STAFF MEMORANDUM

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

DAY TRADING:
EVERYONE GAMBLES BUT THE HOUSE

FEBRUARY 24, 2000

TABLE OF CONTENTS

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I. OVERVIEW OF DAY TRADING

A. Introduction

1. PSI=s Overview Hearing

On September 16, 1999, the Permanent Subcommittee on Investigations (APSI@) held the first congressional hearing on day trading (AOverview Hearing@).[1] The hearing provided an overview of day trading and included testimony from securities regulators and the Electronic Traders Association (AETA@),[2] a trade group that purports to represent the day trading industry. Chairman Collins raised three important questions during that hearing: (1) is day trading nothing more than gambling; (2) are some day trading firms engaged in deceptive and fraudulent practices and, if so, how pervasive is this misconduct; and (3) what is the impact of day trading on individual companies and the markets? In her opening statement, Chairman Collins indicated that PSI would examine these questions through continued investigation of the day trading industry.[3] Furthermore, she announced that, following the Overview Hearing, subsequent hearings would highlight case studies developed through ongoing investigation by PSI staff. Chairman Collins authorized PSI staff to prepare the detailed investigative case studies. We have now completed this investigation and present our findings below.

2. Scope and Methodology of PSI=s Investigation

PSI staff conducted this investigation by casting a wide net and examining the largest day trading firms. PSI staff formally requested documents from nineteen day trading firms through the use of a detailed and comprehensive document request. Eighteen of those firms responded to the staff=s request. Those firms produced approximately 50,000 pages of documents to PSI staff and at least ten videotapes containing television advertisements. The staff reviewed all of these materials. During the course of its investigation, PSI staff interviewed approximately 107 people and deposed seven individuals who are or were employed by the day trading industry. Those witnesses included chief executive officers and other employees of day trading firms, former and current day traders, gambling experts, academics and authors. The staff also met with state and federal regulators and representatives of self-regulatory organizations (ASROs@).

In furtherance of the investigation, PSI staff requested that eighteen day trading firms or companies that support the day trading industry respond to written interrogatories concerning customer lending, third party trading, trading policies, customer financial qualifications and advertising. PSI staff then submitted a second set of interrogatories to fifteen of those firms, primarily requesting financial information such as gross revenues, net income, and commission charges. Based on the information provided to PSI, the staff narrowed its focus to three day trading firms, which we examined in detail: All-Tech Direct, Inc. (AAll-Tech@), Providential Securities, Inc. (AProvidential@), and Momentum Securities, Inc. (AMomentum@). The case studies of those three firms are located in sections III, IV and V of this report.

3. General Findings

After eight months of investigation, we are now able to draw general conclusions concerning the practices of the day trading industry. Day trading is a highly speculative activity that can be fairly compared to certain types of gambling. Although there is no definitive study regarding the profitability of day trading, the best evidence suggests that only a tiny fraction of novice day traders are ever profitable and that, even among well capitalized and experienced day traders, a majority will lose money. Moreover, some day trading firms have failed to adequately disclose the risks attendant to day trading in their advertisements and during their interactions with prospective customers. Even when firms have given prospective customers good written risk disclaimers, some firms have undermined that risk disclosure through contradictory verbal statements about the profitability of day trading or the ease with which risk can be avoided.

Contrary to their own internal policies, some day trading firms have frequently failed to gather the information about their prospective customers that is necessary to determine whether those customers are suitable for day trading.[4] In addition, many day trading firms have gathered the pertinent information, but then accepted customers whose stated financial condition and/or investment objectives were inconsistent with their firms= internal policies regarding the opening of high risk, day trading accounts. For example, firms have opened day trading accounts based on new account forms indicating that the customers= investment objectives were Aincome@ or Along term growth with safety,@ two objectives commonly understood to be at odds with a day trading strategy. Some day trading firms who maintained sound minimum financial requirements for opening new accounts have now lowered their standards to compete with other day trading firms who have weak minimum requirements or no standards at all. These firms are now accepting customers that they previously considered unsuitable for day trading, and they are doing so because they do not wish to lose the commission revenue generated by those unsuitable customers.

Some day trading firms have failed to hire qualified personnel to manage their branch offices and have failed to adequately train and supervise those branch managers after they were hired. Many day trading firms have provided their customers with poor training B training that does little or nothing to prepare a novice for a profitable career as a day trader. Also, many day trading firms arrange for customers who cannot satisfy margin calls to obtain from other customers short term loans at high interest rates. The firms then manage all of the administrative and clerical functions attendant to servicing those loans. Finally, many day trading firms allow individuals to day trade the accounts of third parties without the day traders verifying that they are registered as an investment adviser or that they are not required by law to be registered.

The National Association of Securities Dealers (ANASD@) and the New York Stock Exchange (ANYSE@) have recently proposed rule changes for the day trading industry. The proposed rules would require day trading firms to give new customers risk disclosure before opening their account. The firms would also be required to evaluate the appropriateness or suitability of day trading strategies for their customers before opening their accounts. The last proposal would tighten the rules governing margin trading by day traders. We believe that these rule changes will help combat some of the abuses and problems uncovered by PSI=s investigation but that they require modifications. At the conclusion of this report, PSI staff recommend several modifications to the existing proposals from the NASD and the NYSE. We also propose two new rules to more fully address the problems in the day trading industry. Regulators must also be more aggressive in their enforcement activities relating to errant day trading firms, particularly with respect to the supervision that day trading firms are providing their branch offices.

B. Day Trading Defined

Day trading typically is defined as placing multiple buy and sell orders for securities and holding positions for a very short period of time, usually minutes or a few hours, but rarely longer than a day.[5] Day traders seek profits in small increments from momentary fluctuations in stock prices after paying commissions, which can range from $15 to $25 per trade.[6] The NASD has recently defined a Aday trading strategy@ as an Aoverall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.@[7] In its proposal to amend NASD Rule 2520, which changes margin lending requirements for day traders, NASD seeks to:

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e definition of A pattern day trader@ to include any customer who (a) the fir m knows or has a reasonable basis to believe will engage in pattern day trading, or (b) day trades four or more times in five business days, unless his or her da y trading activities do not exceed 6% of his or her total trading activity for that time period. A day trader would be able to shed the day trader classification if he or she did not day trade for a ninety (90) day period.[8]

The estimated number of Aprofessional@ day traders, those who devote nearly all of their time to the activity, represents only a small fraction of the millions of investors who participate in the securities markets. James Lee, President of the ETA, told PSI staff that about 4,000 to 5,000 individuals trade from 100 or more specialized day trading firms.[9] In response to Subcommittee interrogatories, however, fifteen day trading firms reported opening 12,666 new accounts between January 1, 1998 and October 1, 1999. Although the number of day traders is relatively small, ETA estimates that day traders engage in a disproportionately high number of securities transactions which account for ten to fifteen percent of the daily dollar volume traded on the Nasdaq exchange.[10]

