachusetts regulators and NASAA believe is virtually nil. Massachusetts reached settlements with each of the four day trading firms. The following summarizes the deceptive advertising allegations contained in the Massachusetts complaints:

- In the complaint against Block Trading, regulators alleged that the firm used a brochure that described Block's commitment to "educating others about the unlimited earnings potential of day trading."⁴⁵
- In the complaint against All-Tech, regulators found that the firm's Web site stated that "Electronic Day Trading appeals to executives, victims of downsizing or layoffs, retirees, graduating college students and *anyone who recognizes the*

⁴⁴ NASAA Press Release, *Day Traders Need More Protection Against Abuses, Say State Regulators*, May 28, 1999.

⁴⁵ NASAA Report at 11.

unlimited earnings and quality of life which an Electronic Day Trader May Achieve."⁴⁶

- In the complaint against On-Line Investment Services, regulators found that the firm's Web site asserted that "[W]e have a success rate of around 85 percent with customer traders, meaning people who come here actually make money doing this over time."⁴⁷
- In the complaint against TCI, a training institute that does not offer other day trading services, regulators found that TCI sponsored newspaper advertisements that offered prospective students the ability to achieve a "6 to 7 figure income per year."⁴⁸

Customer Suitability Requirements: Under existing federal and state law, the suitability doctrine requires brokerage firms to recommend only investments that are appropriate for their customers. Under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, a brokerage firm's "recommendation" of unsuitable securities may constitute fraud. NASD's Rule 2310 -- "Recommendations to Customers (Suitability)"-- provides that a NASD member firm shall have reasonable grounds for believing that a securities recommendation is suitable for a customer upon the basis of facts, if any, disclosed by the customer as to his or her financial situation and needs. Prior to making a securities recommendation, NASD members are required to collect basic information to determine customer suitability such as information about the customer's financial status, tax status, investment objectives, and other relevant information. Some states have also established specific rules regarding customer suitability.⁴⁹

The following summarizes NASAA's allegations that several day trading firms have violated existing customer suitability requirements and standards:

- Day trading firms have misrepresented crucial information -- such as income, net worth, and investment experience -- on new customer account forms and accepted customers for day trading who are clearly not suitable for the practice. In Massachusetts' pending case against Landmark Securities, state regulators alleged that a branch manager misrepresented that a customer had an income of \$25,000, when the actual figure was \$15,000; that the customer had a net worth in excess

⁴⁶ *Id.* at 13.

⁴⁷ *Id.* at 11.

⁴⁸ *Id.* at 12.

⁴⁹ NASAA Report at 29.

of \$50,000, when the actual figure was about \$10,000; and that the customer had investment experience when the customer did not.⁵⁰

- Several day trading firms such as All-Tech have explicit policies that encourage customers, who lack sufficient capital, to borrow funds from third parties to begin day trading. NASAA contends that customers who lack adequate capital to day trade clearly are unsuitable for this highly risky activity and should not borrow funds from others. NASAA also argues that third party trading encourages unregistered investment advisory activity.⁵¹
- Several day trading firms including All-Tech and Landmark also have established policies that encourage customers who cannot meet maintenance margin calls to borrow funds from other customers. NASAA alleges that customers' inability to meet margin calls demonstrates that they are trading beyond their means, and that day trading is unsuitable for them. NASAA recommends that NASDR prohibit these customer lending programs.⁵²

NASAA's argument that existing customer suitability requirements apply to the day trading industry is contested by industry groups. Since day trading firms do not necessarily recommend specific stocks for their customers to purchase, the Securities Industry Association ("SIA") and the ETA argue that existing suitability requirements do not apply to day trading strategies.

NASAA believes, however, that NASDR's existing rules and policies concerning risk disclosure already create obligations for the day trading industry and that, as outlined above, day trading firms have violated these policies. NASAA argues that day trading firms promote a "concept" of buying and selling securities by the end of each business day. Thus, NASAA believes that day trading firms explicitly recommend to customers that they buy or sell securities, which brings day trading within the ambit of Rule 2310. However, given the controversy and the ambiguities in the law, NASAA supports the creation of a specific suitability standard for the day trading industry.

Encouragement of Activity By Unregistered Investment Advisers: Section 201(c) of the State Uniform Securities Act of 1956 requires the registration of investment advisers. An investment adviser is defined as someone who, for compensation, advises others as to the advisability of purchasing securities either directly or through written materials. Generally, investment advisers that have less than \$25 million under management must be registered with the states in which they do

⁵⁰ Id. at 16.

