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Day Trading: Case Studies and Conclusions

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DAY TRADING:
CASE STUDIES AND CONCLUSIONS

R E P O R T

PREPARED BY THE

PERMANENT SUBCOMMITTEE ON
INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE



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Mr. THOMPSON, from the Committee on Governmental Affairs,
submitted the following

REPORT

I. EXECUTIVE SUMMARY

On September 16, 1999, the Permanent Subcommittee on Investigations (“Subcommittee”) held the first congressional hearing on day trading (“Overview Hearing”).¹ The hearing provided an overview of day trading and included testimony from securities regulators and the Electronic Traders Association (“ETA”),² a trade group that represents some day trading firms. Subcommittee Chairman Susan M. Collins raised three questions during that hearing: (1) is day trading similar to gambling for many investors; (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 the Subcommittee would examine these questions through an in-depth investigation of the day trading industry and announced that subsequent hearings would highlight case studies developed by the Subcommittee.³

Over an eight month period, the Subcommittee conducted an investigation by casting a wide net and examining the largest day trading firms. The Subcommittee formally requested documents from nineteen day trading firms through the use of a comprehensive document request. Eighteen of those firms responded to the Subcommittee’s request. Those firms produced approximately

¹Day Trading: An Overview: Hearing Before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, 106th Cong., 1st Sess. 106-285 (1999) (“Overview Hearing”).

²The participants were: Arthur Levitt, Jr., Chairman of the U.S. Securities and Exchange Commission; Mary L. Schapiro, President of NASD Regulation, Inc.; Peter C. Hildreth, President of the North American Securities Administrators Association; David E. Schellenberger, Chief of Licensing for the Commonwealth of Massachusetts Securities Division; and Saul S. Cohen, Consulting Counsel for the ETA.

³Opening Statement of Senator Susan M. Collins, Chairman of the Subcommittee, Overview Hearing, at 3-4 (“Collins Statement”).

50,000 pages of documents to the Subcommittee and at least ten videotapes containing television advertisements. The staff reviewed all of these materials. During the course of its investigation, Subcommittee 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 (“SROs”).

In furtherance of the investigation, the Subcommittee 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. The Subcommittee 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.

In addition, the Subcommittee looked extensively at the support industries that have evolved as day trading has become more popular. 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, training programs and seminars, stock picking systems and software, as well as periodic newsletters that firms distribute by e-mail and facsimile. In this regard, the Subcommittee reviewed a variety of websites that the day trading support industry uses to advertise its products and services and found many questionable claims. The Subcommittee then requested that nine support industry firms provide documentation to support these assertions.

Based on all of the information provided, the Subcommittee narrowed its focus to three day trading firms, which were examined in detail: All-Tech Direct, Inc. (“All-Tech”), Providential Securities, Inc. (“Providential”), and Momentum Securities, Inc. (“Momentum”). The case studies of those three firms are located in sections III, IV and V of this report and were the subject of public hearings on February 24 and 25, 2000. As Ranking Member, Senator Carl Levin, stated at the Subcommittee’s February hearings, “The Subcommittee investigation looked behind the claims of day trading companies and found how some day trading firms skirt the rules, and take advantage of their customers in the pursuit of profits.”⁴

Day trading is a highly speculative activity that can be fairly compared to certain types of gambling. A growing number of people are giving up their existing careers or withdrawing their savings to become full-time professional day traders. The Subcommittee’s investigation suggests that day trading closely resembles gambling for novice, undercapitalized traders. The Subcommittee based this conclusion on statements by regulators, members of the day trading industry, gambling experts, documents produced by day trading firms, and profitability data.

The best evidence, based on studies conducted by state securities regulators suggests that only a tiny fraction of novice day traders

⁴Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

are ever profitable and that, even among well capitalized and experienced day traders, a majority will lose money. In fact, the Subcommittee's February hearings found that more than 75% of day traders lose some or all of their investment. Furthermore, the average day trader must realize gains of more than \$200,000 annually just to pay commissions and fees. The Subcommittee's findings contrast with some of the deceptive advertising the Subcommittee found that has created unrealistic expectations of easy profits. 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.⁵ 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 "income" or "long 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 largely 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—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.

⁵ There is some disagreement between the industry and the regulators as to whether existing suitability rules apply to day trading. NASD Rule 2310 (the "suitability" rule) requires NASD members to have "reasonable grounds" for believing that a recommendation to a customer for the "purchase, sale or exchange of any security" is suitable for that customer. See *infra* Section VI(A) & (B). Regardless of whether the rule applies to day trading, most day trading firms have internal standards for determining whether day trading is a suitable strategy for their prospective customers. The NASD has recently proposed a rule that would require day trading firms to perform an "appropriateness" (i.e. suitability) analysis for each potential customer prior to opening a day trading account. *Id.*

The Subcommittee's findings are similar to those of the Securities and Exchange Commission ("SEC"), state securities regulators, and the securities industry's own self-regulatory organization. The regulators have recognized that the day trading industry needs to establish and then comply with responsible industry standards, as have the more respectable day trading firms. In line with this sentiment, the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE") 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 accounts. 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.

The Subcommittee believes that these rule changes will help combat some of the abuses and problems uncovered by the Subcommittee's investigation but that they require modification. At the conclusion of this report, the Subcommittee includes recommended modifications to the existing proposals from the NASD and the NYSE.

The Subcommittee has also proposed two new rules to more fully address the problems in the day trading industry. These reform proposals were submitted to the SEC in March, 2000. 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.