A close relative to the day trader is the Aswing@ trader. This type of trading differs from day trading in that swing traders hold positions open for longer intervals of time. Henry Fahman, President of Providential, described a swing trader as one who finds positions and then holds them for a number of days or sometimes weeks, depending on the projected frequency of price movement.[11]

Day traders do not invest in a particular security based on the fundamental strengths or weaknesses of the company. Indeed, the trading decision may have nothing whatsoever to do with the merits of a particular stock. One day trader was quoted as follows: AWall Street=s not about investing anymore, it=s about numbers. Who cares whether [the stock] is a car company or a chemical company? Who cares what they=re going to be doing in 2000?@[12] In essence, each trade is little more than a bet on the short-term price fluctuation of a particular stock. The training manual for Cornerstone Securities Corporation (ACornerstone@) describes the differences between day trading and traditional investing as follows:

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dexes or prices of issues increasing in value, a day trader is not concerned with whether or not the market goes up. Rather, he cares only that there is move ment B up or down, the direction is not as important as the presence of volatilit

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Mr. Lee explained that day trading is more active than traditional investing and focuses on the short term.[14] He elaborated that the two differ greatly in terms of time commitment, trading volume, the systems used, and the indicators on which those engaged in the activity rely.[15]

C. Regulatory Structure and Enforcement Activities

1. Securities & Exchange Commission (ASEC@)

a) Jurisdiction

The SEC is the federal agency that regulates the United States securities markets. The SEC supervises SROs which are charged with the initial responsibility to regulate the conduct of their member firms.[16] The most prominent SROs include the NYSE, the American Stock Exchange (AAMEX@), the Philadelphia Stock Exchange (APhlx@), and the NASD.[17] In order to change their rules and procedures, SROs must file written proposals with the SEC that are then subject to public comment prior to approval or rejection by the SEC.[18]

The SEC=s Division of Enforcement (AEnforcement@) investigates potential violations of the federal securities laws.[19] If the Enforcement staff finds sufficient evidence that the federal securities laws have been violated, it may seek approval from the Commissioners of the SEC to file a complaint in federal court or to initiate an administrative proceeding.[20] The SEC only has authority to pursue civil remedies for violations of federal securities laws, but it routinely supports criminal law enforcement efforts:

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curities industry sources, press reports, and investor complaints.[21]

The SEC files about 400 to 500 civil enforcement actions each year.[22]

b) Examinations of Day Trading Firms in 1999

In March 1999, due to rising reports of fraudulent practices in the day trading industry, the SEC and NASDR launched a joint examination program of more than sixty of the 100 day trading firms. During the Subcommittee=s Overview Hearing, SEC Chairman Arthur Levitt testified that the SEC was examining more than forty day trading firms.[23] Chairman Levitt testified that the SEC=s examinations indicated that some of the firms were not in compliance with applicable rules and regulations but that the SEC Ahad not found marked and widespread fraud by these firms.@[24] The SEC is particularly concerned with day trading firms not maintaining adequate books and records, and their failure to comply with net capital rules, the short-sale rule and margin requirements.[25] Chairman Levitt stated that the examinations were also focusing on advertisements and promotions that were inconsistent with NASD rules.[26]

c) Enforcement Actions Against Day Trading Firms

During his testimony, Chairman Levitt said that the Division of Enforcement was pursuing Aseveral active investigations concerning day trading operations,@ most of which derived from the examinations being conducted by the SEC.[27] Some of the enforcement actions arose from customer complaints as well. The investigations cover potential violations including margin, short-sale and net capital violations, and misleading advertising.[28] SEC officials confirmed to PSI staff that the SEC has not yet filed any enforcement actions resulting from these investigations.

2. Self-Regulatory Organizations (ASRO@)

a) Jurisdiction

The SEC=s website describes SROs as Athe front line in regulating broker-dealers.@[29] Each SRO is responsible for its member firms. When a firm is a member of more than one SRO, the SEC will appoint one of the SROs to serve as that firm=s ADesignated Examining Authority,@ which is then responsible for regulating the member firm.[30] For purposes of PSI=s investigation of the day trading industry, the relevant SROs are the NASD, the NYSE, and the Phlx.

The NASD is the world=s largest SRO for the securities industry.[31] The regulatory arm of the NASD is NASD Regulation, Inc. (ANASDR@), which is an independent subsidiary of the NASD.[32] AVirtually every broker-dealer in the U.S. that conducts a securities business with the public is required by law to be a member of the NASD.@[33] There are 5,600 NASD member firms, operating over 75,000 branch offices with more than 600,000 registered securities professionals.[34] NASDR performs its regulatory function through Aregistration, education, testing and examination of member firms and their employees, and through the creation and enforcement of rules designed for the ultimate benefit and protection of investors.@[35] NASDR=s regulatory jurisdiction is limited to its members and their associated persons:

NASDR Enforcement brings cases against members and their associated persons based on information developed internally by periodic examination of me

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s from [its] arbitration, corporate financing and advertising departments. It also uses external sources, including federal and state agencies, customer compl aints, news media and anonymous tips.[36]

In 1998, NASDR initiated more than 1,000 disciplinary cases and suspended or barred more than 650 individuals from the securities industry. NASDR is also responsible for adopting rules to govern the brokerage industry, which do not become final until approved by the SEC.[37]

Like the NASD, the NYSE has numerous member firms that it regulates and whose conduct is subject to NYSE rules.[38] NYSE is the Designated Examining Authority for most of its member firms.[39] It is responsible for regulating firms that Acarry 63 million customer accounts and operate over 10,800 branch offices throughout the world, employing 128,000 registered personnel.@[40] The NYSE

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staff; constant monitoring of the status of, and information relating to, its members hip; and finally, the investigation and prosecution of violators of Exchange rules and the Securities and Exchange Act of 1934 and rules thereunder.[41]

As with new rules proposed by the NASD, NYSE also must obtain the SEC=s approval of new rules before they become final.

