REPORT OF THE DAY TRADING PROJECT GROUP

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

FINDINGS AND RECOMMENDATIONS

AUGUST 9, 1999

NASAA PROJECT GROUP ON DAY TRADING

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The North American Securities Administrators Association Project Group on Day Trading Report ("*Report*") is the product of the collective experience of the Project Group members in work related to day trading firms. This has included reviewing numerous applications for registration, conducting numerous examinations, and participating in investigations and enforcement proceedings.

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The Project Group is solely responsible for the *Report*.

PREFACE

This *Report* is primarily intended to assist state securities regulators in understanding, and responding to, the issues posed by the day trading industry. It may also serve as a word of caution for those who believe that day trading offers a viable career opportunity, or that frenetic trading is an alternative to prudent, diversified, long-term investing.

The *Report* is only one of the undertakings by the Project Group. The Group has also provided information in response to frequent media inquiries, commented on rule proposals by the National Association of Securities Dealers, Inc. ("NASD"), shared information and ideas with the U.S. Securities and Exchange Commission ("SEC") and NASD Regulation, Inc., and provided consultation to many state securities divisions. In addition, the chairman of the Group moderated a panel presentation on day trading before the NASAA/Florida broker-dealer training program in June 1999.

NASAA PROJECT GROUP ON DAY TRADING

REPORT

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Summary

Technological advances, particularly in the past few years, have made it possible for the average person to effect transactions in their own brokerage accounts. Day traders are retail customers of brokerage firms who attempt to make profits intra-day on small changes in the prices of stocks. Day trading firms market this type of trading and derive their revenue from the commissions generated.

Day trading firms have high overhead and other costs. In addition, their customers have a high failure rate, leading to a high dropout rate. These factors have led firms to need a continuous inflow of new customers with trading capital.

The need for customers to provide infusions of capital has pressured some firms to skirt existing rules and regulations in order to attract and maintain customer accounts. Some of the abuses and problems that the Project Group has observed include:

- Deceptive marketing, including inadequate risk disclosure
- Violation of suitability requirements
- Questionable loan arrangements, including promotion of loans among firms' customers and loans to customers by brokers
- Abuse of discretionary accounts where brokers have day traded customers' accounts
- Encouragement of unregistered investment adviser activity through the customers trading the funds of third parties.
- Failure to maintain proper books and records
- Failure to supervise

Recent enforcement actions brought by state securities regulators against day trading firms have alleged violations related to these abuses and problems. In addition, the NASD has responded by approving proposed special rules for suitability and risk disclosure.

The *Report* describes and analyses the major problems and abuses observed with respect to the day trading industry and summarizes the enforcement actions brought to date.

The NASAA Project Group retained two consultants to, respectively, 1) tabulate data, and 2) analyze activity in a sampling of customer day trading accounts. The conclusions are consistent with regulators' warnings that most customers will lose money day trading.

The analyst concluded that, based on the study of accounts, "70% of public traders will not only lose, but will almost certainly lose everything they invest." He also concluded that only 11.5% of the accounts reviewed evidenced the ability to conduct profitable short-term trading.

The *Report* supports the NASD's new rules. It also recommends the explicit prohibition of the questionable lending arrangements. The *Report* also calls for enhanced regulatory attention, including more enforcement actions.

I. The Day Trading Industry

A. Definition

Day trading firms differ from traditional brokerage firms in that they provide the means for customers to trade their own accounts, and promote and facilitate a particular type of trading. They also furnish customers with information on order flow and provide electronic execution of orders. Customers may trade through equipment at firms' offices or from their own computers that are equipped with the firms' special software.

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.

Traditional brokerage firms, by contrast, have focused on making recommendations to customers, processing orders from customers, and handling accounts on a discretionary basis. Traditional firms have some customers who trade; however, the level of activity in these customers' accounts is considerably less than the trading that takes place at day trading firms.

Day trading firms differ not only from traditional brokerage firms, but also from traditional discount brokerage firms. Discount brokers tend to passively accept orders from customers, eschewing the making of recommendations. In contrast, day trading firms promote day trading as a strategy, or a program of investment. They also often market courses in trading to their prospective brokerage customers; the courses include recommendations of trading strategies. In addition, firms commonly offer the services of trainers or coaches.

On-line brokerage firms are sometimes confused with day trading firms. On-line brokerage firms simply offer a tool, i.e., services for the placement of orders through the Internet

B. Size of Industry and of Customer Base of Firms

The Appendix to this *Report* includes a chart developed by the Project Group that lists firms that are believed to offer, as at least one of their services, day trading services. The chart includes 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. It is common in the day trading industry for offices to have only one registered agent, so the number of agents employed with each firm is fewer than might be expected.

The Project Group is not aware of any assessment by regulators or other third parties of the number of customers of day trading firms. Stories in the media have cited figures provided by an industry trade group, the Electronic Traders Association, or ETA. The ETA estimates "4,000-

5,000 people trade full-time through day trading brokerages, making 150,000-200,000 trades a day."[1] The transactions of these day traders "represent nearly 15% of daily Nasdaq volume."[2]

C. Comparison of NASD versus Philadelphia Stock Exchange Firms

As reflected by the chart in the Appendix, the majority of day trading firms are registered with the NASD. These firms have customers, whom they often refer to as traders. The firms are subject to the rules of the NASD and the states where they do business.

Day trading firms registered with the Philadelphia Stock Exchange ("PHLX") typically disclaim having "customers." Instead, they register their traders with the PHLX as agents of the firm. These "agents" trade the firm's own capital on a highly leveraged basis through the firm's margin privileges. Some firms issue interests in their firms to their traders; often these interests are in the form of company shares.

The firms typically require the traders to place a substantial security deposit or to make other arrangements to cover losses incurred by the individual traders. This means that the traders, even though they trade with the firm's capital, are themselves exposed to losses.

The PHLX-member day trading firms, as noted above, disclaim having customers, thereby avoiding NASD registration. This arrangement purportedly negates investor suitability considerations. It also permits these firms to provide their traders much higher leverage than do the NASD member firms, since the firms' capital is traded. This means that the firms may not have experienced the problems associated with customer-to-customer lending arrangements. The lending arrangements of some NASD member firms are discussed below.

Some day trading firms registered with the NASD, we believe, have allowed customers to trade beyond their means, and these customers often have been unable to meet their margin calls. Many firms have responded by promoting and arranging loans among customers. Since the PHLX member firms provide greater leverage to their traders, the traders are able to trade larger volumes with less capital, reducing any pressure for the firms to arrange loans.

Nevertheless, PHLX-member firms may still engage in the types of problematic conduct discussed in this *Report*, and they require further scrutiny by regulators. Examinations of the firms suggest that some may suffer from the same problems of casual supervision as do the firms regulators have examined that are registered with the NASD. Finally, the traders/agents should be aware that they might not get the benefit of SIPC insurance.

Until states took action, some PHLX-member firms claimed that they did not have to register with state regulators. Colorado required Bright Trading, Inc. and Generic Trading Associates, LLC to register with the Securities Commissioner. *In re Bright Trading, Inc.* (Co. Sec. Div., Aug. 28, 1998); *In re Generic Trading of Philadelphia, LLC* (Co. Sec. Div., May 27, 1998). Massachusetts has brought a proceeding against one such firm for failing to register with the

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

state. *In re Bright Trading, Inc., et al.* (Ma. Sec. Div. 98-70, Nov. 9, 1998) [hereinafter *Bright Complaint*].

Pennsylvania declined to issue a no action letter concerning the proposed activities of one firm. Pennsylvania's response discusses the possibility that the firm's traders could be treated as customers for regulatory purposes, and also comments on the firm's proposed securities offering, i.e., the issuance of interests in a limited liability company to traders. *Lieber & Weissman Securities, LLC*, (Pa. Sec. Comm. No-Action Letter, Mar. 6, 1998). (Copies of the request for the no action letter and Pennsylvania's response are included in the Appendix.)

Most of the problems discussed in this *Report* have been observed at firms registered with the NASD. The *Report* generally focuses on NASD-member firms, except as noted, but many of the issues are also applicable to PHLX-member firms.

II. Issues Presented by the Day Trading Industry

A. Introduction

Problems in the day trading industry appear to be widespread. Two factors underlie the problems discussed in this *Report*.

The first factor is the failure to follow basic compliance requirements. Firms have engaged in practices that would be clearly unacceptable if conducted by traditional brokerage firms. The officers and managers of many firms have little or no experience in the brokerage industry. As a result, many day trading firms are operated by people with little knowledge of or respect for the regulations or standards of the securities industry.

The second factor is that firms require a continuous inflow of customers and their trading capital. Most customers lose money, leading to high customer turnover. In addition, firms' apparently have high overhead and high expenditures for each customer who trades. This has led firms to take questionable measures to draw new capital, including using misleading and deceptive marketing, pushing day trading without regard for suitability considerations, and allegedly encouraging trading by unregistered investment advisers.

Furthermore, this need for customers has caused firms to attempt to cling to their existing customers, even those who cannot meet margin calls. Firms have retained these customers by operating questionable lending schemes and allegedly participating in the creation of fictitious accounts.

Each of the following sections describes the problems that have been observed, and includes a presentation of the applicable law. The *Report* includes discussion of SEC and NASD rules because violations of these rules may constitute a violation of state laws or regulations.

B. Misleading and Deceptive Marketing

1. The Reality: Day Trading is Speculative, and Unprofitable for Most People

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 simply trading on an extremely short-term basis, and is thus particularly speculative.

Analogy to Gambling

Common sense suggests that day traders will lose money. As Philip Feigin, formerly Securities Commissioner of Colorado and now Executive Director of NASAA, observed last fall, day trading is virtually a form of gambling. This means that most traders at a firm will incur net losses, while the brokerage firm, the "house," reaps profits through commission revenue.

Chairman Arthur Levitt of the SEC has stated that, in his opinion, day trading is not just speculation, but amounts to gambling. He has noted that speculation requires market knowledge and that short-term trading has historically been the domain of professional traders.[3]

Day trading is analogous to guessing the outcome of a coin toss. Just as a coin may land heads or tails, a stock may go up or down during the day. However, the odds with day trading stocks are actually worse than this, akin to guessing the results of tossing a coin that sometimes lands on its edge. A stock's price has *three* possible outcomes, since the stock may remain static. In addition, the day trader has to pay commissions for the privilege of making his guesses.

Analogy to Retail Futures Trading

Day trading is also analogous to futures trading. Both types of speculation entail leverage, and both, by definition, are forms of trading rather than investing.

The lessons from the world of retail futures trading are instructive. Futures trading by retail customers is unsuccessful. Even industry leaders have acknowledged that 80 to 90 percent of individual customers lose money at their firms.[4]

Speculators versus Long-Term Investors

By contrast to traders, the investors and money managers who have been hugely successful, and who have served as legitimate inspiration for individual investors, are those who have invested long-term. Kenneth L. Fisher, in a 1985 article in *Forbes*, noted:

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[3] *No Day Trading Rules Planned*, WORLD SEC. LAW REP. (BNA) May 1999, at 13.

[4] Scott McMurray, *Burned Alive*, WORTH, Apr. 1994, at 68, 70.

> If you could make good money with short-term approaches, there would be lots of visible folks who had done so. Where are those who have made fortunes as short-term traders?
>
> ….
>
> Take a look at John Train's book *The Money Masters*. One thing you will see in common among the big successes – however their style may vary – is that they bought stocks to hold for several years or longer. Warren Buffet, John Templeton, Ben Graham [etc.] – they bought long term.[5]

Analogy to Market Timing

Day trading is analogous, on a microscopic level, to market timing. Market timing refers to when investors attempt to determine when the stock market is at highs and lows. Market timers attempt to sell at the perceived peak of the market, stay in cash, and then buy at the perceived bottom of the market.