⁵¹ Id. at 22-23.

⁵² Id. at 46.

business, while advisers with more than that amount must be registered with the SEC.⁵³ Investment advisers who do not register are subject to enforcement actions and penalties by federal and state securities regulators.

The NASAA Report states that certain day trading firms such as All-Tech and Landmark encourage customers or prospective customers to trade the accounts or funds of third parties and thereby violate investment adviser registration requirements. According to NASAA, the fact that these firms encourage individuals to day trade on behalf of others for compensation constitute violations.⁵⁴ NASAA cited the following examples:

- In a Texas case against The Exchange House, Inc., state regulators alleged that the day trading firm unlawfully permitted 24 unregistered traders to manage customer accounts at the firm. The complaint also alleged that the firm used an unregistered branch office, and employed several unregistered agents to take customer orders. Texas securities regulators imposed fines of about \$124,000 to conclude this case.⁵⁵
- In the Massachusetts complaint against Landmark, state regulators noted that the firm's Web page stated, "HOW DO I PARTICIPATE IN DAY TRADING?" The Landmark Web page answered the question with several options, one of which was to "fund the account of a trader, either as a loan to the trader, or as equity, with a percentage of the trading profits. The terms of the partnership, such as profit split, interest rate, risk parameters, etc. are agreed upon by the trader and the investor at their own discretion."⁵⁶
- In the Massachusetts complaint against All-Tech, state regulators alleged that the firm's policy of encouraging day traders to borrow funds from third parties also resulted in unregistered investment activity. The state's complaint alleged that All-Tech should have known that this policy would result in unregistered investment activity. Two traders at the Watertown office allegedly acted as unregistered investment advisers and one individual abused customer accounts.⁵⁷

Promotion of Lending Arrangements Leads to Fraudulent Practices by Day Trading Firms:
The NASAA report found that several day trading firms have established programs that encourage

⁵³ The National Securities Market Improvement Act of 1996, P.L. 104-290.

⁵⁴ NASAA Report at 22.

⁵⁵ *Id.* at 23-24.

⁵⁶ *Id.* at 22-23.

⁵⁷ *Id.* at 23.

customers to lend funds to other customers who cannot meet margin calls.⁵⁸ As discussed earlier, NASAA believes that these lending programs violate existing suitability requirements. In addition, NASAA alleges that these lending programs have prompted numerous securities violations including forgery, circumvention of margin requirements, and violations related to state usury laws.⁵⁹

According to NASAA, state securities regulators have found that lending programs offer many opportunities for fraudulent activity. For example, in the complaint against Landmark, Massachusetts regulators alleged that the firm transferred almost \$2.7 million in customer loan funds through a customer account established under fraudulent auspices. The Landmark complaint also alleged that the firm's branch manager engaged in many fraudulent schemes to further these lending programs such as forging customer signatures on loan authorization forms, accepting authorization forms that had been forged by others, and effecting unauthorized transfers of funds into and out of customer accounts.⁶⁰

NASAA also argues that the customer lending programs circumvent Federal Reserve and NASD rules that govern margin lending. Under Federal Reserve Regulation T, which governs initial margin requirements, customers seeking to purchase securities on margin must deposit at least 50 percent of the market value of the securities.⁶¹ Regulation T allows the brokerage firm to lend the investor the remaining 50 percent or it may arrange a loan from a third party.⁶² NASD Rule 2520 also has set a margin maintenance requirement of 25 percent equity.⁶³

According to NASAA, the promotion and arrangement of loans among customers to meet margin calls allows day trading firms to circumvent and undermine the regulatory structure concerning margin trading. The margin rules limit the leverage customers may utilize, or, to state it another way, the rules require customers to commit a certain amount of their own funds in order to effect transactions. NASAA contends that, when day trading firms encourage customers to satisfy margin calls for other customers, the firms are defeating the purpose of the margin requirements, which is to prevent customers and firms from becoming over extended.⁶⁴

⁵⁸ *Id.* at 24.

⁵⁹ *Id.* at 29.

⁶⁰ *Id.* at 25.

⁶¹ See Congressional Research Service *Day Trading* 1 (1999).

⁶² *Id.*

⁶³ *Id.* at 2.