The Phlx is a regional exchange that functions as an SRO. About twelve to fifteen day trading firms are members of the Phlx and not the NASD.[42] As such, these Phlx firms need not comply with NASD rules.[43] These firms avoid NASD membership by operating as limited liability companies (A@LLCs@), rather than as traditional broker-dealers.[44] The LLCs sell interests to day traders so that those persons are part-owners of the firm rather than customers of the firm.[45] Not only does this arrangement allow firms to avoid compliance with NASD rules, but it also allows day traders to use more leverage than would otherwise be permitted if they were customers of an NASD member firm.[46] The SEC recently approved a new Phlx rule that requires persons associated with member firms who trade off the floor of the Exchange to successfully complete the General Securities Representative Examination Series 7.[47] Thus, day traders at Phlx firms are now required to take and pass the Series 7 examination.

b) Examinations of Day Trading Firms in 1999

As part of its coordinated examination effort with the SEC, NASDR examined twenty−two day trading firms through the use of fifty-five specially trained examiners.[48] The firms varied in size and composition.[49] For example, two of the day trading firms NASDR examined had 1,500 or more day trading accounts, while six of the firms had fewer than twenty customers that were day trading.[50] During the Overview Hearing, NASDR President Mary Schapiro testified that NASDR discovered several potential problem areas during the examinations, Aincluding advertising, Regulation T and margin lending, registration of individuals, short sales and supervision.@[51] Furthermore, she stated that formal enforcement actions would be instituted to the extent that investigations growing out of the examinations revealed violations of NASD rules or federal securities laws.[52]

c) Enforcement Actions Against Day Trading Firms

The NASDR has yet to bring any enforcement actions against day trading firms resulting from its examinations. The NASDR did file an enforcement action on July 7, 1999, however, against On-Site Trading, Inc. The action resulted in a censure and fine of $25,000 for failing to properly qualify and register fourteen individuals. The NYSE recently initiated and settled disciplinary proceedings against a broker-dealer, its president, vice president, and branch office manager alleging numerous violations of the NYSE Rules and federal securities laws and regulations, many of which involved day trading activities.[53] The allegations included violations of Aday trading margin requirements, sales practice and compliance procedures, financial responsibility standards, books and records requirements, and supervision of its business operations and of persons under its supervision and control.@[54] In addition, the NYSE charged the firm=s president with extending approximately $23 million of credit to about sixty-eight customers to open day trading accounts at the firm or at a non-member organization owned by the president and affiliated with the firm. [55] The NYSE Hearing Panel censured the firm and fined it $1,350,000 and required the firm to, among other things, hire an independent consultant to review the firms Apolicies, procedures, practices and supervisory systems,@ a general counsel, an internal auditor and a full-time Director of Compliance.[56] The Hearing Panel also penalized the individual respondents through censures and suspensions.[57]

3. State Securities Commissions

a) Jurisdiction

Each of the fifty states is also directly involved in the regulation and oversight of the securities industry. Each state has a securities agency which is a member of the North American Securities Administrators Association, Inc. (ANASAA@). NASAA is a voluntary association which acts as the voice of the fifty state securities agencies.[58] The shared system of federal and state securities regulation developed in 1934, when Congress created the SEC.[59] AThe complementary approach to the regulation of the securities markets in the U.S. has resulted in a logical division of labor, under which the states focus, for the most part, on individual investor protection issues, while the SEC deals with matters of broad-based market concerns.@[60] The state securities agencies conduct licensing and registration activities.[61] Each state agency also has an enforcement division that investigates fraud and abusive sales practices.[62]

In most states, persons acting as investment advisers must be registered with the state unless they are exempt.[63] An Ainvestment adviser@ is a person who advises others for compensation concerning the value of securities or the advisability of investing in, purchasing or selling securities.[64] Under the National Securities Markets Improvement Act of 1996

(ANSMIA@), Title III of which is the Investment Advisers Supervision Coordination Act, responsibility for investment adviser oversight is divided between the states and the federal government.[65] In very general terms, an investment adviser with less than $25 million under management is required to register with the state unless he or she is exempt from registration.[66] An investment adviser with more than $25 million under management is required to register with the SEC.[67] Many states, such as Massachusetts and California, have followed NSMIA which allows a person with no place of business in the state to trade up to five accounts for compensation without registration.[68]

b) Examinations of Day Trading Firms

Like the SEC and the SROs, states conduct examinations of firms within their jurisdictions. For example, the Securities Division of the Washington Department of Financial Institutions (AWashington Division@) recently conducted examinations of the seven day trading firms located in the State of Washington.[69] The Washington Division found that profitability among day traders was very low and that there was a significant volume of inter-customer lending to meet margin calls.[70] The Washington Division did not find significant evidence of misleading advertising or inadequate risk disclosures.[71] The Washington Division referred some of its findings to the state=s enforcement division, but the enforcement division has not yet determined whether to initiate enforcement actions.[72]

c) Enforcement Actions Against Day Trading Firms

Several states have brought enforcement actions against day trading firms. For example, within the last two years, Massachusetts,[73] Tennessee,[74] Indiana,[75] Texas[76] and Wisconsin[77] filed cases against day trading firms. The securities violations alleged in those actions included, among other things, failure to supervise, deceptive marketing, unregistered investment advisory activities, arrangement and promotion of unlawful loans, falsification of information on new account forms, unauthorized transactions, and unauthorized transfers of funds among customer accounts.[78] The Massachusetts Securities Division has been the most aggressive state regulator thus far, filing six actions against day trading firms doing business in the state.

d) 1999 Day Trading Report of the North American Securities Administrators Association

In August 1999, NASAA released its Report of the Day Trading Project Group (ANASAA Report@), the purpose of which was Ato assist state securities regulators in understanding, and responding to, the issues posed by the day trading industry.@[79] The Day Trading Project Group, which comprised state securities regulators from Massachusetts, Colorado, Pennsylvania, Texas, and New Jersey, derived its conclusions from reviewing registration applications, conducting examinations and participating in enforcement proceedings.[80] The NASAA Report states that the problems in the day trading industry stem from two underlying factors: (1) firms fail to follow basic compliance requirements, with many of the firms= officers and managers having little or no experience in the brokerage industry; and (2) firms constantly require a steady flow of new customers because most day traders lose money and the firms need new commission revenue to cover high overhead costs.[81]

Overall, the NASAA Report identified the following abuses and problems in the day trading industry:

$ deceptive marketing, including inadequate risk disclosure;

$ violation of suitability requirements;

$ questionable loan arrangements, including promotion of loans among 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 customers trading the funds of third parties;

$ failure to maintain proper books and records; and,

$ failure to supervise.[82]

The NASAA Report also contended that day trading is analogous to gambling and is unprofitable for most customers.[83]

D. Background on the Day Trading Industry

1. Origin of Day Trading

The origins of the modern day trading industry can be traced to 1971, when the NASD introduced Aa computerized, over-the-counter stock market called Nasdaq.@[84] In 1985, Nasdaq created SOES, the Small-Order Execution System, to enable individual traders to directly and automatically trade within the market.[85] AAs its name implies, orders placed in the SOES system (1,000 shares or less) are executed automatically within a few seconds, bypassing the traditional telephone method of executing Nasdaq trades.@[86] Arguably, the greatest attribute of the SOES system is the enhanced liquidity it provides for traders and the requirement that SOES orders must be honored with few exceptions.[87] After the stock market crash of 1987, the Nasdaq generally mandated that market makers honor orders executed through SOES.[88]

There are several key characteristics of SOES that include:

- SOES trades cannot exceed lots of greater than 1,000 shares.

- ASO

ES trader is prevented from either buying or selling the same stock during a five minute period.