As noted by the Vanguard Group, Inc. ("Vanguard"), "The problem is that few investors, if any, can accurately foresee the direction of the stock or bond markets."[6] A study cited by Vanguard, entitled "Stock Market Extremes and Portfolio Performance," was conducted by Professor H. Nejat Seyhun of the University of Michigan in 1994. Seyhun concluded, "The financial results of perfect timing are indeed attractive. Yet they are virtually unreachable."[7]

Similarly, few speculators can correctly determine the short-term movements of individual stocks.

The Inherent Flaws of Day Trading

Day trading is more speculative than longer-term stock trading for two reasons. First, price changes on a given day are usually small. This means that any profits the trader takes will, on average, be small.

Professional traders succeed by quickly cutting their losses and letting their profits run. If day traders close all positions intra-day, they cut their losses but forego the running of profits. In reality, retail customers, including day traders, tend to take profits too quickly and let their losses run.[8]

Also costs, i.e., commissions and bid-ask spreads, will tend to devour profits. Since day trading entails high turnover, the return necessary for a trader just to break even is high.

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[5] Kenneth L. Fisher, *Where are They Hiding? Winners at Short-Term Trading*, FORBES, Aug. 26, 1985, at 162.
[6] *The Danger of Market Timing*, The Vanguard Group, (visited July 16, 1999) <http://www.vanguard.com/educ/module4/m4_8_0.html>.
[7] H. Nejat Seyhun, *Towneley Market Timing Study*, (1994) (Study, School of Business Administration, University of Michigan) (available at <http://www.towneley.com/html/study.htm>).
[8] Jeffrey Heisler, *Loss Aversion Among Small Speculators in a Futures Market*, (1998) (Study, Boston University), at 1.

The commissions charged by day trading firms vary. All-Tech Investment Group, Inc. ("All-Tech") charges its customers a standard commission of $25 for every purchase or sale transaction.[9] The average commission per trade charged by on-line brokerage firms is about $15.[10]

The Paradox of the Existence of the Day Trading Industry

The very existence of an industry devoted to offering day trading of stocks is paradoxical. For those who wish to speculate, futures and options provide much greater leverage than stocks purchased or sold short on margin, allowing bets to be made on small movements. Futures and options also provide the ability to speculate on the direction of the market, rather than on the price of individual stocks. In short, futures and options may be more effective speculative trading vehicles than stocks.

Perhaps day traders are aware that retail customers usually lose money trading futures and options, so they wish to trade a seemingly safer vehicle. This usually results in the slower loss of capital, but in loss nonetheless. It can also result in day traders compensating for the lack of leverage by trading beyond their means, and trading with funds borrowed from other customers and other sources.

Academic Studies of Trading in General

Academic research is consistent with the common sense expectation that day traders generally will lose money. First, consider the findings of Professors Brad M. Barber and Terrance Odean of the Graduate School of Management, University of California, Davis, in what they describe as "the first comprehensive study of the aggregate common stock performance of individual investors who manage their own equity investments without the advice of a full-service broker."[11] Based on the records of activity of customers of a discount brokerage firm over a six-year period ending January 1997, they determined that "individual investors who hold common stocks directly pay a tremendous performance penalty for active trading."[12]

The authors found that "those investors who trade most actively realize, on average, the lowest net returns."[13] They concluded, "Our central message is that trading is hazardous to your wealth."[14] The authors believe the counterproductive level of trading they found "can be at least partially explained by a simple behavioral bias: People are overconfident; overconfidence leads to too much trading."[15]

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[9] All-Tech Investment Group Online, *Costs of Quotes and Execution System* (visited May 10, 1999) <http://www.attain.com/costs.html>.
[10] *The Real Virtual Business*, ECONOMIST, May 8, 1999, at 71.
[11] Brad M. Barber and Terrance Odean, *Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors* (Apr., 1999) (Study, Graduate School of Management, University of California at Davis), (J. FIN. forthcoming).
[12] *Id*. abstract.
[13] *Id.* at 22.
[14] *Id*. abstract.
[15] *Id* at 28.

The Barber and Odean study, through its design, ignored intra-month trades, thus excluding the very short term trading that characterizes day trading. The most active traders in the study had a positive annual return on average, but they substantially underperformed the market (11.4% vs. 17.9%).[16] The study's finding of the inverse correlation between trading and return is consistent with the expectation that day traders will experience a negative return.

Professor Odean's prior study of a set of earlier data from discount brokerage accounts also found that excessive trading leads to losses.[17] He found that "on average, the securities [investors] purchase actually underperform those they sell."[18] Professor Odean concluded:

> [I]nvestors' overconfidence in the precision of their information may contribute to this finding, but it is not sufficient to explain it. These investors must be systematically misinterpreting information available to them.[19]

In this study, Professor Odean explains the model of overconfident traders, based on his own prior work and that of other researchers:

> An investor who receives a signal of low precision but believes it to be of high precision will profit, on average, less than she expects. If the precision of her signal is actually zero, that is, if she has no information but believes she has some, she will on average have zero profit. *In a market with trading costs the profits overconfident traders earn from speculative trading may not be enough to offset trading costs*. (emphasis added).[20]

The model of overconfident traders discussed above correlates well with what common sense tells us about day trading. Day traders are taught to believe they can interpret stock price changes and predict short term price changes. The "precision of the signal" is likely to be zero, and trading costs are likely to absorb any profits.

The facts developed to date are consistent with the theoretical observations above. As alleged in Massachusetts' Complaint against Block Trading, Inc., ("Block") the former branch manager of the firm's Boston office testified in an on-the-record interview that, of 68 accounts in the office, 67 lost money. *In re Block Trading, Inc., et al.* (Ma. Sec. Div. 98-58, Oct. 19, 1998) [hereinafter *Block Complaint*]. The allegations in the Block Complaint even raised a question as to the legitimacy of the profits in the sole account that was claimed to be profitable. The customer who held this account was allegedly an unregistered investment adviser who was in a position to allocate trades, and thus profits and losses, among his own account and the accounts of other customers.

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[16] *Id*. at 2.
[17] Terrance Odean, *Do Investors Trade Too Much?* (Apr., 1993) (Study, Graduate School of Management, University of California at Davis), (AM. ECONOMIC REV. forthcoming).
[18] *Id*. abstract.
[19] *Id*. at 3.
[20] *Id*. at 2.

The branch manager of the Watertown, Massachusetts office of All-Tech testified in an on-the-record interview that an employee of the firm's margin department asked him rhetorically in or about August of 1998, "Why would you even want to be in this business? You know all these people lose money-" Finally, the manager testified that, in a meeting held by about twelve All-Tech managers from around the country, the managers discussed, among other things, that, "most people [lose] money."

Harvey Houtkin, the principal of All-Tech, himself has implied that the vast majority of day traders lose money. Houtkin was quoted as follows in an article in the February issue of *Securities Regulation and Law Report*:

> Day Trading is a business like any other. It's not wild speculation. And, like other businesses, **95 percent will fail in the first two years.** (emphasis added).[21]

Day Trading Industry's Failure to Meet its Burden of Proving its Claims

As discussed below, some day trading firms have marketed to prospective customers through general and specific claims of customer success. Indeed, the existence of the day trading industry is apparently based on a belief that day trading can be an easy route to profits. The day trading industry has the burden of proof to show that its implicit and explicit claims are true.

The day trading industry has failed to meet this burden. As discussed below in the section on deceptive marketing, the day trading industry has demonstrated a pattern of making claims that it is unable to support in response to regulators' inquiries.

An example of this phenomenon occurred in connection with the Project Group's work on this *Report*. The Project Group wrote the Electronic Traders Association ("ETA"), a trade organization of the day trading industry, on February 26, 1999. The Project Group invited the ETA "to provide copies of any reports by [the] organization or its members regarding the profitability of day trading by customers."

The ETA's counsel responded by letter dated March 19, 1999 (See Appendix):

> [I] am unaware of any ETA report of this nature, although I understand that certain ETA members have informally surveyed part of their operations to provide a rough estimate of such profitability. While such information is probably sound, I doubt if the information prepared to date is all that useful since it is so narrow.

By letter dated March 25, 1999, the Project Group wrote the ETA's counsel:

[21] *Much Ado About Day Trading; Are Existing Regulations Adequate?,* SEC. REG. AND LAW REP., (BNA), Feb.12, 1999, at 215.

> As you know, Momentum Securities recently issued a press release concerning its purported analysis of the profitability of its customers' accounts. It would be helpful for the Project Group to have copies of all documents related to the study, including design documents and work papers.

The ETA has yet to respond to the Project Group's request for copies of the documents that would have allowed a review of the claims made by Momentum Securities Management Company ("Momentum Securities").

The subject press release was issued by Momentum Securities on January 28, 1999. According to press coverage in the *Los Angeles Times*, the "study" by Momentum Securities found that 58% of its customers included in the review lost money in their first three months of trading, and that, after three to five months, presumably of those that remained, 65% were making money and 35% losing.[22] James H. Lee, the president of Momentum Securities, as well as the president of the ETA, is cited as stating that "the success rate is strong for those who stick with day trading."[23]

In addition, the article quotes the study's assertion that "there is an extremely high correlation between high profitability [for traders] and high trading volume."[24] The latter claim, whether or not it is true, would certainly promote the day trading industry's interest, since higher trading volume correlates with higher commission revenue for firms. However, the day trading industry has either failed to conduct or to release the analyses supporting this claim.

The analysis conducted by the Project Group was resource-intensive, since the project required obtaining records, checking them for completeness, copying statements for an independent consultant, and having the consultant input thousands of entries from voluminous statements.

By contrast, the day trading industry could simply download the electronic records maintained by its member firms' clearing day trading brokers, and have them analyzed. Yet it chooses not to have the analyses made, or not to release the findings.

2. The Problem: Misleading and Deceptive Marketing

Marketing by elements of the day trading industry has misleading and sometimes deceptive. The problems have included:

- Implicit and explicit representations that customers are likely to achieve profits;
- Implicit and explicit representations that day trading can be a career opportunity for many people; and
- Claims of specific success rates.

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[22] Walter Hamilton, *'Day-Trading' Study Finds Split Results*, LOS ANGELES TIMES, Jan. 29, 1999, at C1.
[23] *Id*.
[24] *Id*.

Four of the six administrative proceedings concerning day trading brought by the Massachusetts Securities Division (the "Division") have alleged the use of deceptive marketing. The Block Complaint alleged the following:

- The firm used a brochure for prospective investors that described Block's commitment to "educating others to the unlimited earning potential of day trading."

- The brochure stated that the firm's principals "help their customers profit from fluctuations in the NASDAQ market."

- The firm's web site referred to Block's "giving individuals the ability to maximize their investment potential."[25]

The Massachusetts Complaint against, *In re All-Tech Investment Group, Inc., et al.* (Ma. Sec. Div. 98-77, Dec. 10, 1998) [hereinafter *All-Tech Complaint*] alleged the following:

- The firm's web site and marketing brochure quoted the firm's principal, Harvey I. Houtkin, stating, "You've probably read about the many successes utilizing my trading techniques" and that "some people claim I have found the key to financial independence."[26]

- All-Tech's Branch Office Manual included a section providing guidance to branch managers in overcoming the objection of prospective customers. The manual stated that managers should respond to the inquiry, "What is your success ratio?" with the following: "Those who follow the program do exceptionally well."

- In an interview with CNBC broadcast on October 23, 1998, in a segment on day trading, Houtkin asked rhetorically, "But how about the thousands of people who love what they're doing, who are making money, changing their lifestyles, and having the time of their life?"

  In response to Houtkin's remark, the Division requested documents from All-Tech relating to all accounts maintained by the firm that had been profitable during the calendar year to date. The firm stated that it did not keep records concerning the profits and losses incurred by its customers, and that it did not know what percentage of its customers have profitable accounts. The response also claimed that Houtkin's remark referred to "day trading as a whole, not just retail customer electronic day trading" and included "market making … of firms."