The Subcommittee does not recommend a ban on day trading. If an investor with adequate capital is fully informed of the risks of day trading, he or she should be allowed to do so. As the Subcommittee found however, far too often, the consumer has no idea of the true risks involved. Too many firms entice inexperienced and undercapitalized individuals to day trade, sometimes with borrowed money that they can ill-afford to lose.

In addition, the Subcommittee closely evaluated the evident impact of the day trading phenomenon on the markets as a whole. The Subcommittee's investigation determined that day trading has had both positive and negative effects on the securities markets, and that the negative developments warrant close scrutiny by regulators and policymakers. As the Subcommittee found, the three developments that have made day trading possible are arguably very positive for investors. First, day traders have added liquidity to the markets. Second, the almost exponential growth in low-cost trading execution platforms has dramatically lowered commissions for investors as more broker-dealers lower commission costs to compete with online trading systems. Third, the new technologies of day trading have greatly expanded access to financial information. All of these changes are positive for investors.

The Subcommittee also found evidence, however that day trading may be contributing to an increase in volatility for individual stocks and the markets as a whole, such as Nasdaq. Some day trading critics contend that the strategies of day traders, such as buying in "up-trending" markets and selling in "down-trending" markets, increases price volatility. Market volatility is generally considered detrimental to investors because stock prices fluctuate

for reasons unrelated to the business prospects of the company or the fair value of its shares. With an estimated ten to fifteen percent of Nasdaq trading volume attributable to day traders, their impact on the markets continues to grow. Though the volatility may be only partially a result of increased day trading, it seems clear that the psychology of day traders has infected the broader markets. Securities regulators and policymakers will need to diligently monitor these trends in order to react prudently to the swift changes underway in our stock markets.

In conclusion, the Subcommittee applauds the democratization of the markets and heralds the many positive developments that have derived from the technology that makes day trading possible. However, simply because an industry utilizes a new technology does not mean that it should be allowed to circumvent the basic tenets of our securities laws. Reasonable and measured government regulation fosters investor confidence and is an important reason the United States has the strongest and most successful capital markets in the world.

II. BACKGROUND

A. Day Trading Defined

Day trading typically is defined as placing multiple buy and sell orders for securities and holding positions for a very short period of time, usually minutes or a few hours, but rarely longer than a day.⁶ Day traders seek profits in small increments from momentary fluctuations in stock prices after paying commissions, which can range from \$15 to \$25 per trade.⁷ The NASD has recently defined a “day trading strategy” as an “overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.”⁸ In its proposal to amend NASD Rule 2520, which would change margin lending requirements for day traders, NASD seeks to:

Revise the definition of “pattern day trader” to include any customer who (a) the firm 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 day 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.⁹

The estimated number of “professional” 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 the Subcommittee that about 4,000 to 5,000 individuals trade from 100 or

⁶Jane Bryant Quinn, “Trade by Day, Lose Sleep by Night,” *Newsweek*, Apr. 18, 1999, at H2. There is no standard definition of the number of trades that characterize a day trading account. Some day traders execute as few as seven buy and sell orders per day, while others may make 100 or more trades per day. See Jeffrey H. Harris and Paul H. Schultz, “The Trading Profits of SOES [“Small Order Execution System”] Bandits,” 50 *J. Fin. Econ.* 39, 51 (1998).

⁷NASAA, Report of the Day Trading Project Group, at 7 (Aug. 9, 1999) (“NASAA Report”).

⁸NASD Proposed Rule 2360(e).

⁹“Proposed Rules Change by National Association of Securities Dealers, Inc.,” File No. SR-NASD-0-03, Jan. 13, 2000.

more specialized day trading firms.¹⁰ 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.¹¹

A close relative to the day trader is the “swing” 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.¹²

Day traders do not invest in a particular security based on the fundamental strengths or weaknesses of the company. Indeed, the trading decision may have nothing whatsoever to do with the merits of a particular stock. One day trader was quoted as follows: “Wall Street’s not about investing anymore, it’s about numbers. Who cares whether [the stock] is a car company or a chemical company? Who cares what they’re going to be doing in 2000?”¹³ 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 (“Cornerstone”) describes the differences between day trading and traditional investing as follows:

Unlike in traditional investing where the investor’s returns are pegged to market indexes 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 movement—up or down, the direction is not as important as the presence of volatility.¹⁴

Mr. Lee explained that day trading is more active than traditional investing and focuses on the short term.¹⁵ 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.¹⁶

B. Regulatory Structure and Enforcement Activities

(1) Securities & Exchange Commission (“SEC”)

(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.¹⁷ The most prominent SROs include the

¹⁰ According to the Congressional Research Service (“CRS”), it is difficult to estimate the total number of day traders since many quit, due to losses, within three months of starting. See Congressional Research Service, Day Trading, at 2 (1999).

¹¹ Interview of William Lauderback, Aug. 11, 1999 (“Lauderback Int.”).

¹² Deposition of Henry D. Fahman, Dec. 15, 1999, at 119 (“Fahman Dep.”).

¹³ Ianthe Jeanne Dugan, “For These Day Traders, Stock Market Is One Big Casino,” Washington Post, Feb. 25, 1999, at A1.

¹⁴ Training Manual, “The Fundamentals of Successful Day Trading,” Cornerstone Securities Corporation, 1999, at 2 (“Cornerstone Training Manual”) (Day Trading: Everyone Gambles But the House: Hearing Before the Permanent Subcommittee on Investigations of the Committee on Government Affairs, 106th Cong, 2nd Sess. (February 24–25, 2000) (“Feb. Hr’gs”) Ex. 135.

¹⁵ Deposition of James H. Lee, Dec. 22, 1999, at 70 (“Lee Dep.”).