$ A market maker must honor the SOES transaction

. [89]

It was through the use of the SOES system that a notorious group of traders, known as ASOES bandits,@ first took advantage of direct access electronic trading to earn quick profits on small price fluctuations in stocks.[90] AThe SOES system . . . enabled the creation of a whole new class of trader, commonly referred to as the SOES Trader.@[91]

The modern day trader is no longer limited to SOES. Indeed,

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m than just SOES. With the advent of the various electronic communication netw orks (ECNs) and advances in the technology that delivers data and executes our orders, SOES today is simply one method of transacting an order.[92]

Originally established over 30 years ago to handle large blocks of stock trades, electronic communication networks (AECNs@) now allow customers to trade directly with each other or place orders directly to the market.[93] Customers who use an ECN are part of an internal network and may place their buy and sell orders within that network of traders.[94] Other traders on that network can see the order and fill it, or contact the trader to negotiate a different price.[95] Day traders utilize ECNs as their primary means to place limit orders.[96] The most prominent ECNs include Instinet, Island, Bloomberg=s B-Trade, and All-Tech=s Attain.

One of the most important tools for a day trader is the Nasdaq Level II screen. As opposed to simply the Ainside@ or best bid that is displayed on Level I screens, Level II shows all the bid prices for all market makers in a selected stock.[97] This improved access provides critical information to the day trader including the number of bids and offers; the sizes and prices of bids and offers; who is bidding and offering; how consistently they do so; and how they move.[98] Using all of these indicators, a trader can estimate how a particular stock will move and trade accordingly.

2. Early Growth of Day Trading Firms

Day trading as a full-time profession has grown dramatically since the early 1990s. Professional day traders generally trade on-site at roughly 100 specialized firms. Some of these firms are large and have branch offices nationwide, while others are smaller organizations with one or two offices in a single state. Table 1 lists the ten largest day trading firms as measured by the number of branch offices.[99] According to NASAA and the SEC, the specialized day trading firms are generally broker-dealers registered with the NASD, although some are registered with the Phlx.

Firms registered with the Phlx typically are organized as LLCs in which each day trader is an agent of the firm rather than a Acustomer.@ These Aagents@ trade the firms= own capital on a highly leveraged basis through the firms= margin privileges. The day trading firms typically require the agents to provide a substantial security deposit or, Aperformance deposit@ as it is called, to cover losses incurred by the individual agents.[100] Phlx firms also charge commissions to their agents.[101]

Day trading firms that are broker-dealers generally do not require a performance deposit and do not receive a percentage of any profits earned by their day traders, since those traders are customers of the firms rather than limited partners. The broker-dealer firms make money primarily from the commissions charged to their customers on a per trade basis and from any fees that they might receive from training customers.

PSI=s investigation found that the day trading industry has grown dramatically over the last three years. The fifteen firms examined by PSI reported gross revenues of $144,359,655 in 1997. Those firms also reported net income of $22,202,459 in 1997. Last year, the firms had gross revenues of $541,440,682, with a net income of $66,538,142. Consequently, these day trading firms have experienced explosive growth in the last three years, witnessing a 276 percent increase in revenues and a 200 percent increase in profits.

PSI=s investigation also determined that, in the aggregate, day traders pay approximately $16 per trade at the fifteen firms examined in this investigation. These firms estimated B in the aggregate B that their customers execute twenty-nine trades per day. Thus, the average day trader at these firms must generate a daily trading profit of $464, each and every day, simply to break even. On an annualized basis, assuming twenty trading days per month, the average day trader must generate a trading profit in excess of $111,360 to achieve profitability for the year. The growth of day trading has also made it more difficult to achieve that profitability. The training manual for Cornerstone Securities notes that, A[u]nlike a few years ago when there were fewer players and the margins of inefficiency were large enough to get in and out virtually unchallenged, today=s environment is extremely competitive. The advantage today is that those traders that lack either the discipline or technology to compete will drop out.@[102]

3. Distinction Between Day Trading Firms and On-Line Discount Brokerage Firms

Day trading firms provide a fundamentally different service than traditional brokerage houses and even on-line discount brokerage firms, such as E*Trade and Charles Schwab.[103] Neither discount on-line brokerage firms nor traditional full-service firms offer customers direct electronic access to the stock market, as do day trading firms. Online brokerage firms generally do not offer immediate stock order execution to their customers.[104] Rather, online brokerage firms generally refer customer orders to other entities B such as market markers B for execution.[105]

The other basic difference between day trading firms and on-line firms is that day trading firms generally promote active trading by their customers and, in most instances, cater primarily to persons seeking to trade for a living.

There are about 1.7 million people in the United States who are categorized as Ahyper-active traders.@[106] It is estimated that hyper-active traders execute 80 to 100 stock trades per year through their online brokerage accounts.[107] In addition, ETA estimates that 250,000 people execute more than 400 trades per year, largely through on-line brokerage firms, such as Charles Schwab and E*Trade.[108]

The immediate order execution capability offered by day trading firms has become a marketing tool by which day trading firms attract active investors from the established on-line, discount brokerage firms. Mr. Lee told PSI staff that day trading firms market their services to the estimated 250,000 individuals who make 400 or more on-line securities trades per year, since these investors would most benefit from the ability to immediately execute their stock orders.[109] Similarly, All-Tech=s Chief Executive Officer, Harvey Houtkin, stated that his firm markets its Attain trading system to individuals who actively trade through on-line brokerage accounts.[110]

The technology available to day trading firms also has attracted the interest of several leading investment and securities firms.[111] Fidelity Investments, Lehman Brothers, and Instinet, a division of Reuters Group, reportedly have discussed adopting the software platforms of day trading firms, forming alliances with them, or making outright acquisitions. Despite concerns about the practices of day trading firms, the electronic trading boom is forcing established securities firms to consider more efficient and inexpensive trading formats.

For instance, in an advertisement directed to hyper-active investors, On-Site Trading, Inc. (AOn-Site@), a day trading firm, markets its execution system as a tool for on-line investors to avoid paying higher execution costs resulting from Aorder flow@ agreements between discount brokerage firms and market makers.[112] The advertisement depicts a large man gorging himself at a buffet table and states that Ayour online broker may not live by commissions alone.@[113] The advertisement then explains as follows: AOnline brokers have made a big business out of low commissions. But they may be receiving payment for your orders . . . When you trade with The On-Site Trader, you get the best opportunity for price improvement because we let you direct your own order flow.@[114] This advertisement illustrates how the once distinct line between day trading firms and online brokerage firms has blurred, as both compete for many of the same customers. This change can likely be attributed to the fact that day trading firms may now have critical experience developing and using advanced trade routing systems that could someday give all investors instant access to the financial markets.[115]

4. Support Industries

As day trading has become more popular, a support industry offering related goods and services has evolved. It is promoted heavily over the Internet. This vast and largely unregulated industry often contributes to the hype and unrealistic expectations regarding day trading. The support industry includes books,[116] training programs and seminars, stock picking systems and software, as well as periodic newsletters that firms distribute by e-mail and facsimile. At the Overview Hearing, Chairman Levitt noted the SEC=s concern about websites attempting to capitalize on the day trading phenomenon by providing so-called Aexpert investment advice@ for a fee.[117] Chairman Levitt added that these websites often highlight the potential rewards of day trading without providing adequate risk disclosure.[118] PSI=s investigation found evidence to support Chairman Levitt=s concern.