The Massachusetts Complaint against On-Line Investment Services, Inc. ("On-Line"), *In re On-Line Investment Services, Inc. et al.* (Ma. Sec. Div. 99-1, Jan. 14, 1999) [hereinafter *On-line Complaint*] alleged the following:

- The firm's web site included, under the heading "Press Releases," the assertion: "We have a success rate of around 85% with customer traders, meaning people who come here and actually make money doing this over time."[27]

[25] The Block Trading web site is no longer operational.
[26] All-Tech Investment Group Online <http://www.attain.com>; cited information no longer found on web site.
[27] On-line Investment Services, Inc. <http://www.onli.com>; cited information no longer found on web site.

The Licensing Section requested "copies of records substantiating the claim [of] a success rate of 85% with customer traders." The firm responded that its "web site makes no such claim."

The firm further stated that the document it had labeled a press release was actually a news article. It also advised that it had deleted the article from its web site to alleviate the "Commonwealth's apparent concern."

- On-Line's web site also included, again under the heading "Press Releases," a release with the title, "Major Day Trading Firm Opens 6 New Offices."

  This release asserted, "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 deleted this page from its web site, too, at the same time it deleted the other page.

The Massachusetts proceeding against TCI Corporation ("TCI") concerned an entity that offered a purported two-day course in day trading, at a cost of $6,000. *In re TCI Corporation, Inc., et al.* (Ma. Sec. Div. 99-9, Mar. 2, 1999) [hereinafter *TCI Complaint*]. This case is thus different from the other Massachusetts cases, which involved broker-dealers. The TCI Complaint cited the following regarding the firm's alleged deceptive marketing:

- Newspaper advertisements claimed "pinpoint accuracy" and "6 to 7 figure income per year."

- The firm's web site claimed that TCI offered the "absolutely best trading system in the financial market."[28]

- The web site also claimed returns of "12% per trading day minus slippage and commission," and a "profit to loss ratio [of] better than 12 to 1."

The Division issued a cease and desist order against TCI on an *ex parte* basis. At the hearing on whether the order should be made permanent, the Respondents claimed that the advertised returns were based on the buy and sell signals they posted on the Internet. The Respondents admitted, however, that TCI posts its purported buy and sell signals the week following market activity. The Licensing Section argued that this *post facto* recording of market signals is analogous to predicting the prior week's weather.

Additional Examples of Problematic Marketing

All-Tech's web site also includes material, in addition to that cited in the All-Tech Complaint that encourages prospects to make a career of day trading. Under the heading, "Who becomes an Electronic Day Trader?", All-Tech states that it hopes day trading will "become a mainstream career choice" and goes on as follows:

[28] TCI Corporation <http://www.tcicorp.net>; cited information no longer found on web site.

> 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 61/2-hour trading day, to take vacations on demand and to leave for the day on a whim.[29] (emphasis added).

This solicitation of unhappy employees, laid-off workers, retirees, and recent college graduates clashes with the fact that day trading is risky and most day traders fail to make money.

All-Tech has also claimed, through an interview of Houtkin on CNBC, that the firm's customers have a "success rate" of "four out of ten." This clashes with Houtkin's implication, cited in the section above, that 95% of customers will fail.

As discussed in the prior section, Momentum Securities advised the media on January 28, 1999 of the alleged results of its study of customer profitability. Shortly thereafter, in an article published January 31, 1999, a spokesman for the firm was reported as stating that "over the course of a year, between 66 percent and 70 percent of the firm's customers are profitable – some in the high six-figures."[30]

This statement is at best misleading, since it fails to disclose that, even according to the firm's own purported findings discussed above, the majority of customers lost money during the first three months of trading. Further, the claim that some customers are making profits in the "high six-figures" is meaningless unless there is disclosure of the amount of capital traded and the period of time during which the profits allegedly were achieved.

As noted above, James Lee, the president of Momentum Securities and president of the Electronic Traders Association, continues to claim that most day traders are profitable. A comment by Lee was cited in an article in the *Wall Street Letter* concerning the Project Group's work on this *Report*: "[E]TA statistics show most transactions placed by day traders are profitable."[31] However, as noted above, the ETA failed to provide the Project Group with any documents or information concerning any statistics to support those claims.

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[29] All-Tech Investment Group Online, *Frequently Asked Questions* (visited July 26, 1999) <http://www.attain.com/faq.html>.

[30] Earl Golz, *Daring Day Traders Try to Make a Fortune in the Fast-Moving World of Stocks*, AUSTIN AM.-STATESMAN, Jan. 31, 1999, at H1.

[31] *ETA Pooh-Poohs NASAA's Day Trading Study*, WALL ST. LETTER, May 10, 1999, at 2.

3. Legal Framework

Deceptive marketing by a brokerage firm may violate state and federal securities law and NASD rules. Generally, the violation of a federal securities law, an SEC antifraud rule, or an NASD conduct rule also constitutes a violation of state securities law.

Securities Act of 1933

Section 17(a) of the Securities Act of 1933 is a general antifraud provision. It 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 purchase or sale of securities.

Securities Exchange Act of 1934

Section 10(b) of the Securities Exchange Act of 1934 prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities.

SEC Rule 10b-5 is a broad antifraud rule applicable to the purchase or sale of any security. It prohibits schemes to defraud, material misstatements and omissions, and engaging in "any act, practice, or course of business which operates … as a fraud or deceit."

State Uniform Securities Act of 1956

Section 101 of the Uniform Securities Act is virtually identical to SEC Rule 10b-5. It constitutes a broad antifraud prohibition.

The Act also includes a general prohibition of misconduct. Under Section 204(a)(2)(G), the administrator may "by order deny, suspend, or revoke" the registration of a broker-dealer, principal, or other registrant if he finds that "the order is in the public interest" and the registrant (or, in the case of a broker-dealer, an officer or controlling person) "has engaged in dishonest or unethical practices in the securities business."

NASD Conduct Rules

Rule 2110 mandates that members "observe high standards of commercial honor and just and equitable principles of trade."

Rule 2120 states, "No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

NASD IM-2310-2 (Interpretive Material) sets forth the NASD's "requirement to deal fairly with the public." The NASD prohibits fraudulent activity, including violations of SEC antifraud rules.

Rule 2210(d) provides standards for "Communications with the Public." The standards require that communications be "based on principles of fair dealing and good faith." The rule also prohibits “exaggerated, unwarranted or misleading statements or claims.” It is applicable not only to advertisements, sales literature, and correspondence, but also to public appearances, including radio and television interviews.

Application to the Day Trading Industry

Deceptive marketing by day trading firms falls within the antifraud provisions of the securities laws. As discussed in the introductory material, while day trading firms generally do not make specific recommendations to customers, they do promote day trading as an investment program, often in conjunction with training courses. Firms’ deceptive marketing may constitute securities fraud under federal and state law and NASD rules. It may also constitute a “dishonest or unethical practice” under the State Uniform Securities Act or a violation of the NASD’S general requirements of fair dealing.

Deceptive marketing of trading programs constitutes securities fraud. For instance, in the case of *In re Thomas J. Furnari*, the SEC found that a broker knew that a type of collateralized options writing program was problematic and that he “had been specifically warned … not to set it up for his customers.” *In re Thomas J. Furnari*, Release No. 34-21046, Fed. Sec. L. Rep. (CCH) ¶83,644 (June 14, 1984). Nevertheless, he set up a similar options program and induced customers to enlist in the program by “misrepresent[ing] to [them] … the anticipated rate of return, his success with other accounts in the program, and the risks inherent in the program’s trading strategy.” The SEC found that the broker’s assertions that his customers were sophisticated investors and understood the speculative nature of options trading did not diminish his responsibility for making misrepresentations. The SEC held that the broker violated section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.

C. Violation of Suitability Requirements

1. The Suitability Doctrine

The suitability doctrine requires brokerage firms to recommend only investments that are appropriate for a customer. Failure to comply with this obligation violates NASD Rule 2310 and violates state and federal law.

2. Application to the Day Trading Industry

The Project Group’s view on the applicability of suitability rules to day trading is included in its May 28, 1999 comment letter in response to NASD’s proposed rules released in Special NASD Notice to Members 99-32 (NASD Regulation Requests Comment on Proposed Day-Trading Accounts, Apr. 1999), (see copy of comment letter and NASD Notice in Appendix):

> We believe that NASDR’s existing rules and policies concerning suitability and risk disclosure already create obligations concerning the day trading industry. Further, we believe that practices of some firms in the day trading industry have violated these existing rules and policies. Nonetheless, we support the issuance of the proposed rules, which explicitly specify the industry’s obligations…

On July 29, 1999, the NASD Board of Governors approved new suitability and disclosure rules concerning day trading. The new rules will not become effective until approved by the SEC after public comment.

3. Violations

We believe that some day trading firms have not adhered to suitability requirements. Day trading firms sometimes do not follow their own stated policies concerning minimum account.

Misrepresentation of Information on Customers on New Account Forms

In addition, regulators have found that branch managers sometimes misrepresent information on new account forms, including such crucial factors as customers' income, net worth, and investment experience. For instance, in Massachusetts' proceeding against Landmark Securities ("Landmark"), the Complaint alleged that the manager had opened accounts for customers for whom day trading was unsuitable. *In re Landmark Securities, Inc., et al.* (Ma. Sec. Div. 99-29, July 8, 1999) [hereinafter *Landmark Complaint*]. The manager allegedly misrepresented information on the new account form for one such customer as follows:

> Income: Misrepresented as $25,000 -- Actual figure of $15,000;
>
> Net worth: Misrepresented as $50,000+ -- Actual figure of $10,000-$15,000; and
>
> Previous investment experience: Checked "yes" -- Actual experience: none.

Promotion of Excessive Activity

Because of the high cost of equipment, software, and trading service subscriptions, day trading firms spend thousands of dollars per customer. James H. Lee, president of Momentum Securities and President of the ETA, cited above, estimates that an online brokerage firm spends $250 per new customer, while an "on-site day-trading firm may spend $30,000 on each new customer, counting the outlay on equipment, office space and training."[32]

Based on their overhead and monthly expenses, day trading firms need to have their customers execute large numbers of trades per day. Project Group members have received complaints from day trading customers alleging that day trading firms explicitly and implicitly encourage their customers to pursue only the highest volume trading strategies.

Effect of Unregistered Trading for Third Parties

As alleged in the All-Tech Complaint, the firm's Branch Office Manual, in the section cited above regarding overcoming prospective customers' objections, recommends responding to the objection, "not enough capital," with the following:

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[32] Diana B. Henriques, *In Day Trading, Less Thrill and More Chill*, N.Y. TIMES, July 18, 1999.

> Have you considered getting either an investor or partner? If client is interested, answer questions, but do not volunteer to assist in finding one for them, stay in contact and follow up periodically to offer encouragement.

The All-Tech Complaint goes on to conclude, "Notwithstanding the purported cautionary clause in the above, the purpose of the sales technique described is to encourage investors who lack sufficient capital to day trade to raise capital from third parties."

Firms' encouragement of customers' raising capital from third parties often promotes highly questionable activity by customers who are not registered as investment advisers, as discussed below. The practice also potentially violates firms' obligations concerning suitability. This is true with respect to not only the immediate customer, since that customer lacks adequate capital to trade on his own, but also any "partner" or "investor" whose funds are used in day trading. The Project Group's May 28, 1999 comment letter states:

> We believe the current NASD suitability rule and policies require firms to make inquiries as to the source of funds under certain circumstances. For instance, if a customer reports a net worth of $20,000, but deposits a check for $100,000, the firm should inquire as to the source of the funds.
>
> Nonetheless, we believe it is appropriate for the rules to include an explicit requirement that day trading firms' suitability obligations include a determination of the source of funds to be used.
>
> ….
>
> In addition, the rules, or commentary issued with the rules, should make it clear that firms' suitability obligations are applicable to all investors whose accounts or funds are traded by a third party.