¹⁶ *Id.*

¹⁷ SROs are “member organizations that create and enforce rules for its members based on the federal securities laws.” “The Investor’s Advocate: How the SEC Protects Investors and

NYSE, the American Stock Exchange (“AMEX”), the Philadelphia Stock Exchange (“Phlx”), and the NASD.¹⁸ 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.¹⁹

The SEC’s Division of Enforcement (“Enforcement”) investigates potential violations of the federal securities laws.²⁰ 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.²¹ The SEC only has authority to pursue civil remedies for violations of federal securities laws, but it routinely supports criminal law enforcement efforts:

While the SEC has civil enforcement authority only, it works closely with various criminal law enforcement agencies throughout the country to develop and bring criminal cases when the misconduct warrants more severe action. The Division obtains evidence of possible violations of the securities laws from many sources, including its own surveillance activities, other Divisions of the SEC, the self-regulatory organizations and other securities industry sources, press reports, and investor complaints.²²

The SEC files about 400 to 500 civil enforcement actions each year.²³

(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 of more than 60 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.²⁴ 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 “had not found marked and widespread fraud by these firms.”²⁵ 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.²⁶ Chairman Levitt stated that the examinations were also focusing on advertisements and promotions that were inconsistent with NASD rules.²⁷

(c) *Enforcement Actions Against Day Trading Firms.* During his testimony, Chairman Levitt noted that the Division of Enforcement was pursuing “several active investigations concerning day trading operations,” most of which derived from the examinations being

Maintains Market Integrity,” www.sec.gov/asec/wwwsec.htm, Dec. 1999, at 6 (“Investor’s Advocate”).

¹⁸ John R. Hewitt et al., *Securities Practice and Electronic Technology* at ¶6.02 (1998).

¹⁹ *Id.*

²⁰ “About the Division of Enforcement,” www.sec.gov/enforce/abenf.htm, Jan. 30, 2000, at 1.

²¹ The SEC has five presidentially-appointed commissioners, each serving a five-year term. *Investor’s Advocate* at 3.

²² *Id.* at 7–8.

²³ *Id.* at 2.

²⁴ Prepared Statement of Hon. Arthur Levitt, Jr., Chairman, U.S. Securities and Exchange Commission, Overview Hearing, at 61 (“Levitt Statement”).

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.* at 62.

conducted by the SEC.²⁸ 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.²⁹ As the result of these investigations, the SEC brought enforcement actions against two day trading firms in February, 2000. The Commission said that the firms violated regulations put in place to protect investors. Specifically, All-Tech Direct Inc., was charged with making 103 loans exceeding \$3.6 million to customers throughout 1998 in violation of federal rules.³⁰ Regulators also contend that All-Tech management failed to advise its customers of the loan terms. A second, smaller day-trading company based in Miami, the Investment Street Company, was accused of similar loan violations. The SEC contends that the firm improperly extended \$250,000 in credit to customers, and allowed people to conduct business as registered stockbrokers even though they were not registered.³¹

(2) *Self-Regulatory Organizations (“SRO”)*

(a) *Jurisdiction.* The SEC’s website describes SROs as “the front line in regulating broker-dealers.”³² 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 “Designated Examining Authority,” which is then responsible for regulating the member firm.³³ For purposes of the Subcommittee’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.³⁴ The regulatory arm of the NASD is NASD Regulation, Inc. (“NASDR”), which is an independent subsidiary of the NASD.³⁵ “Virtually every broker-dealer in the U.S. that conducts a securities business with the public is required by law to be a member of the NASD.”³⁶ There are 5,600 NASD member firms, operating over 75,000 branch offices with more than 600,000 registered securities professionals.³⁷ NASDR performs its regulatory function through “registration, 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.”³⁸ 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 member firms,

²⁸ Id. at 77.

²⁹ Id.

³⁰ Morgenson, Gretchen, “U.S. Accuses 3 Companies Of Violations,” New York Times, Feb. 23, 2000, at C1.

³¹ Id.

³² Investor’s Advocate at 6.

³³ Pursuant to Section 17(d)(1)(B) of the Securities Exchange Act of 1934, the SEC may “allocate among self-regulatory organizations the authority to adopt rules with respect to matters as to which, in the absence of such allocation, such self-regulatory organizations share authority under this title.” 15 U.S.C. § 78q(d)(1)(B).

³⁴ Prepared Statement of Mary Schapiro, President of NASDR, Overview Hearing, at 81 (“Schapiro Statement”).

³⁵ “NASD Regulation—Who We Are,” www.nasdr.com/2200.htm.

³⁶ Schapiro Statement at 81.

³⁷ Id.

³⁸ “NASD Regulation—Who We Are,” www.nasdr.com/2200.html.

broker terminations for cause, market surveillance, and referrals from [its] arbitration, corporate financing and advertising departments. It also uses external sources, including federal and state agencies, customer complaints, news media and anonymous tips.³⁹

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.⁴⁰

Like the NASD, the NYSE has numerous member firms that it regulates and whose conduct is subject to NYSE rules.⁴¹ NYSE is the Designated Examining Authority for most of its member firms.⁴² It is responsible for regulating firms that “carry 63 million customer accounts and operate over 10,800 branch offices throughout the world, employing 128,000 registered personnel.”⁴³ The NYSE

uses a broad range of techniques that includes: sophisticated and comprehensive computer-assisted analysis; field visits by Exchange Examination staff; constant monitoring of the status of, and information relating to, its membership; and finally, the investigation and prosecution of violators of Exchange rules and the Securities and Exchange Act of 1934 and rules thereunder.⁴⁴

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.⁴⁵ As such, these Phlx firms need not comply with NASD rules.⁴⁶ These firms avoid NASD membership by operating as limited liability companies (“LLCs”), rather than as traditional broker-dealers.⁴⁷ The LLCs sell interests to day traders so that those persons are part-owners of the firm rather than customers of the firm.⁴⁸ 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.⁴⁹ 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 7.⁵⁰ Thus,

³⁹ Schapiro Statement at 81a (errata sheet).