PSI staff reviewed a variety of websites that the day trading support industry uses to advertise its products and services and found many questionable claims. Some members of the support industry market their products by promoting a glamorous lifestyle that is work-free and risk-fee, while others make exaggerated claims of wealth and success and provide minimal risk disclosure, if any at all. Others promise simple solutions and guaranteed techniques for success that belie the intensive and disciplined effort that profitable day trading demands. PSI staff requested that nine support industry firms provide documentation to support the claims posted on their websites. The firms= responses ran the gamut: several provided supporting materials, while others simply restated their claims without support, and some simply removed the questionable claims from their websites shortly after receiving PSI=s request.

a) Taking Profits

PSI staff examined a website for Taking Profits Publishing (ATaking Profits@), which contained several statements that promise vast wealth. Louis Russo of Taking Profits contributes to the hype surrounding day trading by posting on his website statements such as the following: ATrading Stocks can make you wealthier beyond your dreams. There is an ocean of money waiting to be brought aboard from trading stocks, and make sure you get yours. Imagine having the extra cash to buy the things you want, and to live the lifestyle you=ve dreamed about.@[119]

In an effort to capitalize on the day trading craze he encourages, Mr. Russo sells a weekly ATaking Profits@ newsletter at a yearly subscription rate of $349, and a ADay Trader Newsletter@ at a yearly rate of $990.[120] Mr. Russo also offers a six lesson online, AHow to Beat the Market,@ course that costs $99.95 and purports to teach students how to use charts, price patterns, and indicators.[121] In Mr. Russo=s own words, A[a]fter taking my course, you=ll know how to spot the WINNERS[.]@[122] Mr. Russo added that A[y]ou can start today and begin to profit tomorrow.@[123] Mr. Russo positioned limited risk information on the ACompany Information@ page of his website at the end of a paragraph detailing the subscription costs of his newsletters.[124]

Despite PSI staff=s written request, Mr. Russo provided no documentation to support the statements about the course posted on his website. Instead, Mr. Russo simply directed PSI staff to the website, a copy of which he enclosed, stating that A[a]ll information is found on our website.@[125] Interestingly, however, the copy of the website Taking Profits mailed to PSI staff did not contain the statements PSI staff questioned, because he had subsequently removed them from his website.

b) Coastal Day Traders

Richard Kane of Coastal Technologies Group (ACoastal Technologies@) posted several questionable claims on the website he uses to promote stock picking software called the AWealth Wizard.@[126] Mr. Kane claimed that he is awaiting a patent for the Wealth Wizard,[127] and that the methods it employs Awere developed over three years of active trading, and take full advantage of 14 years of experience with pattern analysis, mathematical modeling and artificial intelligence.@[128] Coastal Technologies= website does make some risk disclosures,[129] but contains the following claims:

$ Wealth Wizard monitors your portfolio in real time, executing trades automatically.[130]

$ Wealth Wizard performs the kind of careful, tireless monitoring required, giving you a potential daily return on your investments, while minimizing your risks.[131]

$ You make money on the way up and more on the way down.[132]

Coastal Technologies provided no documents to support the claims cited above. The first claim remains on the website unchanged, while the second claim remains on the website with slight modification.[133] Mr. Kane noted in his response to PSI staff that no Wealth Wizard software systems have yet been sold.[134] Coastal Technologies subsequently removed, without comment, the above cited claim that Ayou make money on the way up and more on the way down,@ and posted additional information on the risks associated with day trading.

c) Precision Management Group

Precision Management Group, Inc.=s (APrecision@) website promotes day trading as a stepping stone to a prosperous life. A division of 1-800RETIRENOW.COM, Inc., Precision offers a APrecision Day Trader Seminar@ and the APro-Trader Boot Camp.@[135] Precision also offers several online services such as a ATrader-Online Student Chat Room,@ a ATrade-Tutor Strategic Market Analysis@ and AOnline Mastermind Interactive Seminars.@[136] Precision has a page link from its home page to its risk disclosure page and is one of the few support industry firms PSI staff examined that presented balanced risk information with its claims.[137] For example, unlike other websites, Precision provided approximately four pages of information on the risks associated with day trading, some of which was in boldface font. The statement included, in part: AThe risk of loss in day trading and/or option trading can be substantial. You should, therefore carefully consider whether such forms of trading are suitable for you in light of your circumstances and financial resources.@[138]

Precision did, however, make the following claims that PSI staff found potentially questionable:

The founders of Precision realized long ago that Atrading@ (despite being a very efficient and profitable way of making a living), is nothing more than a A vehicle @ which, when operated correctly, allows you to spend the majority of your time and energies focused on the truly IMPORTANT things in life. Out of this philosophy eventually grew Precision=s simple, one-line mission statement: . . . trading your way to a better LIFE! [139]

Each day of our Boot Camps is jam-packed with LIVE trading sessions an

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ely new level of profitability.[140]

It its response to PSI=s interrogatories, Precision had no support for its statement Atrading your way to a better life,@ or its claim that trading is an efficient and profitable means of making a living, other than to state that those are opinions.[141] Precision attempted to justify its claim that its courses are highly effective by submitting a record of trades made during Precision classes.[142] PSI staff reviewed the record, however, and discovered that the account made only $500 in profits while generating approximately $8,000 in commissions and fees during the six months of trading.[143] Moreover, shortly after receiving PSI=s interrogatories, Precision removed the above cited claims from its website.

d) Winning Day Traders

The Winning Day Traders website promotes a chat room featuring AExceptional >Real-Time= Stock Recommendations@ and AMinute by Minute Market Analysis and News Alerts in Our Trading Auditorium.@[144] Membership in the Trading Auditorium costs $795 quarterly. Winning Day Traders also offers a newsletter published three times each week for $59 per month, and the ASecrets of Winning Day Traders@ Handbook for $149. In addition, the owners of the firm, Brian Zavodnik and Thomas Wolski, offer consultations for $75 per hour to analyze trades and help customers develop a trading style.[145] Winning Day Traders provided PSI staff with no support for the claims of AExplosive Winning Strategies and Secrets to Increased Profitability.@[146] Rather, Winning Day Traders simply referred to the claims as Aslogans that we came up with,@[147] and later removed them from the website without comment.