Effect of Firms' Lending Arrangements

As discussed below, day trading firms commonly engage in lending arrangements. These arrangements generally are highly questionable and they also raise significant issues of suitability. Day trading is unsuitable for customers who have insufficient capital to open an account without borrowing funds. Day trading, we believe, is also unsuitable for customers who are unable to meet margin calls except by borrowing funds from other customers. Customers with little or no account equity, who would therefore not be able to afford to day trade, are allowed to day trade through the use of firms' lending arrangements.

The Landmark Complaint included allegations that Landmark, through the branch manager, had promoted and routinely arranged loans among its customers, so that trading customers could meet their margin calls. The Landmark Complaint also included allegations that the firm and manager had not only opened accounts for customers for whom day trading was unsuitable, as noted above, but also had maintained accounts for which the activity was unsuitable:

> Landmark and [the manager] knew or should have known that day trading was unsuitable for these customers in view of the fact that these customers were unable to meet margin calls with their own funds.

The Project Group's May 28, 1999 comment letter to the NASD stated, in connection with the suggested expansion of the proposed rule on disclosure:

> We suggest that the disclosure under "Day trading is extremely risky" should caution against the use of any borrowed funds, not just the use of student loans and second mortgages.
>
> …
>
> The disclosure should also include a warning that parties that trade the account of others … may be required to register under state or federal law and subject to the laws and regulations governing investment advisers.

4. Legal Framework

General: Failure to Meet Obligation of Suitability as Violation of the Securities Laws

A brokerage firm's recommendation of unsuitable securities may be a violation of SEC Rule 10b-5, i.e., federal securities fraud. The basis for this concept is described as follows:

> The deception in a 10b-5 suitability violation may be supplied on the basis of either one of two theories: (1) that the broker misrepresented to his customer that the recommended security was suitable or failed to disclose to the customer that the recommendation was unsuitable; or (2) that the broker engaged in fraud by his conduct, because recommending an unsuitable security is inherently deceptive.[33]

NASD Rule 2310, "Recommendations to Customers (Suitability)," provides as follows:

> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
>
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers

[33] NORMAN S. POSER, BROKER-DEALER LAW & REGULATION, § 3.03, 3-82 (Aspen Law & Business, 2d.ed. 1999 Supp.).

where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;
(2) the customer's tax status;
(3) the customer's investment objectives; and
(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

(c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an institutional account under Rule 3110(c)(4).

Some states have specific regulations concerning suitability. In addition, some states have regulations that provide that violation of NASD Conduct Rules constitutes a dishonest or unethical practice. Violation of suitability requirements may constitute a dishonest or unethical practice or securities fraud under state law.[34]

Loan Arrangements and Suitability Violations

As noted above, firms sometimes promote and arrange loans among customers to meet margin calls and keep accounts open. Customers' inability to meet margin calls suggests that they are trading beyond their means, and that day trading is unsuitable for them.

NASD IM-2310-2, "Fair Dealing with Customers," includes the following among types of conduct that violate the requirement of fair dealing:

(a)(5) Recommending Purchases Beyond Customer Capability

Recommending the purchase of securities or the continuing purchase of securities in amounts which are inconsistent with the reasonable expectation that the customer has the financial ability to meet such a commitment.

Applicability of the Suitability Doctrine to Day Trading

As noted above, the Project Group's comment letter to the NASD on the NASD's proposed rules on suitability and disclosure took the position that the existing rules on suitability apply to day trading. A firm's recommendation that a customer engage in day trading, or its acceptance of a customer's account, requires the firm to determine that day trading is suitable for that customer.

[34] See JOSEPH C. LONG, BLUE SKY LAW, § 7.07[1][d][ii] (West Group 1998); JERRY W. MARKHAM AND THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES, CREDIT REGULATION AND CONSUMER PROTECTION, No. 5, (West Publishing 1999).

Firms market day trading as an *investment program*, often offering a course that purports to train customers in successful trading. The marketing of day trading as an investment program distinguishes day trading firms from ordinary discount brokers, including on-line brokers.

The brokerage industry has attempted to dismiss the concept that the day trading industry is subject to suitability requirements. For instance, the Federal Regulation Committee, Discount Brokerage Committee, and Ad-hoc Committee on Technology and Regulation of the Securities Industry Association (the "SIA Committees"), in their June 4, 1999 comment letter to the NASD concerning the NASD's proposed rules, Special NASD Notice to Members 99-32, endorsed disclosure of the risks of day trading but objected to the proposed rule on suitability:

> The [SIA] Committees firmly believe that the historical understanding that a recommendation is a specific communication from a broker to a customer at a specific time must be maintained. Expanding the scope of the suitability obligation to cover non-specific recommendations would raise difficult interpretative questions about all forms of communication between firm and client.
>
> ….
>
> Most strategies lack the requisite specificity for purposes of determining appropriateness for individual customers.

The Project Group believes that the SIA's position may be incorrect. Day trading firms market their services in order to attract prospective day trading customers. These firms should assume that accounts are opened for the primary purpose of day trading. The firms, by marketing the concept of day trading, and by approving accounts, implicitly have recommended to customers that they engage in the highly speculative strategy of day trading.

This situation is distinguished from that of traditional discount brokerage firms. Such firms do not market trading, day trading, or long-term investing, but instead only offer a ministerial service to customers.

As discussed above, day trading is inherently speculative, since the customer must speculate (or guess) on short-term price changes of stocks. This means that firms that approve day trading accounts determine that their customers have the sophistication to day trade and the financial means allowing them to risk the loss of not only the amount of their "investment," but, as discussed below, even greater amounts.

A day trading customer's exposure to the risk of losing more than his investment results from two factors. First, securities purchased in a margin account may decline to the point where the amount owed by the customer exceeds the equity in his account. Second, customers who engage in short selling, which is necessary to day trade in a declining market or with respect to a declining stock, face theoretically unlimited loss, since stocks can rise to theoretically unlimited prices.

Day trading firms themselves tend at least nominally to recognize that the suitability doctrine applies to their business. They virtually always include provisions concerning suitability requirements in their compliance manuals.

The Landmark Complaint included an allegation, in connection with the firm's alleged failure to supervise the Boston office, that the firm should have terminated the branch manager in January 1999. The Landmark Complaint cited a memorandum from Landmark to the manager. This document reflects Landmark's awareness of the firm's obligations with respect to suitability:

> By memorandum dated January 20, 1999 … the firm's Director of Office of Supervisory Jurisdiction Operations advised [the branch manager] that his misconduct had included, among other things:
>
> > **Failure [to] comply with customer suitability** and verbally misstating material facts to our office about your customers. Failure to establish family accounts in the Landmark system. Failure to follow the Supervisory Procedures Manual. (emphasis added).

The SIA Committees, we believe, are incorrect in their assertion that suitability "historically" includes only a specific recommendation. Suitability also encompasses unsuitable programs or strategies. As observed by Norman S. Poser ("Poser"):

> The suitability doctrine is not limited to the choice of securities for an account. For example, a broker who uses margin in an account may violate the doctrine, even though the securities in the account are suitable for the customer. Trading on margin falls under this doctrine because it increases the risks to the customer.[35]

In the *In re Application of Rangen* case, cited above by Poser, the SEC sustained the New York Stock Exchange's findings of a violation and the sanctions it imposed. *In re Application of Rangen*, 64 SEC Docket 628, Release No. 34-38486 (Apr. 8, 1997). The broker had, among other misconduct, unsuitably used margin to trade the customers' account. The case also includes the following statement, which, like the SEC's finding of unsuitability, is relevant to day trading:

> Even if we were to accept [the broker's] view that these clients wanted to speculate and were aware of the risks… the Commission has held on many occasions that the test is not whether [the customers] considered the transactions in their account suitable, but whether [the broker] 'fulfilled the obligation he assumed when he undertook to counsel [them], of making only such recommendations as would be consistent with [their] financial situation and needs.' (second and third use of brackets in original; citation omitted).

[35] POSER, at § 3.03, 3-69.

Further, the Project Group disagrees with the assertion of the SIA Committees, in arguing that the concept of suitability should not apply to day trading, that "[m]ost strategies lack the requisite specificity for purposes of determining appropriateness for individual customers." Day trading is speculative; it is likely to result, over time, in the loss of funds put at risk. It is therefore appropriate only for customers who can bear the loss of any funds deployed, and the exposure to loss of their other assets.

Brokerage firms <u>routinely</u> determine whether strategies are appropriate for customers. This is seen most commonly in connection with options strategies. Firms set minimum standards for customer income and liquid net worth for various types of options activity, depending on the level of risk. In addition, as discussed below in the section on "Recommendations," the NASD has special suitability requirements for options accounts.

Furthermore, regulators routinely determine in enforcement proceedings that certain strategies are unsuitable for customers. See, e.g., *In re David Allen*, NYSE Hearing Panel Decision 96-147 (Dec. 19, 1996) (explaining that the broker's "recommendations of the foregoing options strategies to the [customers] was unsuitable in light of their investment objectives, which did not include speculation, their financial resources and their limited experience in options trading"). See also, *In re Application of Clyde J. Bruff*, 52 SEC Docket 1266, Release No. 34-31141, Fed. Sec. L. Rep. (CCH) ¶85,029 (Sept. 3, 1992) (affirming the NYSE's finding of a violation of its Rule 723, noted that the options activity "involved a high degree of financial risk and complexity, and was unsuitable" for the customers).

D. Encouragement of Activity by Unregistered Investment Advisers

1. The Phenomenon

Day trading firms sometimes encourage customers or prospective customers to trade the accounts or funds of third parties. Firms present such trading as an opportunity for people who lack funds of their own. Day trading firms' incentive in encouraging the trading of third parties' funds is, of course, the same incentive that drives them to attempt to draw the business of regular customers, i.e., the generation of commissions.

An example of a firm's encouragement of the trading of third parties' funds appears on the web site for Landmark Securities:

> HOW DO I PARTICIPATE IN DAY TRADING?
>
> [A]n interested party can participate in a variety [sic] different ways:
>
> --A *Trader* is the customer of Landmark Securities … A trader can work on his own behalf, or on the behalf of others.
>
> --An *Investor* may 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.[36]

Some firms have encouraged the trading of third party accounts without regard to the registration requirements to which investment advisers are subject. Generally, investment advisers that have less than $25 million under management are required to be registered with the states in which they do business, while advisers with more than this amount under management must be registered with the SEC. In view of this regulatory regime, the problems with registration have been in connection with state requirements. Two of the proceedings brought by Massachusetts have included allegations of encouragement of activity by unregistered investment advisers.

The Block Complaint alleged that the branch manager had recommended the trading services of a customer, a friend of the manager's, who was not registered as an investment adviser. The Block Complaint further alleged that the trader had misrepresented his investment experience on the trading authorization form, and that he had agreed to manage the customer's account on the basis of being paid a percentage of profits. The trader was included as a respondent in the proceeding.

As noted in the preceding section, the All-Tech Complaint alleged that the firm had "maintained a corporate policy of encouraging customers and prospective customers to trade with the capital of third parties." The All-Tech Complaint concluded, "All-Tech knew or should have known that its policy would lead to the unlawful trading of accounts by unregistered investment advisers, and the abuse of parties whose funds were handled by such investment advisers."

The All-Tech Complaint included as respondents two unregistered individuals who allegedly had engaged in investment advisory activity. The All-Tech Complaint alleged, among other things, that one of the respondents had made misrepresentations to a customer concerning the value of the client's account. It further alleged that he had entered into unlawful fee arrangements with customers involving compensation based on a percentage of profits.

The Landmark Complaint alleged that the branch manager had, among other things, unlawfully entered into certain arrangements with customers, through entities in which the branch manager was a part owner and manager. These arrangements included the raising of funds from a customer for the funding of customer accounts and the splitting of profits with the customer who loaned these funds and with the customers who traded the funds in their accounts. While to date, not specifically charged in the Landmark Complaint, the activity of the trading customers may be another example of unregistered investment advisory activity.