⁶⁴ NASAA Report at 26.

Finally, NASAA alleges that these customer lending programs violate state usury laws. The complaint against Landmark Securities alleged that the firm's branch manager in Boston promoted and arranged inter-customer overnight loans that typically entailed interest charges of .1 percent, or 36.5 percent annualized. Massachusetts law prohibits the making of loans with interest rates in excess of 20 percent and prohibits the possession of records of usurious loans.⁶⁵

Failure to Supervise: The NASAA Report states that each of the abuses cited above – including lending arrangements, unauthorized third-party trading, and forgeries – represent a failure to supervise on the part of the day trading firms. NASAA alleges that several large day trading firms do not adequately supervise their branch offices to ensure that such abuses are identified and corrected. The NASAA report identifies All-Tech and Landmark Securities as two day trading firms that failed to adequately supervise their branch offices.⁶⁶

B. NASAA Report Recommendations

The NASAA report makes the following recommendations to improve the disclosure of information to investors and deter fraudulent and deceptive practices in the day trading industry:

Promote suitability and disclosure of risks: The NASAA report recommends that NASDR develop a specific rule regarding risk disclosure and suitability standards for the day trading industry.⁶⁷ As noted already, NASDR has proposed such a rule, which is discussed at Section VI below.

Explicit prohibition of lending arrangements: Given the problems that it identified with customer lending programs, NASAA recommends that NASDR adopt a rule banning such lending programs.⁶⁸ To date, NASDR has not proposed such a rule.

Enhanced regulatory focus: NASAA recommends that all securities regulators focus much greater attention and resources on day trading firms to deter fraudulent and deceptive practices.⁶⁹

⁶⁵ Id. at 29.

⁶⁶ Id. at 40-41.

⁶⁷ Id. at 45.

⁶⁸ Id. at 46.

⁶⁹ Id.

C. Joint SEC and NASDR Examinations and Enforcement Cases Have Also Identified Violations At Day Trading Firms

In March 1999, due to rising reports about fraudulent practices in the day trading industry, the SEC and NASDR launched a joint examination program of more than 60 of the 100 day trading firms. SEC and NASDR developed common examination procedures and criteria to assess the operations and practices of these day trading firms. SEC and NASDR officials also divided responsibility for examining these 60 day trading firms: SEC is responsible for examining 36 of these firms and the NASDR is responsible for examining 25 firms.

SEC officials told PSI staff that they are still in the process of conducting examinations and have not yet summarized their findings. They believe, however, that Chairman Levitt will be able to do so by the hearing. An SEC official told us that preliminary information suggests that day trading firms have committed several violations of securities laws. For example, SEC examiners have found that certain day trading firms fail to comply with capital requirements for broker-dealers. In addition, the SEC has identified margin violations and questionable customer lending arrangements, such as those discussed in the NASAA Report.

NASDR officials told us that, between March and May 1999, its examiners initiated 20 examinations nationwide of day trading firms and the preliminary results of these examinations are now being tabulated.⁷⁰ NASDR officials confirmed that a preliminary analysis of the 20 examinations found the following abusive practices: (1) deceptive advertising, (2) margin violations, (3) registration issues, (4) failure to supervise, and (5) books and records violations. In addition, NASDR officials indicated that they expect to bring enforcement actions against several large day trading firms. The NASDR officials declined to provide the names of these firms or the timing of these enforcement actions.

VI. NASDR HAS APPROVED A NEW RULE TO MINIMIZE THE RISKS ASSOCIATED WITH DAY TRADING

Due to rising reports about the risks that day trading poses to average investors, the NASDR approved a rule on July 29, 1999, which places new obligations on NASDR members who promote day trading strategies.⁷¹ NASDR forwarded the proposed rule to the SEC on August 20, 1999. The SEC must review NASDR's proposed rule and submit the rule to the public for official comment.

⁷⁰ NASD had not yet initiated examinations of the other five day trading firms.

⁷¹ National Association of Securities Dealers, Inc., Approval Procedures for Day Trading Accounts, SR-NASD-99-41. According to SEC officials, the new NASDR rule would not apply to day trading firms that are registered with the PSE because these firms are exempt from NASDR rules. SEC officials said that they are considering proposing a rule that would require PSE member firms to comply with the NASDR proposal.

An NASDR attorney told PSI staff that the SEC may not finalize the rulemaking process until early in the year 2000.