e) RML Trading

Another support industry firm is RML Trading, which is run by Robert Luecke. RML Trading offers a two-part online training course which, along with a text, costs $995.[148] RML Trading also offers direct market access to its customers.[149] RML Trading=s website provides the following optimistic view of a day trader=s chances of success:

$ Do I have to know anything about the stock market? No! Because of our support system you will be helped along the way to becoming a successful day trader.[150]

$ Can anyone electronically day trade successfully? If you have an average intelligence, discipline and desire you have a very good chance of becoming a successful trader.[151]

RML Trading stated in its cover letter to PSI staff that the above statement reflects Athe opinions of successful day traders.@[152] It is unclear which successful day traders RML Trading consulted, since in that same letter, RML Trading stated that it Adoes not have information, including internal or external reports, on the financial performance of the individuals who have completed the StockCam program.@[153] RML Trading also disclosed that it is undergoing NASD review.[154] RML Trading removed the above cited claims from its website shortly after it received PSI=s letter. The website=s risk disclosure is comprised of the following three sentences: AThe risk of loss in Electronic Day Trading can be substantial. You should carefully consider whether such trading is suitable for you. See SEC=s speech on Online Trading, the website does have a link to Chairman Levitt=s May 4, 1999, Speech at the National Press Club.@[155]

This burgeoning support industry for day traders is a troubling development because, as these websites illustrate, the support firms contribute heavily to the perception that day trading is a vehicle to easy money. They do so with very little, if any, risk disclosure and, thus, present unsophisticated investors with an unbalanced picture of the risks and rewards of being a professional day trader. As Chairman Levitt noted at the Subcommittee=s Overview Hearing, these support industries also pose regulatory problems since most of the companies involved are not broker-dealers or exchange members that would be subject to regulatory scrutiny and accountability.

E. Day Trading Closely Resembles Gambling for Novice, Undercapitalized Traders

At the Overview Hearing, one of the questions the Subcommittee considered was whether day trading is in fact gambling. This is an important matter because, as Chairman Collins noted in her opening statement, Avery few Americans would think it prudent to quit their jobs or to cash in their retirement savings to become professional gamblers who support their families at a Las Vegas casino.@[156] Yet, a growing number of people are giving up their existing careers or withdrawing their savings to become full-time professional day traders. PSI=s investigation suggests that day trading closely resembles gambling for novice, undercapitalized traders. PSI staff based this conclusion on statements by regulators, members of the day trading industry, gambling experts, documents produced by day trading firms, and profitability data.

Like gambling, which is defined as playing a game of chance for money or other stakes,[157] day trading offers the chance for quick riches. The odds are somewhat longer for the day trader than for the professional blackjack player, however: the day trader pays a commission charge for every trade regardless of whether it is profitable.

1. Regulators Liken Day Trading to Gambling

Securities regulators have been comparing day trading to gambling for some time. In 1998, Philip A. Feigin, Executive Director of NASAA, said that, Afor the typical retail investor, day trading isn=t investing, it=s gambling. If you want to gamble, go to Las Vegas; the food is better.@[158] Peter C. Hildreth, President of NASAA, testified at PSI=s Overview Hearing that Athe odds are you will not get rich. The odds are you will lose all the money with which you trade. The fact is, day trading is not investing, it is gambling. There are no other words for it.@[159] Because most day traders buy and sell securities without the benefit of the research associated with traditional investing and attempt to time the short term movement of a stock, many analysts have analogized the day trader to a card counter playing blackjack. Chairman Levitt cited the limited market knowledge of most day traders when he noted that Asome argue that day trading is nothing more than speculation. And speculation is not new to our markets. Personally, I don=t think day traders are speculating, because speculating requires some market knowledge, and they are instead gambling, which really doesn=t.@[160]

2. Day Trading Industry Rejects Gambling Comparison

Most day trading firms reject the comparisons between gambling and day trading. Harvey Houtkin, Chief Executive Officer of All-Tech, testified that Chairman Levitt was Ajust wrong@ when he called day trading gambling and that Aif he went back and thought about it, he=d recant.@[161] Other industry representatives have countered the regulators= statements with a variety of arguments. For example, Jim Lee, Momentum=s President, pointed out in a press account that Aif day trading was nothing more than a gamble, the turnover rate would be high, and if you=re running a revolving door, you=re gone.@[162] Mr. Lee said that he preferred that people not draw analogies between day trading and gambling, because society has a negative perception of gambling, and because he felt that the gambling analogy is not the most descriptive of the day trading industry.[163] Mr. Lee conceded, however, that he understood why people may associate gambling with some day trading firms, but felt that the comparison did not apply to Momentum.[164]

In order to distinguish day trading from gambling, other industry officials have drawn attention to the tools day traders have at their disposal. In his written testimony at the Overview Hearing, Saul S. Cohen, Consulting Counsel to the ETA, quoted day trader Dan Ripoll who stated that Aday trading is not gambling.@[165] Mr. Cohen added that Ait requires skill, state of the art technology and hard work.@[166] In its training manual, Cornerstone Securities also takes issue, at least in part, with the gambling analogy:

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ay have heard comments equating trading to gambling. While this notion may ap ply to some traders participating in the markets today, it certainly does not apply to those that have earned consistent returns over time. For them, only by

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Instead, Cornerstone compares day trading to meteorology.[168] Cornerstone notes that, like day traders, weathermen rely Aon systems and historical data to predict short-term, future movements in the weather.@[169] Though Cornerstone disputes what it calls the Agambling myth,@ the firm=s training manual concedes that

> [t]here will always be recreatio

nal gamblers, and, I suppose, there will always be traders that simply gam ble. Far too many existing traders throw caution to the wind, and their hard-earned money along with it. Because they lack the guidance, discipline, and a w ell thought-out trading plan, they are left to the uncertainties of guessing, wi shing, hoping, and of course gambling.[170]

3. Industry Representatives Identify Day Trading with Gambling

Despite attempts by members of the day trading industry to distance themselves from gambling, representatives of several day trading firms have openly compared successful day traders to professional gamblers. Richard McCall, described as a behavioral therapist, martial-arts master, professional trading coach and casino gambler, offered a course in the fall of 1999 aboard a river-boat casino that taught students how to day trade using strategies commonly applied to craps.[171] Mr. McCall was quoted in the press as follows: AThere are too many people getting into trading the markets who let their emotions rule the game. These are the folks you have to worry about. Craps is the fastest way to learn how to trade the markets right. It requires strategy, strict discipline, and impeccable timing.@[172]

Mr. Houtkin discussed the similarities between professional gamblers and certain traders, noting that traders who have the skills, technology and capital turn their trading into a business and are no longer gambling.[173] Mr. Houtkin also likened himself to a card counter and the brokerage industry to a casino that tried to throw him out of the house for winning.[174] He testified as follows:

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them at their own game and they tried to throw you out of the house?