⁴⁰ Id. at 81a (errata sheet)—82.

⁴¹ “NYSE, Member Firm Regulation,” www.nyse.com/regulation/memberfirmreg.html.

⁴² Id.

⁴³ Id.

⁴⁴ Id.

⁴⁵ Levitt Statement at 60.

⁴⁶ Id.

⁴⁷ Under Rule 15b9-1 of the Securities Exchange Act of 1934, a broker-dealer that does not have customer accounts and is a member of a national securities exchange is not required to be a member of the NASD. 17 CFR § 240.15b9-1.

⁴⁸ Levitt Statement at 59.

⁴⁹ Id. at 60.

⁵⁰ “Order Granting Approval to Proposed Rule Change and Amendment Nos. 1 and 2 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change Requiring Off-Floor Traders for which the Phlx is the Designated Examining Authority to Successfully Complete the General Securities Representative Examination Series 7,” SEC Release No. 34-41776, File No. SR-Phlx-99-07 (Aug. 20, 1997).

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.⁵¹ The firms varied in size and composition.⁵² 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.⁵³ During the overview hearing, NASDR President Mary Schapiro testified that NASDR discovered several potential problem areas during the examinations, “including advertising, Regulation T and margin lending, registration of individuals, short sales and supervision.”⁵⁴ 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.⁵⁵

(c) *Enforcement Actions Against Day Trading Firms.* The NASDR has yet to bring any enforcement actions against day trading firms. 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.⁵⁶ The allegations included violations of “day 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.”⁵⁷ 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.⁵⁸ 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 firm’s “policies, procedures, practices and supervisory systems,” a general counsel, an internal auditor and a full-time Director of Compliance.⁵⁹ The Hearing Panel also penalized the individual respondents through censures and suspensions.⁶⁰

(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

⁵¹ Schapiro Statement at 92.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ NYSE Exchange Hearing Panel Decisions 99–158, 99–159, 99–160, and 99–161, Nov. 18, 1999. The firm, Schonfeld Securities, LLC, is a proprietary trading firm with two categories of traders—day traders and overnight traders. Although the majority of the firm’s traders were proprietary traders, the firm also had over 100 customer accounts. *Id.* at 11–12. The respondents consented to the findings by the Hearing Panel, although they neither admitted nor denied guilt. *Id.*

⁵⁷ *Id.* at 10.

⁵⁸ *Id.*

⁵⁹ *Id.* at 28–29.

⁶⁰ *Id.* at 30.

American Securities Administrators Association, Inc. (“NASAA”). NASAA is a voluntary association which acts as the voice of the fifty state securities agencies.⁶¹ The shared system of federal and state securities regulation developed in 1934, when Congress created the SEC.⁶² “The 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.”⁶³ The state securities agencies conduct licensing and registration activities.⁶⁴ Each state agency also has an enforcement division that investigates fraud and abusive sales practices.⁶⁵

In most states, persons acting as investment advisers must be registered with the state unless they are exempt.⁶⁶ An “investment adviser” is a person who advises others for compensation concerning the value of securities or the advisability of investing in, purchasing or selling securities.⁶⁷ Under the National Securities Markets Improvement Act of 1996 (“NSMIA”), 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.⁶⁸ 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.⁶⁹ An investment adviser with more than \$25 million under management is required to register with the SEC.⁷⁰ 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.⁷¹

(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 (“Washington Division”) recently conducted examinations of the seven day trading firms located in the State of Washington.⁷² 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

⁶¹ “NASAA: Who We Are,” www.nasaa.org/whoweare, at 1–2.

⁶² *Id.* at 1.

⁶³ *Id.* at 2.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ The states that do not register investment advisers are Georgia, Louisiana, Michigan, Minnesota, New Jersey, New York, Tennessee, and Wyoming. “NASAA: New Investment Advisers must take ‘competency exam’ starting Jan. 1,” www.nasaa.org/whoweare/media/IAexam.html, at 2.

⁶⁷ Investment Advisers Act of 1940, Section 202(a)(11), 15 U.S.C. §806–2(a)(11)(A).

⁶⁸ “Memorandum of Understanding Concerning Investment Advisers and Investment Adviser Representatives,” Apr. 27, 1997, www.nasaa.org/iaoversight/iamou.html, at 1.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ National Securities Markets Improvement Act of 1996, National Pub. L. No. 104–290 (Oct. 11, 1996); Mass. Regs. Code tit. 950, §12.205; Cal. Corp. Code §25202.

⁷² Telephone Interview of Deborah Bortner, Director of Securities for the Washington Securities Division, and Christina Knipe, Counsel for the Washington Securities Division, Nov. 18, 1999, at 1 (“First Bortner Int.”); Telephone Interview of Deborah Bortner, Director of Securities for the Washington Securities Division, and Christina Knipe, Counsel for the Washington Securities Division, Dec. 20, 1999, at 1 (“Second Bortner Int.”).

calls.⁷³ The Washington Division did not find significant evidence of misleading advertising or inadequate risk disclosures.⁷⁴ 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.⁷⁵

(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,⁷⁶ Tennessee,⁷⁷ Indiana,⁷⁸ Texas⁷⁹ and Wisconsin⁸⁰ 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.⁸¹ 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 ("NASAA Report"), the purpose of which was "to assist state securities regulators in understanding, and responding to, the issues posed by the day trading industry."⁸² 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.⁸³ 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.⁸⁴

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;

⁷³First Bortner Int. at 1. For example, at one firm, the examiners found that the president of the firm was lending money to customers. Second Bortner Int. at 2. While at another firm, a person in a different city loaned an aggregate of more than \$1 million to several Washington State customers. Id.