The major elements of NASDR's proposed new rule governing the operations of day trading firms are as follows:

Risk Disclosure: A firm promoting day trading strategies must deliver a disclosure statement to the customer discussing the unique risks posed by day trading. The disclosure must include several points for customers to consider before engaging in day trading, including that they should be prepared to lose all of the funds used for day trading and that day trading on margin or engaging in short sales may result in losses beyond the initial investment. Firms will be permitted to develop an alternative disclosure statement so long as it is substantially similar to the mandated statement and is approved by NASDR.

New Account Approval: To approve an account for day trading, the firm must have reasonable grounds for believing that a day trading strategy is appropriate for a customer by gathering essential facts about the customer's financial status and investment goals. According to NASDR officials, this information could include the individual's income, net worth, source of funds, and investment objectives. An NASDR attorney told PSI staff that a customer with limited income and investment experience, who must borrow funds from a credit card company or obtain a second mortgage, would probably not be considered "appropriate" for day trading. A firm need not make this determination if it obtains from the customer a written agreement that the customer does not intend to use the account for day trading. If a firm later discovers that a customer who provided this written agreement is using the account for day trading, the firm must approve the account for day trading within ten days of the date of discovery.

According to the NASDR, customers seeking to establish day trading accounts at these firms would be covered by the proposed rules, regardless of whether they engage in day trading activities in their own names or under partnership or corporate names. The rules would apply only to customer accounts that are opened after the effective date of the proposed rule and would not apply to existing accounts.

VII. THE DAY TRADING INDUSTRY REJECTS MOST REGULATORY CRITICISMS

The day trading industry – through ETA and certain large firms – disputes most of the regulatory criticisms leveled against it and argues that day trading actually provides many benefits to investors. In particular, the industry makes a populist argument that day trading has opened up the markets to the average investor at the expense of the established brokerage industry. The industry argues that direct and instant access to the markets previously was reserved for large brokerage firms

that bought and sold securities at prices favorable to themselves and at the expense of retail customers. According to the industry, day trading allows investors to bypass broker-dealers and make trades themselves at favorable prices. Therefore, the day trading industry contends that large broker-dealers are losing business and responding with attacks against day trading firms. The ETA notes that NASDR, for example, is largely composed of NASD-registered market makers. The day trading industry believes that the brokerage industry is using NASDR and SEC examinations and rulemaking initiatives to suppress the growth and popularity of day trading.⁷²

On July 21, 1999, PSI Investigators, Brian C. Jones and Wesley M. Phillips, attended a free 2-hour seminar presented by All-Tech CEO, Harvey Houtkin. A crowd of about 300 people attended the seminar, which was standing room only. At the seminar, Houtkin repeatedly stressed the populist argument and the benefits that day trading offers to investors. Houtkin stated that the established brokerage industry and regulators have always opposed day trading because it threatened the status quo and the high profit structure that securities firms have traditionally enjoyed. During Houtkin's presentation, an overhead projection showed All-Tech's proprietary trading software with various orders entered by large trading firms – such as Goldman Sachs and Morgan Stanley – along with an order entered by a fictional day trader. Houtkin made the point that All-Tech and day trading generally now allow investors to compete on an equal footing with established securities firms. In addition, Houtkin argued that favorable prices on securities that investors realized from day trading more than offset the commissions charged. Houtkin did not offer any specific data to support this contention.

A. Day Trading is Profitable For Many Investors

As discussed previously, ETA argues that day trading is profitable and that the NASAA Report is biased and erroneous. In addition, ETA argues that the NASAA Report is flawed and not representative of the industry as a whole. ETA notes that the NASAA Report is based on only about 26 customer accounts at one All-Tech branch office in Massachusetts. As discussed previously, Momentum's "unscientific" study found that about 65 percent of the individuals who day trade for more than five months can make significant amounts of money.

B. Fraudulent and Deceptive Practices Are Not Widespread

James Lee, President of ETA, told PSI staff that fraud and questionable practices are not widespread in the day trading industry. He said that the NASAA Report is very limited and based on a very small sample of firms. Mr. Lee agreed that there are isolated problems in the day trading industry that need to be corrected. With respect to customer lending programs, Mr. Lee said that the day trading industry is willing to work with regulators on this issue. He also said that current state

⁷² Saul S. Cohen, *The Empire Strikes Back Part Two: The Empire's Inevitable Defeat*, <http://www.electronic-trades.org/press.144.html> (1999).

enforcement actions against day trading firms on the basis of their lending programs are unfair because such lending programs are legal under existing law.