In a Notice of Hearing filed against The Exchange House, Inc., the Texas Securities Board alleged that the day trading firm unlawfully permitted 24 unregistered traders to manage customer accounts at the firm. *In re The Exchange House, Inc., et al.* (Tex. SSB Ref. 97-011, May 7, 1997). This group of traders managed essentially all of the accounts at the firm. The complaint also alleged that the firm used an unregistered branch office, and employed several unregistered brokerage agents to take customer orders. (The Exchange House eventually

[36] Landmark Securities Corporation, *Frequently Asked Questions*, (visited July 2, 1999) <http://www.landmarksecurities.com/faq/htm>.

withdrew its brokerage license, and consented to a censure and a $20,000 fine. After a hearing on the merits, the Texas Securities Commissioner issued a cease and desist order and fines totaling $104,000 against the various investment advisers involved in the case.)

In a Consent Order entered against Day Trade, Inc. the Texas Securities Commissioner found, among other things, that a related brokerage firm, Superior Financial Group, Inc., permitted unregistered traders to manage customer accounts. The individuals acting as unregistered investment advisers were employees of Superior Financial Group. *In re Day Trade, Inc., et al.* (Tex. SSB Ref. 98-020, Apr. 6, 1998).

2. Legal Framework

Section 201(c) of the Uniform Securities Act requires the registration of investment advisers. Section 401(f) of the Act defines investment advisers as follows:

> 'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities.

This definition, subject to the exceptions set forth, generally covers people who trade others' funds or accounts for compensation. In the day trading industry, the typical compensation of unregistered advisers is a percentage of profits.

Traders who violate the registration provisions, have unlawful fee arrangements, or otherwise engage in misconduct (e.g., deceptive practices) are themselves subject to enforcement action by state regulators. The brokerage firms that encourage unregistered investment advisory activity may be engaging in dishonest or unethical practices under state law, and violating NASD Rule 2110, "Standards of Commercial Honor and Principles of Trade."

E. Promotion of Lending Arrangements

1. The Phenomenon

Certain day trading firms engage in lending arrangements. These arrangements are separate from margin lending to customers by clearing brokers.

Promotion and Arrangement of Loans among Customers

The most common type of this activity is the promotion and arrangement of loans among customers to meet margin calls. This activity, we believe, appears to be so prevalent that it may be an integral part of the day trading industry.

The arrangement results from the fact, as noted above, that stocks are a poor vehicle for short-term trading by individual customers. Most customers lack sufficient capital to take advantage of small price changes. The margin structure for equity securities allows a maximum of 50% to be borrowed for initial purchases. This limits the leverage that may be used to magnify gains beyond commission charges.

Some day traders thus commonly trade beyond their means, and are unable to meet margin calls. Day trading firms recognize that clearing brokers generally will not tolerate flagrant or repeated violations of margin requirements by customers. Therefore, to prevent clearing brokers from closing or restricting customer accounts, some day trading firms promote and arrange loans among customers.

The volume of these loans can be high. The Landmark Complaint alleged that the total transfers of funds into one account alone, between August 1998 and May 1999, was almost $2.7 million. Within a single branch of a day trading firm, the transfers over the course of a year could total tens of millions of dollars.

The Block Complaint alleged that the firm actively arranged loans to and among its customers. One alleged major lender was the father of the firm's president.

The Landmark Complaint alleged that the branch manager promoted and arranged loans among the firm's customers. The Complaint further alleged the following misconduct in connection with the loan arrangement:

- The branch manager forged customers' signatures on funds transfer forms (letters of authorization, or LOAs);
- The branch manager accepted LOAs that bore customer signatures that were forged by parties other than the manager;
- The firm permitted improper procedures whereby 1) the manager transmitted LOAs directly to the clearing broker rather than through the firm itself, and 2) the manager was allowed to use photocopies of customers' signatures on LOAs (subject to the customers purportedly authorizing blanket use of such photocopies);
- The manager used or accepted the use of photocopied signatures even with respect to customers who had not purportedly authorized the use of such photocopies; and
- The manager effected or accepted the effecting of unauthorized transfers of funds into and out of a customer's account.

Lending by Principals and Agents of Firms

Some principals and agents of day trading firms have loaned funds to customers. The Landmark Complaint alleged that the manager had, respectively, direct and indirect ownership interests in two entities that engaged in lending, borrowing, and profit splitting arrangements with customers.

2. Legal Framework Concerning Promotion and Arrangement of Lending Among Customers

Circumvention of Margin Regulatory Structure

The day trading industry commonly defends its promotion of loans among customers by asserting that the activity does not violate Regulation T of the Federal Reserve Board. This is true, since Regulation T applies only to secured loans, and is thus inapplicable to the unsecured loans that are the norm in inter-customer lending. Therefore, the day trading industry's assertion is meaningless, and the matter of the legality of the loan arrangements must be examined in the light of other regulatory concerns.

It is sometimes stated that the Federal Reserve Board has moved towards deregulation of margin lending and the arrangement of loans by brokerage firms. This is inaccurate; the Board has moved towards reducing its regulation of these areas and increased reliance on the existing rules of other regulatory agencies. The SEC, NASD, and NYSE still have applicable rules in place, and still have regulatory responsibilities in these areas.

The NASD requires that day trading be done in margin accounts. Customers must have equity of at least 50% for any purchase, even if the account is flat at the end of the day (i.e., all open positions have been closed). The NASD also has a margin maintenance requirement of 25% equity. The NASD additionally has special margin requirements for short sales, and specific requirements for day trading accounts. NASD Notice to Members 98-102, *Calculating Margin for Day Trading and Cross-Guaranteed Accounts*, Dec. 1998.

Firms' promotion and arrangement of loans among customers to meet margin calls has the effect of circumventing and undermining the regulatory structure concerning margin. 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. When day trading firms have customers meet margin calls for other customers receiving the calls, the firms are defeating the purpose of the margin requirements. This practice was recently discussed in a *Wall Street Journal* article.[37]

As noted by Michael T. Reddy in *Securities Operations*, "The thrust or intent of many of the rules … is to avoid a situation in which securities firms or their customers become overextended."[38] The lending arrangements create, in economic terms, a moral hazard, i.e., they encourage customers who lack the financial ability to day trade nonetheless to undertake the risks of day trading. This puts the firms and their clearing brokers (who are financially exposed if transactions are not paid for or debits are not paid) at risk. As discussed above, it also has the effect of maintaining accounts that have traded beyond their means, in violation of suitability requirements.

[37] Ruth Simon, *Regulators are Investigating Effort by Firms to Circumvent Margin Rules*, WALL ST. J., June 23, 1999.

[38] MICHAEL T. REDDY, SECURITIES OPERATIONS, 263 (New York Institute of Finance, 2d ed. 1995).

Violation of SEC Rule 15c2-5

SEC §240.15c2-5, *Disclosure and Other Requirements when Extending Credit in Certain Transactions*, requires brokerage firms to make special disclosures, and imposes special suitability requirements, in connection with firms' arrangement of loans outside of margin arrangements that are subject to Regulation T. Rule 15c2-5 provides as follows:

> (a) It shall constitute a "fraudulent, deceptive, or manipulative act or practice" as used in section 15(c)(2) of the [1934] Act for any broker or dealer to offer or sell any security to, or to attempt to induce the purchase of any security by, any person, in connection with which such broker or dealer, directly or indirectly offers to extend any credit to or to arrange any loan for such person, or extends to or participates in arranging any loan for such person, unless such broker or dealer, before any purchase, loan or other related element of the transaction is entered into:
>
> (1) Delivers to such person a written statement setting forth the exact nature and extent of (i) such person's obligations under the particular loan arrangement, including, among other things, the specific charges which such person will incur under such loan in each period during which the loan may continue or be extended, (ii) the risks and disadvantages which such person will incur in the entire transaction, including the loan arrangement, (iii) all commissions, discounts, and other remuneration received and to be received, in connection with the entire transaction including the loan arrangement, by the broker or dealer, by any person controlling, controlled by, or under common control with the broker or dealer, and by any other person participating in the transaction; Provided, however, That the broker or dealer shall be deemed to be in compliance with this subparagraph if the customer, before any purchase, loan, or other related element of the transaction is entered into in a manner legally binding upon the customer, receives a statement from the lender, or receives a prospectus or offering circular from the broker or dealer, which statement, prospectus or offering circular contains the information required by this subparagraph; and
>
> (2) Obtains from such person information concerning his financial situation and needs, reasonably determines that the entire transaction, including the loan arrangement, is suitable for such person, and retains in his files a written statement setting forth the basis upon which the broker or dealer made such determination; Provided, however, That the written statement referred to in this subparagraph must be made available to the customer on request.

> b) This section shall not apply to any credit extended or any loan arranged by any broker or dealer subject to the provisions of Regulation T (issued by the Board of Governors of the Federal Reserve System) if such credit is extended or such loan is arranged, in compliance with the requirements of such regulation, only for the purpose of purchasing or carrying the security offered or sold: Provided, however, That notwithstanding this paragraph, the provisions of paragraph (a) shall apply in full force with respect to any transaction involving the extension of or arrangement for credit by a broker or dealer (i) in a special insurance premium funding account within the meaning of Section 4(k) of Regulation T or (ii) in compliance with the terms of Rule 3a12-5.

The legal research conducted on behalf of the Project Group suggests that the rule is applicable to firms that arrange inter-customer loans. Firms "arrange" such loans as that term is used in the rule. See *In the Matter of Sutro Bros. & Co.*, Release No. 7052, Fed. Sec. L. Rep. (CCH) ¶76,913 (Apr. 10, 1963), see also, *In the Matter of Russell L. Irish*, Release No. 7718, Fed. Sec. L. Rep. (CCH) ¶77,297 (Oct. 5, 1965) (citing *Sutro* regarding the definition of "arranging").

Further, the rule applies to loans that are not made pursuant to Regulation T, which includes such inter-customer lending. See *Rule 15c2-5 Stating Duties of Brokers and Dealers to Credit Customers Amended to Include Insurance Premium Funding Programs*, Release No. 34-9823, Fed. Sec. L. Rep. (CCH) ¶79,030 (Oct. 18, 1972) and Ohio Division of Securities Department of Commerce, SEC No-Action Letter (Oct. 21, 1973).

If the Project Group's interpretation Rule 15c2-5 is correct, some day trading firms have engaged in violations of the rule's disclosure and suitability requirements.

Violation of Suitability Requirements

As discussed above in the section of this *Report* concerning suitability, when firms promote and arrange loans to meet customers' margin calls, they effectively maintain accounts for customers who have traded beyond their means and who lack the financial resources to day trade. Day trading, we believe, is unsuitable for these customers.

The loan arrangements thus may constitute unethical practices under the Uniform Securities Act and violations of the NASD's requirements of compliance with just and equitable principles of trade and fair dealing with customers.

Circumvention of Rules against Agents Lending to or Borrowing from Customers

Certain states, generally prohibit agents, i.e., stockbrokers, from lending to or borrowing from customers. When agents essentially act as loan brokers for inter-customer lending, they circumvent this prohibition and violate the policies behind the prohibition, including avoidance of conflicts of interest.

Violations Related to Usury Laws

The inter-customer loans that firms promote and arrange are sometimes usurious. The Landmark Complaint alleged that the branch manager had promoted and arranged inter-customer overnight loans that typically entailed interest charges of .1%, or 36.5% annualized. Massachusetts law prohibits the making of loans with interest rates in excess of 20% and also prohibits possession of records of usurious loans. The Complaint charged Landmark and the manager with engaging in unethical or dishonest business practices in view of the alleged promotion and arrangement of usurious loans and their possession of records of the loans (including the corresponding LOAs).

Many states have criminal laws prohibiting usurious loans. Many states also prohibit aiding and abetting the violation of criminal laws including those related to usury. The Appendix includes a chart of examples of usury laws.

