Statement
of
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Permanent Subcommittee on Investigations

On Detail From The Securities & Exchange Commission
Hearing On
DAY TRADING: EVERYONE GAMBLES BUT THE HOUSE
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Thank you Chairman Collins, Senator Levin, and Members of the Subcommittee. My name is Deborah Field, and I am Counsel to the Permanent Subcommittee on Investigations. I am currently on detail to the Subcommittee from the Securities and Exchange Commission. I have been a member of the SEC's Division of Enforcement for about two years. Prior to joining the SEC, I was an attorney with the law firm, Wilmer, Cutler & Pickering, where I worked in the firm's securities enforcement and litigation practice. As Counsel to the Subcommittee, I have been intimately involved with the staff's investigation of the day trading industry. Today, I am presenting a brief overview of that investigation.

Scope and Methodology of PSI's Investigation

The Subcommittee staff conducted this investigation by casting a wide net. We examined the largest day trading firms and some that were very small. The Subcommittee sent detailed and comprehensive document requests to 19 day trading firms. In response, those firms produced approximately 50,000 pages of documents and at least ten videotapes containing television advertisements. In addition to reviewing all of these materials, Subcommittee staff interviewed or deposed over 100 people. These witnesses included chief executive officers and other employees of day trading firms, former and current day traders, gambling experts, academics and authors. We also spoke with state and federal securities regulators and representatives of self-regulatory organizations.

Based on the evidence gathered by the Subcommittee, we narrowed our focus to three day trading firms: All-Tech Direct, Providential Securities, and Momentum Securities. The staff conducted a detailed examination of these three firms.

General Findings

While some of our findings pertain to potentially illegal conduct, such as forgery and unauthorized trading, perhaps the most disturbing evidence gathered by Subcommittee staff relates to business practices that are – under the current regulatory framework – entirely legal.

Perhaps the single most important finding of this investigation was that many firms allow – and even encourage – unsuitable customers to day trade. Contrary to their own internal policies, many firms have routinely failed to gather the information about their prospective customers that is necessary to determine whether those customers are suitable for day trading. Frequently, customers end up losing tens of thousands of dollars – losses that they cannot sustain.

[Refer to Ex. 3] This is a page from the compliance manual of Providential Securities. As you can see, Providential advises its employees that "[l]iving in such a litigious society, [brokers] need to take special care in gathering complete and accurate financial information about [their] customers. You must take the time with your clients to assess their situation on a regular basis, and make [sic] recommendations based on your fact finding mission. <u>Suitability is the key to client recommendation</u>."

However, this next exhibit shows that Providential frequently disregarded its own compliance manual. [Refer to Ex. 4] This new account form contains virtually no information about the prospective day trader. Providential did not document the customer's employer, credit references or tax status. And, even though Providential supposedly requires its day traders to disclose a minimum income of $50,000 and a minimum net worth of $200,000, it opened this new account without documenting this customer's net worth or income. And, Providential had an initial deposit requirement, yet no initial deposit amount is written on this form. It's hard to imagine what basis the firm had for determining that this customer was suitable for day trading.

Even when day trading firms have gathered the pertinent information, many have accepted customers whose disclosed financial condition did not meet their own criteria for opening day trading accounts. For example, firms have opened day trading accounts based on new account forms indicating that the customers' investment objectives were "income" or "long term growth," two objectives commonly understood to be at odds with a high risk, day trading strategy. In fact, we reviewed over 300 All-Tech new account forms that contained objectives that were inconsistent with day trading.

We have also uncovered evidence that some day trading firms altered new account forms to make their customers appear more suitable for day trading. [Refer to Ex. 5] For example, this is a new account form produced to the Subcommittee by Terra Nova Trading. As you can see from the form, this customer initially indicated that his income and net worth were $24,000 and $15,000, respectively. These figures were then crossed out, and someone wrote $30,000 in each category. As you may have guessed, Terra Nova's minimum financial requirement for day traders is $30,000 of income and $30,000 of net worth.

The Subcommittee staff asked Terra Nova about the changes to this account form as well as four others. Terra Nova informed the Subcommittee that its employees made these changes but contended that they were made "with the knowledge and consent of the customer based on information received from the customer." However, we found 50 Terra Nova new account forms that were similarly altered. It's hard to believe that 50 customers first provided the firm with incorrect financial information and then later informed the firm that their net worth and income were actually $30,000 or more.

Some day trading firms who formerly maintained sound minimum financial requirements for opening new accounts have lowered their standards. They have done so to compete with other day trading firms who have weak minimum requirements or no standards at all. These firms are now accepting customers whom they previously considered unsuitable for day trading. These firms readily admit that they are doing so because they do not wish to lose the commission revenue generated by those customers.

Not only do firms accept new customers that they know have very little chance of success, they also allow – and even encourage – those customers to trade beyond their means. For instance, the Subcommittee staff found that many day trading firms systematically arrange for customers who cannot satisfy margin calls to obtain from other customers short term loans at high interest rates. The firms then manage all of the administrative and clerical functions attendant to servicing those loans. As an example, we found that Momentum Securities used one customer's account to lend almost $10 million to 52 customers in a single month. These margin loans often exceeded $100,000.

We also found that day traders end up paying exorbitant commission fees throughout the course of the trading day. Although the fees per trade are not necessarily high, day traders may make up to 50, or even 100, trades per day, thereby generating significant fees. That means that day traders may spend much of their time and capital just trying to break even, before accruing one cent of profit.

Another troubling finding of our investigation related to the quality of the management and supervision of day trading firms. Some day trading firms have hired unqualified personnel to manage their branch offices. For example, some firms have hired branch managers who had little or no prior experience in the securities industry and some who weren't even licensed. They have also failed to adequately train and supervise branch personnel after they were hired. And, despite their claims to teach customers everything necessary for day trading, many day trading firms have provided their customers with poor training – training that gives customers a false sense of security about day trading and their likelihood of success. For that training, customers paid thousands of dollars. And, in fact, most day traders end up losing money.

Case Studies

The testimony over the next two days will focus primarily on the case study firms All-Tech, Providential, and Momentum. [Refer to Ex. 6] We have prepared this chart to help you understand the relationships between the hearing witnesses and the case study firms. Today, you will hear from former customers of these firms or their representatives. They will be followed by former and current branch managers of the firms as well as one third-party trader. The Chief Executive Officers whose names appear on the second line of the chart will each testify tomorrow morning. Harvey Houtkin is the CEO of All-Tech, Henry Fahman is the CEO of Providential, and James Lee is the President of Momentum.

Conclusion

In conclusion, the Subcommittee's investigation uncovered many disturbing – and in some cases – illegal practices by the day trading industry.

Chairman Collins, I would be pleased to answer any questions that you and the Subcommittee Members might have.