⁷⁴Second Bortner Int. at 2.

⁷⁵First Bortner Int. at 1; Second Bortner Int. at 2.

⁷⁶In re Landmark Securities, Inc., Mass. Sec. Div. 99-29 (July 8, 1999); In re TCI Corp., Inc., Mass. Sec. Div. 99-9 (Mar. 2, 1999); In re On-Line Investment Services, Inc., Mass. Sec. Div. 99-1 (Jan. 14, 1999); In re All-Tech Investment Group, Inc., Mass. Sec. Div. 98-77 (Dec. 10, 1998); In re Bright Trading, Inc., Mass. Sec. Div. 98-70 (Nov. 9, 1998); In re Block Trading, Inc., Mass. Sec. Div. 98-58 (Oct. 19, 1998).

⁷⁷Tennessee Securities Div. v. Carlin Equities Corp., Docket No. 12.06-004482J, File No. 98-011 (Dec. 11, 1998), Complaint Amended, Apr. 23, 1999.

⁷⁸In re Self Trading Securities, Inc., In. Sec. Div., Cause No. 99-0047 (Feb. 16, 1999).

⁷⁹In re Infnitum Capital Management, Inc., Tex. SSB, Docket No. 97-011 (Jan. 6, 1999); In re Day Trade, Inc., Tex. SSB, Ref. 98-020 (Apr. 6, 1998).

⁸⁰In re Block Trading, Inc., Wis. Sec. Div., File S-981 (Dec. 17, 1998).

⁸¹NASAA Report at 41-44.

⁸²NASAA Report, "Preface."

⁸³Id. at "Members of Project Group."

⁸⁴Id. at 4.

- 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.⁸⁵

The NASAA Report also contended that day trading is analogous to gambling and is unprofitable for most customers.⁸⁶

C. 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 “a computerized, over-the-counter stock market called Nasdaq.”⁸⁷ In 1985, Nasdaq created SOES, the Small-Order Execution System, to enable individual traders to directly and automatically trade within the market.⁸⁸ “As 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.”⁸⁹ 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.⁹⁰ After the stock market crash of 1987, the Nasdaq generally mandated that market makers honor orders executed through SOES.⁹¹

There are several key characteristics of SOES that include:

- SOES trades cannot exceed lots of greater than 1,000 shares.
- A SOES trader is prevented from either buying or selling the same stock during a five minute period.
- A market maker must honor the SOES transaction.⁹²

It was through the use of the SOES system that a notorious group of traders, known as “SOES bandits,” first took advantage of direct access electronic trading to earn quick profits on small price fluctuations in stocks.⁹³ “The SOES system * * * enabled the creation of a whole new class of trader, commonly referred to as the SOES Trader.”⁹⁴

The modern day trader is no longer limited to SOES. Indeed, it has become increasingly evident that today’s day trader conducts his business via a much broader mechanism than just SOES. With the advent of the various electronic communication networks (ECNs) and advances in the technology that delivers data and executes our orders, SOES today is simply one method of transacting an order.⁹⁵

⁸⁵ Id. at “Summary.”

⁸⁶ Id. at 5.

⁸⁷ Cornerstone Training Manual, Introduction, at 2.

⁸⁸ Jennifer Basye Sander and Peter J. Sander, *Day Trading Like a Pro*, at 69 (1999).

⁸⁹ Cornerstone Training Manual, Introduction, at 2.

⁹⁰ Sander and Sander, *Day Trading Like a Pro*, at 69.

⁹¹ Id. at 19.

⁹² Id. at 69.

⁹³ Harvey I. Houtkin and David Waldman, *Secrets of the SOES Bandit 1–2* (1999).

⁹⁴ Cornerstone Training Manual, Introduction, at 3.

⁹⁵ Id.

Originally established over 30 years ago to handle large blocks of stock trades, electronic communication networks (“ECNs”) now allow customers to trade directly with each other or place orders directly to the market.⁹⁶ Customers who use an ECN are part of an internal network and may place their buy and sell orders within that network of traders.⁹⁷ Other traders on that network can see the order and fill it, or contact the trader to negotiate a different price.⁹⁸ Day traders utilize ECNs as their primary means to place limit orders.⁹⁹ 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 “inside” 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.¹⁰⁰ 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.¹⁰¹ 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 has grown dramatically as a full-time profession 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.¹⁰² 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 “customer.” These “agents” 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, “performance deposit” as it is called, to cover losses incurred by the individual agents.¹⁰³ Phlx firms also charge commissions to their agents.¹⁰⁴

⁹⁶ Sander and Sander, *Day Trading Like a Pro*, at 70.

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* at 71.

¹⁰⁰ *Id.* at 157.

¹⁰¹ *Id.* at 159.

¹⁰² Table 1: The Ten Largest Day Trading Firms as Measured by Number of Branch Offices:

Firm; Home Office Location; and Number Of Branch Offices:

Carlin Financial Group—New York, New York: 36

All-Tech Direct, Inc.—Montvale, New Jersey: 23

Bright Trading, Inc.—Las Vegas, Nevada: 23

Cornerstone Securities—Austin, Texas: 19

Landmark Securities—Houston, Texas: 15

Andover Brokerage—Montebello, New York: 13

Tradescape, LLC—New York, New York: 12

Terra Nova Trading—Chicago, Illinois: 11

On-line Investment—Jersey City, New Jersey: 10

Stock USA—San Diego, California: 10

Source of Information: NASAA Report.