Possible Failure to Disclose Activity on Form BD

Brokerage firms that engage in promoting and arranging loans among customers should disclose this activity on Form BD, the application for broker-dealer registration. Specifically, item 10Y on page 5 asks if the firm is engaged in other types of businesses, and requires details on Schedule D for any positive response.

As discussed above, the lending activity often involves the transfer of many millions of dollars per branch. The activity is not within the ordinary course of broker-dealer business and should be reported on Form BD so that regulators can properly examine the activity and the effects thereof.

Failure to Report Interest to the IRS

In view of the large amounts loaned among customers, and the high interest rates charged, significant amounts of interest are paid by customers who lend funds. In some firms or branch offices, one or more customers act as the chief lenders, thus concentrating the interest earned. It is unknown to what extent the lenders declare this income. As discussed below, day trading firms are required to report the interest credited to lenders; however, at the firms examined, there appears to be little or no compliance with this obligation.

Section 6041 of the Internal Revenue Code requires "all persons engaged in a trade or business and making payment in the course of such trade or business to another person of salaries, wages, compensation, remuneration, emoluments, or other fixed or determinable gains, profits and income of $600 or more" to "provide an information return setting forth the amount of such gains, profits, income, and the name and address of the recipient of such information." 26 U.S.C. §6041 (1986). In addition Revenue Ruling 93-70 explains that in certain situations, an intermediary who "performs an oversight function" or "management function" when making a payment on behalf of another is considered a payor, not just a paying agent, and is subject to the 6041 reporting requirement. Rev. Rul. 93-70 1993-2 C.B. 294 (Oct. 25, 1993).

Section 6041 applies to day trading firms. Firms collect and journal the interest from the borrower to the lender. This activity fulfills the "making payment" requirement. Firms are clearly in a "trade or business" and they facilitate the loans in order to keep customer accounts open. Thus the loans and repayments thereof with interest are made "in the course of such trade or business." The interest is paid in a stated amount and repayment is required within a set time period (often overnight). The fixed nature of the loan satisfies the "fixed or determinable income" requirement. "Fixed and determinable" is defined, in part, as "income [that] is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained." Treas. Reg. §1.6041-1(c), 26 C.F.R. 1.6041-1 (Apr. 1, 1998).

Section 6041 may also apply to the borrower who pays interest to the lender via the day trading firm. Day trading customers often consider their trading to be their "trade or business" engaged in for "gain or profit." The interest payments are made on loans to meet margin calls. If the calls are not met, the borrower would no longer be able to day trade. This direct relationship of the lending activity to the day trader's purported trade or business means that the interest payments on the loans are made "in the course of such trade or business." Finally, the interest paid by the borrower is "fixed and determinable."

Day trading firms presumably are also required to report the interest to states of customers' residences that have income taxes.

Public Policy Considerations

Firms' promotion and arrangement of the lending create an imprimatur of legitimacy concerning the loans. Customers draw the false impression that the loans are a normal part of the securities industry, that the loans are an appropriate tool for customers who cannot meet their own margin calls, and that there is no risk to lenders associated with the repayment of their loans.

As discussed above, the lending arrangements violate specific laws and rules. In addition, the arrangements almost invariably lead to other serious violations. These violations include forgeries of customers' signatures and unauthorized transfers of customers' funds. In addition, customers who have lent funds have lost funds through the failure of borrowers to repay loans. Finally, firms have not met their supervisory responsibilities despite the huge amount of funds that are transferred.

3. Legal Framework Concerning Brokers Lending to Customers

As discussed above, brokers or principals of day trading firms sometimes directly lend to customers. This creates a conflict of interest between the broker or principal and the customer, apart from being potentially violative of SEC Rule 15c2-5 and some of the other rules and regulations discussed above.

Lending to customers by registered persons is specifically prohibited under the regulations of some states, as noted above,. Even in states where it is not explicitly addressed, the practice may constitute "dishonest or unethical" conduct under the Uniform Securities Act.

F. Abuse of Discretionary Accounts

1. The Phenomenon

While day trading usually entails customers trading their own accounts, some branch managers and other registered agents of firms trade accounts for certain customers. This can lead to abuses, given the supervisory problems in the day trading industry. Some of the possible abuses are suggested by the alleged misconduct in two cases brought to date.

The All-Tech Complaint alleged that the branch manager engaged in misconduct in handling the assets of a family with several accounts. The manager allegedly commingled the three accounts that were supposed to be separate and failed to follow the customers' instructions to purchase specific securities for two of the intended accounts, instead trading these funds. The manager also allegedly offered to trade another customer's account for 50% of any profits.

The On-Line Complaint also alleged that the branch manager engaged in misconduct in handling a customer's account. The alleged abuses included a) establishing an exploitative joint account for the customer with a friend of the manager; b) establishing an exploitative account guarantee by the customer in favor of an account in the name of the manager's wife; c) churning the account (e.g., commissions of about $50,000 in a month when the average equity was about the same amount); d) appropriating 80% of the profits in the account, through commissions, as a purported management fee; and e) unlawfully using the customer's funds, through effecting transfers between the customer's account and an account in the name of the manager's wife.

2. Legal Framework

The types of alleged misconduct discussed above violate NASD rules. In addition, they may violate specific state regulations or constitute securities fraud or "dishonest or unethical practices" under the Uniform Securities Act.

NASD Rule 2330 prohibits registered personnel from sharing in customers' accounts except under specific circumstances:

> **2330. Customers' Securities or Funds**
>
> (a) Improper Use
>
> No member or person associated with a member shall make improper use of a customer's securities or funds.
> … .
>
> (f) Sharing in Accounts; Extent Permissible
>
> (1)(A) Except as provided in paragraph (f)(2) no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member; provided; however, that a member

> or person associated with a member may share in the profits or losses in such account if
>
> (i) such member or person associated with a member obtains prior written authorization from the member carrying the account; and
> (ii) the member or person associated with the member shall share in the profits or losses in any account of such customer only in direct proportion to the financial contributions made to such account by either the member or person associated with a member.

NASD IM-2310-2 describes certain types of misconduct that have been observed in connection with discretionary accounts, and which violate the obligation of fair dealing:

> **IM-2310-2. Fair Dealing with Customers**
>
> (4) Fraudulent Activity
> (A) Numerous instances of fraudulent conduct have been acted upon by the Association and have resulted in penalties against members. Among some of these activities are:
>
> (i) Fictitious Accounts
> Establishment of fictitious accounts in order to execute transactions which otherwise would be prohibited, such as the purchase of hot issues, or to disguise transactions which are against firm policy.
>
> …
>
> (iii) Unauthorized Transactions
> Causing the execution of transactions which are unauthorized by customers or the sending of confirmations in order to cause customers to accept transactions not actually agreed upon.
> (iv) Misuse of Customers' Funds or Securities
> Unauthorized use or borrowing of customer's funds or securities.
>
> (B) In addition, other fraudulent activities, such as forgery, non-disclosure or misstatement of material facts, manipulations and various deceptions, have been found in violation of Association Rules. These same activities are also subject to the civil criminal laws and sanctions of federal and state governments.

G. Failure to Maintain Proper Books and Records

1. Introduction

One compliance area that often receives little attention from day trading firms is maintenance of required books and records. Several of the examinations conducted by state securities regulators have revealed potential violations of federal and state books and records requirements.

2. Transactional Records

Order Tickets/Sales Blotters

By their nature, day trading firms execute thousands of securities transactions each day. For the most part, these transactions are executed electronically. Most day trading firms permit their clients to enter trades directly into the firm's computer system. Execution takes place without the direct involvement of any registered personnel. This practice was approved by the NASD in 1998 (see Notice to Members 98-66).

Once a trade is entered into the firm's computer system, it is usually run through a program that automatically checks it for compliance with NASD Conduct Rules 4730(c)(3) (the “Order Aggregation Rule,” also known as the “Five Minute Rule”) and 3350 (the "Short Sale Rule"). The Order Aggregation Rule prohibits entry into SOES of orders for a public customer in excess of the maximum SOES share size. (NASD Notice to Members 88-61 established a presumption that all orders entered within five minutes should be aggregated for the purpose of this rule. This presumption was recently eliminated by NASD Notice to Members 99-21.)

The Short Sale Rule prohibits short sales of Nasdaq National Market System securities when the current best bid is below the preceding best bid. After the order is checked for compliance with these rules, it is sent to SOES, Selectnet, or an Electronic Communication Network (“ECN”) selected by the customer.

At the end of the day (twice a day at some firms), the trading data from the day trading firm is uploaded to the computer of its clearing firm. The clearing firm then reconciles this data to the trades presented to it by the market maker for settlement. Before the correspondent day trading firm uploads its data, the clearing firm is not able to identify which client account executed which trade. The data received by the clearing firms from the market maker show only which correspondent firm executed the trade.

Whether a trade is entered by a customer or by a registered agent, there is usually no written order ticket completed. Day trading firms maintain the required order ticket information electronically. The Project Group has not identified significant problems with firms maintaining basic order ticket information. However, an examiner of a firm’s home office should review enough computerized records or printouts to be sure that all of the order ticket information is being maintained for the appropriate period. Firms using computerized recordkeeping systems should maintain appropriate backups as required by all NASD member firms.

The Project Group has identified a number of recordkeeping violations related to trades that have been cancelled or reassigned from one account to another account. In the terminology of the day trading industry, a trade is "reassigned" from one account to another account if the trade is moved within the computer system of the day trading firm, prior to the data upload to the clearing firm.

If a trade is reassigned from Account A to Account B, it appears to the clearing firm that the trade was originally executed in Account B. A trade is "cancelled" from one account and "rebilled" to another account if the trade is moved within the computer system of the clearing firm, after the data upload from the correspondent firm. A cancelled trade will appear on the customer statement for Account A, and the rebilled trade will appear on the statement for Account B.

Examination of day trading firms has revealed that they have moved trades from one account to another for many different reasons. These reasons have included:

- An agent mistakenly puts a trade into the wrong customer's account.

- A customer sits at the terminal assigned to another customer for part of a day. (This should not happen much anymore, as most current systems allow a customer to log on to any terminal in the office.)

- A customer makes a few trades in his account for another customer who is out of the office. He then gets the firm to move the trades to the other customer's account.

- A party is trading for multiple third parties. He places all of the trades into his own personal account, and then gets the firm to move them into the accounts of his investment advisory clients.

- A broker is trading for one of the customers of the firm. He takes an order from another customer over the telephone. He places that trade in the account of the customer for whom he is currently trading, and later gets the firm to move it to the correct account.

- A customer wishes to create a hedged position in a particular stock, with a long position in his trading account and an offsetting short position in his cross-guaranteed short account. The firm moves a previous sell of the stock from the trading account to the short account. NASD Notice to Members 98-65 reminded members that they could not use hedged positions in cross-guaranteed or otherwise related accounts to get around the Short Sale Rule. It remains to be seen whether this Notice has stopped the practice.

- A customer generates a Regulation T or margin maintenance call in his account. Instead of depositing funds, the client gets the firm to move trades out of his account.

- A customer has committed a violation of the Order Aggregation Rule or Short Sale Rule. The firm moves the trade into the firm's error account or into the account of another customer in whose account it would not create a violation. This second customer may then move a trade with a similar gain to the account of the first customer.

- A customer wishes to transfer trades made during the day in his trading account to his retail or IRA account.

Although a reassignment or a cancel/rebill transaction could accomplish each of these objectives, firms usually prefer the reassignment because it is easier to execute. However, the documentation for a reassigned trade should not be any less substantial than that required for a cancelled trade. All of the basic information required on an order ticket must also be recorded for a cancellation. Traditional retail firms usually make use of a cancellation ticket.

Some day trading firms have failed to maintain records reflecting trade reassignments executed on their computer systems. One firm examined even had a practice of destroying forms completed by customers to execute reassignments. Failure to maintain complete records of these transactions makes it difficult for compliance personnel and regulators to detect and evaluate the types of activities listed above. It also makes it difficult for the firm to handle customer complaints about improper reassignments, which have been common at some firms.