C. Day Trading Improves Securities Pricing and Market Liquidity

The day trading industry and its advocates contend that day trading improves the pricing of securities available to investors. For example, the industry argues that day traders force NASD market makers to provide the best possible securities prices to investors by eliminating “stale” quotes. To illustrate, there are situations where an NASD market maker may offer to buy a security from investors at \$19.75 (“bid”) and sell the security at \$20.00 (“ask”). The difference between the bid and ask price is called the “spread” and the market makers retain some of the spread as profit. Occasionally, market makers allow their bid and ask prices to go “stale” – that is, as the prices of the securities move up or down, the market maker’s quote may be out of line with the price quotes of other market makers.

Thus, in the example cited above, a market maker might maintain bid and ask prices of \$19.75 and \$20.00, respectively, while other market makers may be offering bid and ask prices on the same security of \$20.25 and \$20.50. With instant access to such stale quotes, a day trader can buy the security from the original market maker at \$20.00 and sell to the second market maker at \$20.25 – thus earning a profit of \$.25 per share on the transaction. In this scenario, the original market maker is penalized for not keeping his price quotes in line with the price quotes of other market makers.⁷³ By constantly compelling market makers to update their price quotes, the day trading industry argues that market efficiency is improved. In the example cited above, day traders prod market makers to buy securities from investors at the highest possible bid price, \$20.25 per share rather than \$19.75 per share. However, according to a GAO official we contacted, this benefit to the market may be losing its relevance since many market makers have automated their stock quotations, which significantly reduces the incidence of stale market quotes.

The day trading industry also contends that day trading improves liquidity in the securities markets. Liquidity is the ease with which securities markets can accommodate large volumes of securities trading without significant price changes.⁷⁴ The industry argues that day trading improves the liquidity of the markets because it increases trading volume. According to a 1998 GAO report, however, available studies do not provide any evidence to suggest that day trading increases market liquidity and, in fact, may limit liquidity.⁷⁵ The GAO report, however, noted that the available studies

⁷³ In this scenario, the market maker with the stale price quote suffers because it receives a price of only \$20.00 rather than the going price of \$20.50.

⁷⁴ GAO, *Securities Market Operations: The Effects of SOES on the NASDAQ Market*, (GAO/GGD-98-194), p. 3, Aug. 31, 1998 (hereafter GAO SOES report).

⁷⁵ GAO SOES Report at 14-15.

are limited in that they did not consider all factors necessary to understand the aggregate impact of day trading on market liquidity.⁷⁶

VIII. THE CONNECTION, IF ANY, BETWEEN DAY TRADING AND MARKET VOLATILITY

Some brokerage firms and other market participants have argued that day trading increases the volatility of the securities markets. These critics contend that the strategies of day traders, such as buying in “up trending” markets and selling in “down trending” markets, increases price volatility.⁷⁷ Market volatility is generally considered detrimental to investors because stock prices fluctuate for reasons unrelated to the business prospects of the company or the fair value of its shares. Thus, investor stock purchase decisions based on careful analysis of the company’s financial prospects may be thwarted because the price of the stock responds to unrelated factors, such as the trading volume attributed to day traders. Companies seeking to raise capital through the securities markets may also suffer due to price volatility because share prices may decline for reasons unrelated to the company’s business prospects, which may in fact be positive.

As part of its 1998 study, GAO reviewed available studies on any potential links between day trading and market volatility.⁷⁸ Based upon the available literature, the GAO found that there is no conclusive evidence to support the contention that day trading results in market volatility. Although some studies found that there is a correlation, these studies did not establish whether day trading caused volatility or whether other market factors caused volatility.⁷⁹ Another study that GAO reviewed also found mixed evidence about the impacts of day trading on market volatility.⁸⁰ The study concluded that large volumes of day trading increased market volatility in the short-run, but contributed to lower volatility in the long-run.⁸¹

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⁷⁶ Id. at 14.

⁷⁷ Id.

⁷⁸ Id. at 14.

⁷⁹ Id.

⁸⁰ Robert H. Battalio, Brian Hatch, and Robert Jennings, *SOES Trading and Market Volatility*, Vol. 32, No. 2 (June 1997).

⁸¹ GAO SOES Report at 14.