¹⁰³ NASAA Report at 3.

¹⁰⁴ Dugan, “For These Day Traders, Stock Market Is One Big Casino,” at 3. For example, Bright Trading—a Phlx firm—charges its customers a penny a share per trade. *Id.*

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 trading customers.

The Subcommittee's investigation found that the day trading industry has grown dramatically over the last three years. The fifteen firms examined by the Subcommittee 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.

The Subcommittee'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—in the aggregate—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, “[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.”¹⁰⁵

(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.¹⁰⁶ 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.¹⁰⁷ Rather, online brokerage firms generally refer customer orders to other entities—such as market makers—for execution.¹⁰⁸ 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.

¹⁰⁵ Cornerstone Training Manual, Introduction, at 3.

¹⁰⁶ Id.

¹⁰⁷ Id.

¹⁰⁸ U.S. General Accounting Office, “Securities Market Operations; The Effects of Small Order Execution System (“SOES”) on the NASDAQ Market,” Aug. 31, 1998 (GAO/GGG-98-194), at 3 (“GAO SOES Report”). Market makers are NASD-member securities firms that “make markets” in particular securities by agreeing to buy and sell the securities at quoted prices. Market makers provide liquidity to the Nasdaq market.

There are about 1.7 million people in the United States who are categorized as “hyper-active traders.”¹⁰⁹ It is estimated that “hyper-active” traders execute 80 to 100 stock trades per year through their online brokerage accounts.¹¹⁰ 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.¹¹¹

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 Subcommittee 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.¹¹² 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.¹¹³

The technology available to day trading firms also has attracted the interest of several leading investment and securities firms.¹¹⁴ 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. (“On-Site”), a day trading firm, markets its execution system as a tool for on-line investors to avoid paying higher execution costs resulting from “order flow” agreements between discount brokerage firms and market makers.¹¹⁵ The advertisement depicts a large man gorging himself at a buffet table and states that “your online broker may not live by commissions alone.”¹¹⁶ The advertisement then explains as follows: “Online 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.”¹¹⁷ 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 rout-

¹⁰⁹ Interview of Dan Burke, Gomez Advisers, July 29, 1999 (“Burke Int.”). Gomez Advisers is a consulting firm located in Concord, Massachusetts that provides information about on-line broker-dealers. Id.

¹¹⁰ Id.

¹¹¹ Telephone Interview of James H. Lee, President of ETA, Aug. 11, 1999.

¹¹² Id.

¹¹³ Harvey I. Houtkin, Remarks at an All-Tech Informational Seminar, July 21, 1999 (“Houtkin Remarks”).

¹¹⁴ David Barboza, “Why Big Firms Are Courting Day Traders,” N.Y. Times, Aug. 13, 1999, at C1.

¹¹⁵ Advertisement of On-Site Trading, Inc. (Feb. Hr’g Ex. 1).

¹¹⁶ Id.

¹¹⁷ Id.

ing systems that could someday give all investors instant access to the financial markets.¹¹⁸

(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,¹¹⁹ 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 "expert investment advice" for a fee.¹²⁰ Chairman Levitt added that these websites often highlight the potential rewards of day trading without providing adequate risk disclosure.¹²¹ The Subcommittee's investigation found evidence to support Chairman Levitt's concern.

The Subcommittee 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-free, 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. The Subcommittee 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 the Subcommittee's request.

(a) *Lazy Day Trader*. "Lazy Day Trader" is a website that made statements promising a life of leisure and independence with very little effort. Frank van der Lugt continually refers to his product, which he sells for \$300,¹²² as a "system" and describes it as "a simple method to determine what to buy and sell, how much, and when to buy and sell which everyone can follow."¹²³ On only one of the more than twelve pages of his website does Mr. van der Lugt refer to his "system" as a paper document. In his response to the Subcommittee's interrogatories, however, Mr. van der Lugt claimed

¹¹⁸ Barboza, "Why Big Firms Are Courting Day Traders," at C1.

¹¹⁹ Subcommittee staff counted nearly 50 day trading titles currently for sale as of January 2000. Amy Lambo, "bn.com" business editor, included *The Day Trader: From the Pit to the PC* by Lewis J. Borsellino and Patricia Commins on her list of "Best Business Books of 1999." bn.com Subjects—Business, at www.barnesandnoble.com/book. In August 1999, Subcommittee staff contacted publisher John Wiley & Sons and learned that at least 55,000 copies of *Day Trade Online* by Christopher Farrell have been sold. In August 1999, two of the Barnes & Noble Top 20 business books were the day trading titles: *How to Get Started in Electronic Day Trading* by David S. Nassar and *Electronic Day Traders' Secrets* by Marc Friedfertig and George West. bn.com Subjects—Business, at www.barnesandnoble.com/subj. In addition, Mr. Houtkin has published two books: *Secrets of the SOES Bandit: The Original Electronic Trader Reveals His Battle-Tested Trading Techniques* in 1999, and *SOES Bandits' Guide: Day Trading in the 21st Century* in 1995.

¹²⁰ Levitt Statement at 64.