The importance of maintaining these records becomes very clear when the firm's computer system malfunctions. One firm examined had a malfunction which prevented trade data uploads for more than a day. All of the trades executed during that day were reflected by the clearing firm as having been executed against the correspondent firm. It took two weeks of work for the correspondent firm to move the trades for that day into the proper customer accounts.

Cash Receipts Blotter

Some branch offices of day trading firms examined have failed to maintain cash receipt blotters. These offices were unable to demonstrate to examiners the details of funds received from their customers, when these funds were deposited into local depository accounts, or when they were forwarded to the home office.

Authorization Forms for Journals, and Request Forms for Checks and Wires

As discussed above in the section covering lending arrangements, day trading firms frequently journal funds from one account to another in order to satisfy Regulation T or margin maintenance calls. After the margin requirement is satisfied, another journal is usually executed to return the funds to the original account, often with interest.

Many third party traders also use journal authorizations or wire authorizations to transfer their share of the profits out of client accounts. Firms examined have generally done a good job of maintaining the reams of journal and wire authorization forms generated by this activity. However, they have not done a good job of ensuring that these forms actually reflect the authorization of their customers.

Some firms have been lax in their control over the funds in client accounts, placing these funds at risk to unscrupulous brokers or third party traders. Some day trading firms have accepted and processed journal authorization forms, which were not authorized by the customer who owned the account. The Landmark Complaint alleged that the branch manager both forged customers' signatures on authorization forms and accepted forms with signatures that were forged by others.

In a situation observed at another firm, the branch manager had customers sign journal authorization forms in blank. He made copies of the forms, and filled in the blanks on the copies to create multiple purported authorizations. He then faxed the copies to the firm's home office, taking advantage of the fact that it is not possible to distinguish a faxed copy from a faxed original document.

In another variation, a branch manager routinely accepted copies of journal authorization forms signed by customers in blank and completed for each purported authorization. The firm supplied the manager with a form letter to be executed by customers authorizing the acceptance of photocopied signatures. Of course, firms may not lawfully accept photocopied signatures on journal authorization forms, even with the purported blanket authorization of customers. Otherwise, the firm is deprived of its ability to ensure that requested journal entries are in fact authorized.

In other cases, third party traders signed journal authorization forms under purported powers of attorney, when there was no power of attorney on file with the firm. Based on the observations of Project Group members, day trading firms often do not check with customers to determine whether they have authorized these transfers.

Firms' lax procedures respecting the acceptance of journal authorization forms have facilitated misconduct of the type discussed above by brokers, managers, and traders of third parties' accounts. Many customers have suffered losses due to the unauthorized transfer of funds.

In a similar vein, some customers have complained of theft of funds by forged check request forms or wire request forms. In some cases, these losses could have been prevented by improved procedures for the use of these authorization forms.

Problems caused by forgeries of journal authorization forms, check request forms, and wire request forms are exacerbated by the fact that many third party traders are personal friends of the managers or principals of firms. These managers or principals often fail to question their friends' activities; in the worst situations, the managers or principals actively facilitate or participate in their friends' activities.

The lax internal control of disbursements and transfers at some firms may lead to the conclusion that the firms are, for the purposes of net capital requirements, effectively taking custody of customer funds. Firms that routinely use journal authorization forms that are signed in blank, or that hold such forms in their files, may be subject to heightened net capital requirements under SEC rules.

Many of these problems could be resolved if day trading firms were required to accept only journal authorization or wire/check request forms bearing original signatures of the customers. In situations where firms must accept a form by fax, the firm's home office should speak directly with the customer (not the third party trader, if one is involved) on the account to confirm the authorization. The firms should then maintain the original documents at the home office for a period of time before relying on microfilm or other storage methods.

3. Client Account Documentation

Trading Authorizations/Power of Attorney Forms

A substantial percentage of the accounts at most day trading firms are traded by someone other than the owner of the account. NASD Conduct Rule 2510(b) provides that written authorization is required for broker trading in a discretionary account. NASD Conduct Rule 3110(c)(3), as well as many state securities regulations, requires that a broker-dealer obtain written authorization before permitting a broker or third party to trade an account. Examinations of day trading firms have uncovered numerous instances in which brokers or third party traders were permitted to trade accounts without proper written trading authorizations on file.

In many cases, no written trading authorization ever existed, or the form was lost by the firm. In other cases, a written authorization was on file, but lacked the signature of the customer or lacked critical details such as the date of the authorization. At one firm, examiners located several trading authorization forms signed by the customer in blank, without the name of the trader authorized to trade the account. These forms were later completed by the firm with the name of the trader assigned to the account by an unregistered investment adviser operating at the firm.

As discussed under the section above, examinations have identified several brokers and third party traders who routinely journaled funds from accounts without written authorization from the customers. The firms allowed this activity despite the lack of executed powers of attorney.

Client New Account Information/Suitability Documentation

NASD Conduct Rule 2310 and most state securities codes require that all brokerage firms obtain and record certain information concerning the financial resources, sophistication, and investment objectives of their customers. The obligation of day trading firms to insure that only suitable clients engage in day trading is discussed above. However, many firms examined have failed to obtain information about their customers required by regulatory rules and their own procedure manuals.

Examiners have also found that the customers or manager fabricated information on new account forms in order to meet suitability requirements. The Landmark Complaint alleged that the branch manager falsified information on a new account form this reason.

Some firms have minimum net worth or liquid net worth requirements of $50,000 or $100,000 for a day trading account. Some day trading firms have a striking number of client accounts with exactly $100,000 net worth. Interviews with some customers show that they are implicitly or explicitly encouraged to report an exaggerated figure in order to qualify. When a customer must borrow funds from a firm principal in order to trade, the firm and regulators should be skeptical of high net worth figures.

Partnership Account Documentation

Examiners have noted that most day trading firms have some accounts opened in the name of general or limited partnerships. One firm examined had a branch office at which almost every active account was a partnership. These partnership accounts are largely funded by one or more investors who do not trade the account.

Most firms make a practice of obtaining a copy of the partnership agreement, as well as documentation demonstrating who is authorized to trade the account. However, some firms have failed to obtain information about the financial resources, sophistication, and investment objectives of the investors in the partnership.

In some cases, the firm will record the financial information about the partnership itself, as reported by the trader. In other cases, the firm records only the financial information of the *trader*, even if he or she has contributed little or no capital to the account.

In one instance, a trader set up a partnership funded with the entire retirement savings of a single investor, a disabled veteran. The firm obtained a copy of the partnership agreement, and was well aware that the trader contributed no money to the account. However, the firm obtained net worth, income, investment experience, and investment objective information only for the trader. The firm never made an effort to determine the financial condition or investment objectives of the true customer, the investor. The first contact the firm had with the investor was after the money was gone, and the trader had fled the state.

4. Compliance Records

Correspondence

Day trading firms generally do not send out the types of correspondence seen at a traditional broker-dealer. Some day trading firms initially claim that they have little or no correspondence. However, most firms actually do generate a large volume of correspondence in specific areas. Several firms examined have failed to properly maintain and review this correspondence. See NASD Conduct Rule 2210(b) “Communications with the Public; Approval and Recordkeeping.”

One type of correspondence generated frequently by day trading firms is status reports. Clients who trade at home or through a third party trader sometimes request a written status report showing the value of the positions in their account. Some firms have failed either to maintain this correspondence, or to forward it for supervisory review. In one instance, a registered representative trading on behalf of a client of the firm sent daily handwritten trade blotters to his client. Many of these trade blotters misrepresented the gains and losses in the account. The firm failed to maintain this correspondence, and no supervisor reviewed it.

Another common type of correspondence observed by examiners at day trading firms is e-mail responses to questions from potential clients. Most day trading firms have Internet websites to advertise their services. Most firms examined have received substantial volumes of e-mail from potential customers, asking questions about day trading and the firm's services. Firms will often respond to these inquiries by e-mail.

The recordkeeping rules of state securities agencies require firms to maintain e-mail correspondence under the same terms that they maintain regular correspondence. Several firms examined have failed to maintain their e-mail correspondence for the required period of time. Several also have failed to establish supervisory procedures for review of e-mail, although some were in the process of developing these procedures when they were examined.

Problems with the maintenance and supervision of electronic communications have also been found at firms outside of the day trading industry. However, because both the agents and customers of day trading firms are much more Internet-literate than the average person, these firms are more likely to have problems in this area.

Complaint Files

Several of the day trading firms examined had received written customer complaints. In most cases, the complaints appear to have been properly maintained and disclosed. However, examinations have uncovered some complaints that were not properly handled. In a few instances, written complaints were either not maintained, or they were not forwarded to the home office for review.

In other instances, written complaints were brought to the attention of the firm, but were never disclosed as amendments to the agents' Form U-4 (Application for Registration) as required by NASD Conduct Rule 1013 and state regulations. On at least one occasion, a firm even failed to disclose an NASD arbitration on an agent's Form U-4. The All-Tech Complaint included an allegation of failure to report a customer complaint.

Compliance Manual/Audit Reports

Most of the current day trading firms have at least one branch office location. Some of the compliance problems noted in this *Report* are exacerbated by the difficulty that all firms have in supervising small branch offices with only one or two agents. At some day trading firms, the lack of supervision is compounded by the lack of brokerage experience on the part of their branch managers.

During the examinations of branch offices of some day trading firms, the branch manager could not produce a copy of the firm's written supervisory procedures. In at least one instance, the branch manager also failed to produce copies of the reports generated by his firm's audits of the branch office.

5. Financial Records

The examinations conducted to date have not revealed significant deficiencies related to the financial books and records of day trading broker-dealers. However, it is important to note one problem that may arise when examining the financial records of a day trading firm.

The corporate entity registered as a broker-dealer by a day trading operation sometimes serves just as a shell. The net commissions from the brokerage activities pass through the broker-dealer to one or more affiliated entities, which in turn pay most of the expenses of the broker-dealer.

Often each branch office will be "owned" by a different entity affiliated with the broker-dealer. These entities receive the net commissions for activity at that branch office. These entities also will often pay the agents of the broker-dealer, both registered and unregistered.

At the time of this *Report*, examiners have not encountered much difficulty in getting access to the financial records of affiliates of day trading firms. However, states should be prepared to counter any resistance to a request for these records. The argument that registered agents are compensated by an affiliate is usually sufficient. SEC Rule 17h-1T provides for access to records of “material associated persons.” If a parallel state rule cannot be invoked, states with subpoena authority should be prepared to subpoena these records.

H. Failure to Supervise

1. The Phenomenon

The highly questionable practices, discussed above, are a product of firms’ failure to properly supervise their operations and practices. For example, each of the five cases brought by Massachusetts against broker-dealers has included allegations of failure to supervise.

2. Legal Framework

NASD Rule 3010, “Supervision,” provides as follows:

> (a) Supervisory System
>
> Each member shall 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 with the Rules of this Association. Final responsibility for proper supervision shall rest with the member.

In addition, Section 204(a) of the Uniform Securities Act of 1956 provides:

> The [Administrator] may by order deny, suspend, or revoke any registration if [he] finds (1) that the order is in the public interest and (2) that the applicant or registrant (J) has failed reasonably to

supervise his agents if he is a broker-dealer or his employees if he is an investment adviser.

III. Summary of Cases Brought to Date

A. Case Brought by Indiana

February 16, 1999-- In re. Self Trading Securities, Inc. (In. Sec. Div. Cause No. 99-0047). The Indiana Securities Division summarily suspended Self Trading Securities, Inc. ("Self Trading"), a registered broker-dealer. The complaint alleged that Self Trading violated the Indiana Securities Act by failing to notify the Securities Division of a branch office, failing to notify the Securities Division of changes in "circumstances" (i.e., status of registered principals), and failing to file annual financial reports. Through a consent agreement, Self Trading was censured and agreed to (1) correct its alleged violations by complying with the Indiana Securities Act, (2) maintain records in accordance with the NASD recordkeeping requirements, and (3) permit two on-site audits to be conducted annually.