A: I

think that would be an analogy that would certainly have certain validity to it. [1

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Don Bright, Chief Executive Officer of Bright Trading, which is appropriately based in Las Vegas, considers himself, like Mr. Houtkin, essentially a card-counter.[176] Mr. Bright is a professional gambler and day trader who said that his Atraders don=t gamble, just like blackjack card counters don=t gamble. They only make a trade when they have an edge.@[177] Mr. Bright also said of day trading and gambling, Athe discipline=s the same, the focus is the same, the edge is the same.@[178]

4. Gambling Experts Cite Dangers of Day Trading As An Addiction

The analogy between day trading and gambling seems to extend to the pathology of addiction that frequently accompanies gambling. Psychotherapist and former stockbroker, Chris Anderson, described day trading as Alethal, toxic, and addictive@ because so much money can be gained and lost so quickly.[179] Mr. Anderson noted that this can produce a rush of excitement in the trader similar to that experienced by a gambler.[180] He added that, as losses mount, day traders often retreat to a fantasy world and increasingly chase their losses with more trades.[181] Another gambling counselor, Dr. Frederick Woolverton, Director of The Village Institute, told PSI staff that, like addicted gamblers, traders often live in a fantasy world in which the next trade is the one that will propel them into wealth.[182] Dr. Woolverton found striking similarities between a room full of day traders clicking a mouse on a computer screen, complete with dancing lights, and a casino full of gamblers pulling the levers of slot machines.[183]

Members of the day trading industry acknowledge the addictive thrills of trading. For example, in his book Secrets of the SOES BANDIT, Mr. Houtkin describes the attitude of fellow day traders: AMany of my associates curse the long weekends that keep them away from trading. Day trading is so exhilarating that it can become almost addictive.@[184] During his Subcommittee deposition, Mr. Houtkin elaborated on that statement, noting that, when his customers Astart losing money, I mean, they beg us, beg us. When they lose money, we say, look, we=re going to close you down . . . . They literally, [say] please, let me trade some more.@[185] Mr. Bright=s daughter, Tammy Bright, herself a day trader and blackjack dealer, described the feeling she gets from day trading as Aa natural high; it=s wonderful.@[186] Several firms acknowledge the addictive nature of trading in their training materials. For example, in its training manual, On-Site Trading describes the rush of excitement trading provides: A[T]rading is a heady experience and can be very addictive. Losers who drop money in the markets receive a tremendous entertainment value.@[187]

These statements echo the thrill-seeking motivation described by Ed Looney, Executive Director of the New Jersey Council on Problem Gambling, who said, Awhen you look at the day traders you=re talking about an activity that attracts people who love action, who love excitement. You=re going to see a lot of them who are really in it for gambling.@[188] The Stockcam Institute, Inc. noted a similar phenomenon in its training manual:

Many traders feel that they must trade all day, every day, or at least every da

y. In other words, they are addicted to trading. An hour or day without a trade is like a day without a meal. The fact is that there are some days which offer fe

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away for a while until you regain your perspective.[189]

According to Mr. Looney, the ranks of day traders addicted to gambling are growing: ALast year [1998], slightly under three percent of the council=s hot line calls were from day traders. This year [1999], they=re running at about four percent.@[190] The hot line averages about five or six calls per day from day traders and, when the markets are falling, day traders represent approximately forty percent of the hot line calls.[191] Mr. Looney, Mr. Anderson and Dr. Woolverton agree that increased awareness of the similarities between trading and gambling is one way that compulsive behavior by day traders can be minimized.

PSI=s investigation found one firm that has implemented precautionary measures to detect compulsive trading and provide counseling. At its expense, Broadway Trading, LLC (ABroadway@) has hired Dr. Woolverton=s The Village Institute to consult with its traders whenever they are in need of help.[192] On some occasions, Broadway employees have suggested to day traders who appeared to be having problems that they visit Dr. Woolverton.[193] Dr. Woolverton said that he has met with a significant number of day traders, both from Broadway and other firms and that, in most cases, the traders he counsels return to trade profitably and with discipline.[194] Dr. Woolverton added that Broadway has discussed potential group sessions for all its traders.[195]

F. **Only a Small Percentage of Novice Day Traders Will Be Profitable and Even A Majority of Experienced and Well Capitalized Day Traders Lose Money**

PSI=s investigation indicates that only a small percentage of novice day traders will be profitable and that, even among experienced and well capitalized traders, a majority will lose money. PSI staff reached this conclusion after reviewing internal documents that day trading firms produced to the Subcommittee, interviewing day traders and representatives of the day trading industry, and examining profitability data collected by several day trading firms and securities regulators.

1. Anecdotal Evidence Suggests That Day Trading Is Highly Unprofitable

PSI staff have compiled strong anecdotal evidence suggesting that day trading is highly unprofitable. Much of this evidence comes directly from day trading firms themselves, although the firms continue to speak about day trading careers in glowing terms when talking with potential customers. Barry Parish, the former manager of All-Tech=s San Diego office, admitted during his Subcommittee deposition that eighty to ninety percent of customers who traded at the San Diego office lost enough money to quit within six months.[196] Mr. Houtkin would not take issue with Mr. Parish=s estimate but did indicate that he believes only about one-third of all day traders ever become full-time traders.[197]

In addition, All Tech=s Branch Office Surveys (ASurveys@) from the Boca Raton and Seattle offices indicate that very few customers were turning a profit. In response to the survey question Awhat percentage of your customers are making money,@ the former manager of the Boca Raton Office wrote A0%@[198] and the branch manager of the Seattle office wrote A>10%.@[199] All-Tech=s Chicago office had the most successful traders, noting on the survey that A30%@ of the traders were profitable.[200] In an interview with Subcommittee staff, the Seattle branch manager estimated that about 90 percent of his Seattle customers lost money.[201]

The chances for success were equally grim at Providential. Mr. Fahman testified that only about 20 to 30 percent of traders at Providential make money.[202] Tae Goo Moon, the branch manager of Providential=s Los Angeles office, reported in his response to Subcommittee interrogatories that none of the day traders in the Los Angeles office were profitable.[203] In fact, Mr. Moon estimated that the average day trading customer traded for approximately one month before quitting, and lost approximately $50,000.[204] At his Subcommittee deposition, Mr. Fahman did not dispute Mr. Moon=s estimates.[205] He added that only a Acouple@ of day traders at Providential=s Oregon branch office were profitable and that a substantial majority lost money.[206]

Similarly, Mr. Bright, of Bright Trading, stated in a press account that fewer than 10% of day traders will turn a profit if the trader universe includes those who trade out of their homes.[207] Mr. Bright added that about two-thirds of traders quit day trading during their first year.[208] In response to Subcommittee interrogatories, Direct Net Trading indicated that, as of June 30, 1999, A[a]pproximately 30-40% of total traders at any one time are making money. Typically, less experienced traders lose for three months and by the fourth month they have either become successful or given up.@[209] In its training manual, Cornerstone stated that, A[i]t=s a well known fact that somewhere between

70% and 90% of new traders go bust or quit trading within 6 to 12 months of their first trade.@[210]

While not conclusive, this voluminous anecdotal evidence strongly indicates that, on the whole, day traders lose money and that an extremely high percentage of novice traders fail to achieve profitability. This tentative finding is also generally supported by what little empirical data exists on the success rates of day traders.