¹²¹ *Id.*

¹²² www.lazydaytrader.com, July 30, 1999. On the "What will your Day Trading System give me" page of his website, Mr. van der Lugt refers to his system as "[a] complete 220 page structured Electronic Day Trading System allowing you to start Trading and to Make Money immediately." *Id.*

¹²³ "The Ideal Profession: Daytrading!", www.lazydaytrader.com, July 30, 1999, at 1.

that his website is designed to promote a book recounting his experiences as a day trader.¹²⁴ Mr. van der Lugt posted the following glowing statements on his website, creating the impression that day trading is a simple way to get rich:¹²⁵

- I can work my own hours, take as much time off as I want and when I am finished trading I am finished and the money is in my account insured up to \$500,000.¹²⁶
- I will show you how you can make money even when the market is down, up or sideways and how you can protect against losses while letting the winners ride.¹²⁷
- You don't have to be able to understand Economics, the [sic] Stockmarket or International Finance.¹²⁸
- I am not a rocket scientist, [sic] brainsurgeon or computer whiz.¹²⁹

(b) *Taking Profits*. The Subcommittee examined a website for Taking Profits Publishing (“Taking 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: “Trading 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.”¹³⁰

In an effort to capitalize on the day trading craze he encourages, Mr. Russo sells a weekly “Taking Profits” newsletter at a yearly subscription rate of \$349, and a “Day Trader Newsletter” at a yearly rate of \$990.¹³¹ Mr. Russo also offers a six lesson online, “How to Beat the Market,” course that costs \$99.95 and purports to teach students how to use charts, price patterns, and indicators.¹³² In Mr. Russo’s own words, “[a]fter taking my course, you’ll know how to spot the winners[.]”¹³³ Mr. Russo added that “[y]ou can start today and begin to profit tomorrow.”¹³⁴ Mr. Russo positioned limited risk information on the “Company Information” page of his

¹²⁴ Letter from Frank van der Lugt, Lazy Day Trader, to K. Lee Blalack, II, Chief Counsel & Staff Director for the Subcommittee, Sept. 17, 1999, at 1 (Feb. Hr’g Ex. 2).

¹²⁵ “The Ideal Profession: Daytrading!” www.lazydaytrader.com, July 30, 1999, at 3. Mr. van der Lugt posted the following at the bottom of his website home page under the heading “Important: Please Read”:

This System was designed and is being sold with the understanding that my personal trading experiences past and future may and will not be the same as yours.

You should also understand that Day Trading is a very high risk business in which you may lose considerable amounts of money.

The System is also being sold with the understanding that the author is not engaged in rendering legal, accounting or other professional services.

The Trading System is not meant to be an endorsement or offering of any stock for purchase.

We do not represent ourselves as investment advisors [sic] and you should consult a professional stockbroker or competent financial advisor before utilizing the techniques outlined in our Day Trading System. Id.

¹²⁶ Id.

¹²⁷ Id.

¹²⁸ Id.

¹²⁹ Id.

¹³⁰ “Home page.” www.takingprofits.com, July 29, 1999, at 1.

¹³¹ “Taking Profits Publishing—Company Information Page,” www.takingprofits.com, July 29, 1999, at 1.

¹³² “How to Beat the Market—Online,” www.takingprofits.com, July 29, 1999, at 1.

¹³³ Id.

¹³⁴ Id.

website at the end of a paragraph detailing the subscription costs of his newsletters.¹³⁵

Despite the Subcommittee's written request, Mr. Russo provided no documentation to support the statements about the course posted on his website. Instead, Mr. Russo simply directed the Subcommittee to the website, a copy of which he enclosed, stating that "[a]ll information is found on our website."¹³⁶ Interestingly, however, the copy of the website *Taking Profits* mailed to the Subcommittee did not contain the statements the Subcommittee questioned, because he had subsequently removed them from his website.

(c) *Coastal Day Traders*. Richard Kane of Coastal Technologies Group ("Coastal Technologies") posted several questionable claims on the website he uses to promote stock picking software called the "Wealth Wizard."¹³⁷ Mr. Kane claimed that he is awaiting a patent for the Wealth Wizard,¹³⁸ and that the methods it employs "were developed over three years of active trading, and take full advantage of 14 years of experience with pattern analysis, mathematical modeling and artificial intelligence."¹³⁹ Coastal Technologies' website does make some risk disclosures,¹⁴⁰ but contains the following claims:

- Wealth Wizard monitors your portfolio in real time, executing trades automatically.¹⁴¹
- Wealth Wizard performs the kind of careful, tireless monitoring required, giving you a potential daily return on your investments, while minimizing your risks.¹⁴²
- You make money on the way up and more on the way down.¹⁴³

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 modifica-

¹³⁵The risk information, printed in small font on the sample "Day Trader" newsletter, stated the following:

Contents herein are believed to be reliable, however, their accuracy and completeness cannot be guaranteed. Past performance cannot be indicative of future results. Do not assume that present or future recommendations will be profitable. The securities portfolios of employees, or affiliated companies may include securities included in "Taking Profits" and "Day Trader" newsletter.

"Company Information Page," www.takingprofits.com, July 29, 1999. In addition, *Taking Profits'* risk disclosure statement also included the following:

Sophisticated traders only, who are aware of the risks in forecasting and trading, should use the Day Trader. There is absolutely no guarantee that any indicators, theory charts or indices will assure stock market success. Making money in the stock market is a high-risk undertaking.

"June 23," www.takingprofits.com, July 29, 1999.

¹³⁶Letter from Louis Russo, *Taking Profits*, to Subcommittee staff, Sept. 20, 1999, at 1 (Feb. Hr'g Ex. 3).

¹³⁷"Home page" www.coastaldaytrader.com, July 30, 1999.

¹³⁸Letter from Richard Kane, Coastal Technologies Group, to K. Lee Blalack, II, Chief Counsel & Staff Director for the Subcommittee, Sept. 9, 1999, at 1 ("Kane Letter") (Feb. Hr'g Ex. 4).

¹³⁹"Home page," www.coastaldaytrader.com, July 30, 1999.