B. Cases Brought by Massachusetts

Summary

The cases have concerned allegations of deceptive advertising, failure to register as a broker-dealer, encouragement of activity by unregistered investment advisers, conducting unlawful loan and profit sharing schemes, unauthorized transfers of customers' funds, forgeries of customer signatures, creation of fictitious customer accounts, falsification of information on new account forms, failure to report customer complaints, misrepresentations to the Division, and failure to supervise.

October 19, 1998-- In re Block Trading, Inc., et al. (Ma. Sec. Div. 98-58). The Division alleged deceptive marketing, arrangement and promotion of unlawful loans, encouragement of investment advisory activity by unregistered persons, and failure to supervise. The respondents included the firm, three of its principals, the branch manager, and a customer who allegedly engaged in investment advisory activity without being registered with the Division.

This case was settled on the basis of the individual respondents' agreement not to apply for registration with the Division for five years. The firm is in bankruptcy.

November 9, 1998-- In re Bright Trading, Inc., et al. (Ma. Sec. Div. 98-70). The Division alleged operation of a day trading brokerage office in Massachusetts without registering with the Division as a broker-dealer. The firm, which is registered with the Philadelphia Stock Exchange (PHLX), initially contended that it was not required to register with the state, since the firm purportedly does not have customers, but rather traders who register with the PHLX.

This case was settled on the basis of the firm's payment of $30,000 to the state's investor education fund. The firm, at the Division's request, corrected information on its web site and established an institutional trust arrangement for funds deposited by its traders. The Division then approved the firm's application for registration.

December 10, 1998-- In re All-Tech Investment Group, Inc., et al. (Ma. Sec. Div. 98-77). The Division alleged deceptive marketing by the firm, encouragement of investment advisory activity by unregistered persons, and failure to supervise. The Division also alleged that the branch manager engaged in commingling of customer funds, forgery of customer signatures, unauthorized transfers of funds among customer accounts, misrepresentations to the Division, and cooperation in the creation of fictitious accounts.

The respondents included the firm, three of the firm's principals, the branch manager, and two customers who allegedly engaged in investment advisory activity without being registered.

The case was settled on the basis of the firm's payment of $50,000 to the state's investor education fund, its reimbursement of $228,000 in customer funds lost due to unauthorized transfers, its hiring of a new compliance officer, its agreement not to accept any new customers for two years, and its commitment to retain an independent compliance consultant to examine the firm and file reports every six months for a two-year period with the Division. One of the principals consented to the entry of a cease and desist order, and the branch manager and two alleged unregistered advisers agreed not to apply to the Division for registration for two years.

January 14, 1999-- In re On-Line Investment Services, Inc. et al. (Ma. Sec. Div. 99-1). The Division alleged deceptive marketing by the firm, including claims on its web site, now deleted, that 85% of customers were successful, and failure to supervise. (Copies of a former page from the firm's web site are included in the Appendix.)

The Division also alleged abuse of a customer's account through churning (e.g., commissions of about of $50,000 in a month when the average equity was about the same amount), appropriation of 80% of any profits as a purported management fee (through the charging of adjusted commissions), and transfers of funds between the customer's account and the manager's wife's account.

This case was settled on the basis of the firm and manager paying a total of $20,000 to the state's investor education fund. In addition, the firm withdrew its registration with the state, and agreed not to reapply for registration for one year. The manager also withdrew his registration, and agreed not to reapply for two years.

March 2, 1999-- In re TCI Corporation, Inc., et al. (Ma. Sec. Div. 99-9). The Division alleged deceptive marketing in promoting day trading course, including claims that its system provides "6 to 7 figure income per year" and is the "absolute best trading system in the financial market." The Division also alleged that the firm conducted business as an investment adviser without registration, and that it solicited funds for an "Institutional Trading" program for trading bank instruments that is a Ponzi scheme or other unlawful program.

The Division issued a temporary cease and desist Order. A hearing on whether the Order would be made permanent was held on March 29. By Order dated June 4, 1999, the cease and desist Order was ordered to continue with respect to the Institutional Trading investment program, and the matter was referred to the Massachusetts Attorney General for further investigation into potential violations of the state's Consumer Protection Act or other laws.

July 8, 1999-- In re Landmark Securities, Inc., et al. (Ma. Sec. Div. 99-29). The Division alleged misconduct by the firm and branch manager including: violation of suitability requirements; falsification of information on new account form; unauthorized transactions; unauthorized transfers of customer funds; conducting unlawful loan and profit sharing schemes, including promotion and arrangement of usurious inter-customer loans; forgeries of customer signatures; use of improper procedure whereby photocopies of signatures were utilized; creation of account under fictitious name; misrepresentations to the Division; and failure to supervise.

The Division also alleged misconduct by the branch manager and the entity that purportedly acted as facilities manager of the branch, i.e., unlawful issuance of unregistered and non-exempt securities to raise funds used for loans and profit sharing arrangements with Landmark's customers.

C. Cases Brought by Texas

January 6, 1999-- In re Infinitum Capital Management, Inc., et al. (Tex. SSB Docket No. 97-011.) After a hearing on the merits, the Texas Securities Commissioner found that Respondent Juan Carlos Nieto, and the firms he owned, Infinitum Capital Management and Infinitum Management Company, acted as dealers without proper registration under the Texas Securities Act. Under Act, the term "dealer" includes investment advisers. Respondent Nieto orally contracted to manage the investments made by Colombian customers in the U.S. stock market. Respondent Nieto invested his customers' money through "independent contractor" traders who used the Small Order Execution System (SOES). He set up Infinitum Capital Management to handle his relationship with the Colombian customers and Infinitum Management Company to manage his relationships with the traders.

Respondent Nieto was fined $20,000 and ordered to cease and desist from acting as a dealer without proper registration. Both Infinitum entities were ordered to cease and desist from unlawful activity and each was fined $30,000. Eight traders were fined $3,000 each for failure to register as an agent or salesperson of a dealer.

[Note: In a Notice of Hearing filed against The Exchange House, Inc., the Texas Securities Board alleged that the day trading firm unlawfully permitted 24 unregistered traders affiliated with Nieto to manage customer accounts at the firm. *In re The Exchange House, Inc., et al.* (Tex. SSB Ref. 97-011). This group of traders managed essentially all of the accounts at the firm. The complaint also alleged that the firm used an unregistered branch office, and employed several unregistered brokerage agents to take customer orders. The Exchange House eventually withdrew its brokerage license, and consented to a censure and a $20,000 fine.]

April 6, 1998-- In re Day Trade, Inc., et al. (Tex. SSB Ref. 98-020). In a Consent Order entered against Day Trade, Inc. the Texas Securities Commissioner found, among other things, that a related brokerage firm, Superior Financial Group, Inc., permitted unregistered traders to manage customer accounts. The individuals acting as unregistered investment advisers were employees of the brokerage firm. The Order also found that Superior Financial Group, Inc. used unregistered agents and failed to supervise its agents. Day Trade, Inc. consented to a $10,000 fine.

D. Case Brought by Wisconsin

December 17, 1998-- In re Block Trading, Inc., et al. (Wis. Sec. Div. File S-981.) The Wisconsin Division of Securities alleged that a "business opportunity" to operate a branch office of Block Trading was a franchise within the Wisconsin statutory definition. The Division further alleged that Block Trading had failed to register this franchise. The Administrator prohibited Block Trading from making any further sales of franchises unless they are registered in accordance with Wisconsin law.

E. Case Brought by the SEC

May 18, 1999-- In re Datek Online Brokerage Services Corp., et al. (SEC Release No. 34-41417.) The SEC found that Datek, an online broker-dealer, violated rules mandating the maintenance of a separate reserve bank account for customer funds. The purpose of the rule is to ensure that the broker-dealer will not utilize customer monies. Datek also failed to maintain certain required records. By consent order, Datek and the Chief Financial Officer agreed to cease and desist from committing violations and to pay administrative fines in the amounts of $50,000 and $10,000, respectively.

F. Case Brought by the NASD

July 7, 1999-- On-Site Trading, Inc. The NASD censured and fined $25,000 the day trading firm of On-Site Trading, Inc. ("On-Site") of Great Neck, New York for failing to properly qualify and register 14 individuals. The NASD found that On-Site violated the NASD Series 55 registration requirement for employees trading the NASDAQ markets. On-Site consented to the entry of the NASD findings without admitting or denying the charges and agreed to implement new compliance procedures to prevent future violations.

IV. Analysis of Customers' Day Trading Accounts

Thirty (30) short-term trading accounts were randomly selected for analysis from accounts that had been maintained at the Watertown, Massachusetts office of All-Tech in 1997 and 1998. Copies of customer account statements had been obtained in connection with Massachusetts' proceeding against All-Tech.

The Project Group retained Erik Sikowitz of STZ Analytical Services in New York, New York to tabulate account statement data and quantify trading activity. Mr. Sikowitz made calculations of profits and losses; commissions; turnover; and cost-to-equity ratios.

The Project Group retained Ronald L. Johnson, a Securities and Futures Consultant, of Palm Harbor, Florida to analyze and evaluate the trading performance of the accounts. Mr. Johnson's findings and conclusions are as follows:

- The average account was open four months, had an average annual turnover of 278, and a cost/equity ratio of 56%. Six of the accounts were traded by two individuals so four accounts were removed to avoid skewing the performance analyses.

- All trading in the accounts was analyzed and evaluated (4,093 trades in 26 accounts). Seventy percent of the accounts lost money and were traded in a manner that realized a 100% Risk of Ruin (loss of all funds).

- Only three accounts of the twenty-six evaluated (11.5% of the sample), evidenced the ability to conduct profitable short-term trading.

- The statistically significant day trading (2,754 trades in 17 accounts) was evaluated. Sixty-five percent of the accounts lost money and were traded in a manner that realized a 100% Risk of Ruin (loss of all funds)

- There was only one successful day trading account in the 17 accounts analyzed, and this account did not have trading returns commensurate with the risks to which the account was exposed.

- The most successful account in the study had limited short-term trading and no day trading.

Mr. Johnson's analysis and exhibits are separately bound. Messrs. Sikowitz's and Johnson's résumés are in the Appendix.

V. Recommendations

A. New Rules

1. Promotion of Suitability and Disclosure of Risks

As discussed above, the Project Group endorsed the NASD's proposed rules on suitability and disclosure with respect to day trading firms, 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 day trading suitability rules are warranted.

There is ample precedent for special suitability rules. The NASD has already determined that certain types of securities or trading are particularly risky and therefore has established heightened suitability obligations for brokerage firms. Day trading is also a particularly risky program of trading that warrants heightened suitability and disclosure requirements.

The NASD has established special suitability requirements for opening options accounts (NASD Rule 2860); for purchasing stock index, currency index and currency warrants (NASD Rule 2844); for participation in direct participation programs (NASD Rule 2810); and for purchasing certain low-priced securities (NASD Notice to Members 96-60, Clarification of Member's Suitability Responsibilities Under NASD Rules With Special Emphasis on Member Activities In Speculative and Low-Priced Securities).

2. Explicit Prohibition of the Lending Arrangements

As discussed above, day trading firms' promotion and arrangement of lending among customers is unlawful under existing law. Nonetheless, the Project Group believes that the NASD should adopt an explicit rule prohibiting the practice. The lending arrangements invite precisely the types of misconduct that have been observed, including forgeries, unauthorized transfers of customers' funds, and maintenance of accounts for which day trading is unsuitable.

B. Enhanced Regulatory Focus

The Project Group believes that enhanced regulatory focus is needed. 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 more recently by the media. More enforcement actions should be brought. Failure to respond may encourage firms to continue their questionable behavior.