2. NASAA Report=s Profitability Study

The NASAA Report was one of the first large scale examinations of the day trading industry. The NASAA Report concluded that A70 percent of public traders will not only lose, but will almost certainly lose everything they invest.@[211] In order to evaluate the profitability of day traders generally, NASAA commissioned a financial consultant to perform a limited study of day trading accounts at one day trading firm=s branch office in Massachusetts. The consultant reviewed 26 randomly selected accounts at the branch office and found that 70% of them lost money, and would likely lose all the capital they traded.[212] Based on that review, the consultant estimated that 70 to 90 percent of all day traders at that branch office lost money.[213]

The day trading industry roundly criticized the NASAA Report because it was based on a relatively small sample of day trading accounts.[214] At the Overview Hearing, ETA=s Counsel, Mr. Cohen, noted that NASAA=s profitability analysis only examined seventeen day trading accounts at a single branch office of a single firm.[215] He also correctly stated that NASAA=s consultant examined only four months of account activity.[216] Mr. Cohen alleged that the sample analyzed in the NASAA report was insufficiently representative to draw broad conclusions about the profitability of day trading generally.[217]

PSI staff find ETA=s critique of the NASAA profitability study valid, though we do believe the study is somewhat instructive regarding profitability. The findings of the NASAA Report are generally consistent with the anecdotal evidence that PSI uncovered in this investigation. Thus, the NASAA Report clearly has some probative value on the question of profitability. PSI staff agree, however, that the sample of accounts reviewed was too limited to draw broad conclusions about the day trading industry as a whole.

3. ETA Indicated at PSI=s Overview Hearing That It Was

Preparing A Broader Profitability Study But ETA

Declined To Commission Such A Study

During PSI=s Overview Hearing, Mr. Cohen testified that ETA was Ain the process of retaining KPMG to conduct a day trading profitability study,@ which was Aexpected to be completed@ within two months of the hearing.[218] In January of this year, PSI staff inquired of ETA about the progress of the study. Through counsel, ETA advised PSI staff that it declined to pursue this study because the cost was prohibitive.[219] Given Mr. Cohen=s strong condemnation of NASAA=s profitability analysis at PSI=s Overview Hearing and his declaration that ETA intended to commission an independent study A[t]o put the matter [of day trading profitability] to rest,@[220] PSI staff find it telling that ETA declined to pursue the study.

4. Profitability Data From Day Trading Firms

In response to Subcommittee document requests, several day trading firms produced profitability data to PSI, including Momentum, Tradescape, LLC (ATradescape@), and Broadway. A cursory review of the data produced by these firms indicates that many of their traders are or were profitable. PSI staff concluded that the profitability data from Momentum,[221] Tradescape[222] and, to a lesser degree, Broadway[223] was unrepresentative for the industry as a whole for many of the same reasons that we found the NASAA Report of limited value. In all three cases, the profitability data derived from a limited sample of day trading accounts and was derived from one firm or even a subset of the firm=s total universe of traders. As such, PSI staff believe that, like the NASAA Report, the profitability data from Momentum, Tradescape and Broadway has limited predictive value for the industry as a whole.

The Momentum data, which the firm has not made public, indicates that 64 percent of Momentum=s experienced traders were profitable from September 1998 through January 1999, and that 44 percent of inexperienced traders were profitable.[224] By comparison, Tradescape reported that 48 percent of its traders were profitable over a six month average when commissions were included.[225]

Broadway posted useful data on its website charting the profitability of its traders in 1999, dividing them by branch office and by experience.[226] For example, Broadway=s data indicates that, when experienced and novice traders are grouped together, a majority lost money in six months of the year.[227] When the sample consisted solely of novice traders, however, the data shows that they were profitable during only the last two months of 1999, and those two months no longer reflected truly novice traders since many of the customers included in the sample at the end of the year had been trading for more than six months by that time.[228] Segregating the novice from the experienced traders clearly demonstrates the significance of the learning curve. Some traders who survived the learning curve eventually began to profit.

A few aspects of Broadway=s data, however, prevent it from presenting an accurate and complete view of the day trading industry overall. For example, Broadway does not keep statistics on how long its traders keep their accounts open and active,[229] and it is impossible to assess from Broadway=s data how many traded for a short time and then gave up. Data concerning this turnover rate would provide a more complete study of overall trader success at Broadway. Moreover, while Broadway=s data is useful, it is still limited to one firm.

Broadway=s 1998 data, which is not posted on the website, probably provides a more accurate picture of the industry because it tracks each trader for the entire year, regardless of how long he or she traded.[230] The 1998 data shows that 53% of Broadway day traders lost money for the year.[231]

5. Though There Is No Definitive Study Regarding the Profitability of

Day Trading, the Best Evidence Suggests That Only a Small Fraction

of Novice Day Traders Are Ever Profitable and That, Even among

Well Capitalized and Experienced Day Traders, a Majority Will Lose Money

In 1999, the Washington Securities Division examined every day trading firm in the State of Washington and, in the process, conducted the most comprehensive profitability analysis that PSI staff have seen to date.[232] The Washington examiners analyzed the day trading account records at the seven day trading firms doing business in the State of Washington.[233] The examiners reviewed day trading account records at each firm for the life of every account, commencing at the opening of each account and ending on the day of the exam.[234] At five of the firms, the examiners reviewed the records for every account.[235] For All-Tech and Richmark Capital Corporation (ARichmark@), however, the examiners reviewed a sampling of accounts because the firms are so large.[236]

Based on this comprehensive analysis, the Washington examiners concluded that, net of commissions, 77 percent of the traders were unprofitable.[237] Moreover, even for the remaining 23 percent that incurred net gains, the profits were small in comparison to the individual losses suffered by the vast majority of day traders.[238] PSI staff find the Washington State study to be the most accurate picture of profitability in the day trading industry because it is based on the most representative sample of day trading accounts. The examiners did not limit their analysis to one firm as was the case with the NASAA Report and the profitability data submitted by Momentum, Tradescape and Broadway. In addition, the examiners determined account profitability based on the life of the account rather than a limited snapshot of a day trader=s success over several months. Lastly, the examiners reviewed all accounts at five of the seven firms, which accurately measures the high turnover that frequently attends day trading and that is often disguised by profitability data that averages the success rates of a changing universe of traders over time.

G. Day Trading Has Resulted In Positive And Negative Market Developments