OPENING STATEMENT
OF
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CHAIRMAN

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Hearing On
DAY TRADING: EVERYONE GAMBLES BUT THE HOUSE

February 24, 2000

Today, the Permanent Subcommittee on Investigations continues its examination of day trading. Last fall, the Subcommittee began its investigation with an overview hearing. After several months of investigation, we now will draw back the curtain and provide an in-depth look at the practices of three day trading firms representative of the industry.

Day trading involves taking positions in stocks for very short periods of time, usually minutes or hours, but rarely longer than a day. Day traders seek small increments of profit from momentary fluctuations in the price of a stock. The firms that cater to day traders provide their customers high-speed computer access and real-time market quotes, both of which are necessary to take advantage of small changes in stock prices.

Over the course of eight months, the Subcommittee has investigated 15 firms, which reported a total of about 12,700 day trading accounts. While a day trader could open more than one account, the Subcommittee's review indicates that the number of day traders is significantly higher than most of the earlier estimates. At our hearing last fall, we heard testimony that there were about 5,000 day traders at approximately 60 firms.

Commission income, which is normally generated on a per trade basis, is the primary source of revenue for most day trading firms. The day trading firms we investigated charged an average commission of $16 per trade. In the aggregate, those firms estimated that the average customer executes about 29 trades each day. Consequently, the average day trader must generate a minimum trading profit of over $450, each and every day, simply to break even. On an annualized basis, assuming twenty trading days per month, the average day trader must generate a trading profit of more than $111,000 to achieve profitability for the year. As the testimony today will show, most day traders are not breaking even; in fact, they're losing money – big money. The consumers who will testify before us today lost tens of thousands of dollars.

The same can't be said, however, of the day trading industry. It seems to be doing quite well. The 15 firms that we examined reported aggregate gross revenues of over $541 million in 1999, and aggregate profits of about $144 million. The Subcommittee found that the industry is growing by leaps and bounds. Indeed, the revenues of the day trading firms we analyzed grew by a whopping 276 percent from 1997 to 1999.

Everyone – even the industry – appears to agree that day trading is highly speculative and extremely risky. Both the Chairman of the SEC and the President of NASAA went so far as to call day trading "gambling" during the Subcommittee's hearing last fall. The Electronic Traders Association, the trade organization for the industry, objects strongly to that analogy, contending that day trading "requires skill, state of the art technology and hard work."

That may be true, but many day traders seem comfortable with the comparison to gambling. The president of one day trading firm was quoted in the press as saying, "[d]ay trading is like blackjack." Documents obtained by the Subcommittee also indicate that some firms consider day trading to be essentially gambling. [Refer to Ex. 1] This is a listing of trading tips from a firm called Insider Trading. You'll note that Insider Trading cautions its customers not to get greedy. It states, "[w]hen you reach your goal, stop, and quit trading. Try not to get greedy and still trade. Remember, you are gambling and most likely will loss [sic] what you have made."

I believe that day trading can be fairly compared to certain types of gambling. For inexperienced traders, it is little more than a game of chance. I reached this conclusion based primarily on data showing that only a small percentage of day traders ever make money. Our investigation indicates that the small percentage of day traders who are successful generally start with large amounts of risk capital and substantial experience. The best evidence suggests that a significant majority of all day traders – more than 75 percent -- lose money and that for novice, undercapitalized traders, there is almost no chance of success.

A document produced to the Subcommittee by the firm, All-Tech Direct, sums up my concern about the profitability of day trading. When the branch manager for All-Tech's Seattle office was asked to comment on the progress of his 51 customers, he wrote, "[o]verall good! We need to have a couple of people making money." In fact, when interviewed by Subcommittee staff, the branch manager estimated that only about 10 percent of his Seattle customers were profitable. Even more striking, the branch manager of the Los Angeles office of another day trading firm, Providential Securities, stated that none of his day trading clients ever made money. In fact, he estimated that the average customer lost approximately $50,000.

Because of the poor success rate of most day traders, one might wonder why the industry has grown. After all, why would people give up good jobs or put their savings at risk to pursue a day trading career when their chances of making money were very small? The reason, of course, is that most of the people who lost money, including the consumers we will hear from today, did not fully appreciate the risk. While some day trading firms give their customers very good risk disclaimers, on the whole, the industry has failed to disclose adequately the risks of this speculative activity. Many day trading firms improved their written risk disclosures only after regulatory and congressional scrutiny increased last year. And, as today's testimony will show, written risk disclosures are often contradicted by oral statements that minimize risk through promises of big profits or "can't lose" systems.

Even when the written risk disclosures are provided, they may be undermined by deceptive advertising or other hype. [Refer to Ex. 2] For instance, this web site for the "Lazy Day Trader" entices potential customers with an unbalanced and exaggerated testimonial. It says, "[t]his is the only business I know of where there is absolutely no limit ever as to how much I can earn. I am doubling my money every 3 months buying and selling stocks . . . . I have developed a simple method to determine what to buy and sell, how much, and when to buy and sell which everyone can follow. You can start with as little as $2,500 – and still make money . . . ." It even adds, "[y]ou don't have to be able to understand Economics, the Stock market or International Finance." In other words, with very little capital and no understanding of the markets, the average person can get rich by following the Lazy Day Trader's "can't lose" system. If only it were that easy!

What's most disturbing about these types of misleading claims is that they often appeal to the very people who have limited investment experience. Press reports have noted that day trading attracts many young people because it is computer-intensive, fast paced, and offers the tantalizing prospect of quick riches. The customers of Landmark Securities are a good example. The Subcommittee staff conducted an analysis of Landmark Securities' new account forms and found that 42 percent of Landmark's customers were 26 years old or younger. The disclosed median income and median net worth of these young traders was only $30,000.

These data really highlight the most troublesome finding of our investigation: most day trading firms have accepted customers whose stated financial condition or investment objectives are inconsistent with the firms' internal policies governing the opening of new accounts. We will hear testimony today from several former day traders whose disclosed financial conditions were well below the minimum requirements of their respective firms. Ironically, these firms must be commended for having any minimum requirements at all. Twenty percent of the firms we examined maintained <u>no</u> minimum financial requirements to open a day trading account. In light of this evidence, it probably shouldn't be surprising that so many day traders eventually fail.

Let me conclude by reaffirming that I will not propose a ban on day trading. If an investor who has adequate capital is fully informed of the risks of day trading and still elects to pursue this speculative strategy, so be it. But, if day trading firms fail to disclose the risks and entice unsophisticated investors with misleading ads or exaggerated claims of profitability, regulators – and the industry – must put a stop to it. Consumers who choose to day trade must be warned that they could easily lose their entire investment.

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