¹⁴⁰Id. Mr. Kane posted the following statement at the bottom of his website's home page: "There is no guarantee that past results will be recreated in the future. Investing in the markets, actively or not, carries significant risk. Invest only risk capital, that you are prepared to lose. If you can not tolerate risk, do not invest with this program." Id.

¹⁴¹Id.

¹⁴²Id.

¹⁴³Id.

tion.¹⁴⁴ Mr. Kane noted in his response to the Subcommittee that no Wealth Wizard software systems have yet been sold.¹⁴⁵ Coastal Technologies subsequently removed, without comment, the above cited claim that “you make money on the way up and more on the way down,” and posted additional information on the risks associated with day trading.

(d) *Precision Management Group*. Precision Management Group, Inc.’s (“Precision”) website promotes day trading as a stepping stone to a prosperous life. A division of 1-800RETIRENOW.COM, Inc., Precision offers a “Precision Day Trader Seminar” and the “Pro-Trader Boot Camp.”¹⁴⁶ Precision also offers several online services such as a “Trader-Online Student Chat Room,” a “Trade-Tutor Strategic Market Analysis” and “Online Mastermind Interactive Seminars.”¹⁴⁷ Precision has a page link from its home page to its risk disclosure page and is one of the few support industry firms the Subcommittee examined that presented balanced risk information with its claims.¹⁴⁸ 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: “The 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.”¹⁴⁹

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

The founders of Precision realized long ago that “trading” (despite being a very efficient and profitable way of making a living), is nothing more than 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!¹⁵⁰

Each day of our Boot Camps is jam-packed with live trading sessions and focused, small group tutorials that cannot help but propel your skills to an entirely new level of profitability.¹⁵¹

In its response to the Subcommittee’s interrogatories, Precision had no support for its statement “trading your way to a better life,” or its claim that trading is an efficient and profitable means of mak-

¹⁴⁴“Home,” www.coastaldaytrader.com, Nov. 4, 1999. The second claim now reads: “Wealth Wizard performs the kind of careful, tireless monitoring required, giving you a potential daily return on your investment, while *attempting* to minimize your risk.” *Id.* (emphasis added).

¹⁴⁵Kane Letter at 1. Mr. Kane also stated in his response that, “prior to the sale of the software we will seek support to re-work the informational and disclosure sections of the license agreement, web site, and related materials to ensure compliance with both the spirit and intent of regulations and in keeping with good business practice.” *Id.*

¹⁴⁶“Weekly Calendar of Advanced Support Services,” www.precisiondaytrader.com, July 29, 1999, at 1.

¹⁴⁷The Subcommittee was unable to determine course prices from the website, although documents Precision provided to the Subcommittee indicate that the Precision Day Trader Seminar costs approximately \$1,495 and the Pro-Trader Boot Camp costs approximately \$3,500. “Customer Data Base From Inception through the end,” at 1.

¹⁴⁸“Risk Disclosure,” www.precisiondaytrader.com, July 29, 1999.

¹⁴⁹*Id.*

¹⁵⁰“Explanation of Events,” www.precisiondaytrader.com, July 29, 1999, at 1.

¹⁵¹*Id.*

ing a living, other than to state that those are opinions.¹⁵² Precision attempted to justify its claim that its courses are highly effective by submitting a record of trades made during Precision classes.¹⁵³ The Subcommittee 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.¹⁵⁴ Moreover, shortly after receiving the Subcommittee's interrogatories, Precision removed the above cited claims from its website.

(e) *Winning Day Traders*. The Winning Day Traders website promotes a chat room featuring "Exceptional 'Real-Time' Stock Recommendations" and "Minute by Minute Market Analysis and News Alerts in Our Trading Auditorium."¹⁵⁵ 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 "Secrets 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.¹⁵⁶ Winning Day Traders provided the Subcommittee with no support for the claims of "Explosive Winning Strategies and Secrets to Increased Profitability."¹⁵⁷ Rather, Winning Day Traders simply referred to the claims as "slogans that we came up with,"¹⁵⁸ and later removed them from the website without comment.

(f) *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 \$995.¹⁵⁹ RML Trading also offers direct market access to its customers.¹⁶⁰ 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.¹⁶¹
- 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.¹⁶²

RML Trading stated in its cover letter to the Subcommittee that the above statement reflects "the opinions of successful day trad-

¹⁵² Letter from Kathy K. Cregan, CFO of 1800retirenow.com, Inc., to Eileen Fisher, Subcommittee Investigative Assistant, Nov. 10, 1999, at 2 (Feb. Hr'g Ex. 5).

¹⁵³ "Copies of Trades Made During the Live Course," Precision Management Group, Inc. (Feb. Hr'g Ex. 6).

¹⁵⁴ Id.

¹⁵⁵ "WinningDayTraders," www.winningdaytraders.com, Sept. 21, 1999, at 1.

¹⁵⁶ "Consulting Services," www.winningdaytraders.com, Aug. 2, 1999.

¹⁵⁷ "Welcome to WinningDayTraders," www.winningdaytraders.com, Aug. 2, 1999. In addition, the website's risk disclosure is limited to the following disclaimer: "Please note: We are required by the SEC to state that past performance is not indicative of future results and that we also do not expect that members or guests achieve these exact or similar results. Commissions have not been used to compute the results as they vary." "WinningDayTraders," www.winningdaytraders.com, Sept. 21, 1999, at 1.

¹⁵⁸ Letter from Brian Zavodnik, WinningDayTraders, to K. Lee Blalack, II, undated, at 2 (Feb. Hr'g Ex. 7).

¹⁵⁹ "RML Trading," www.thestockcam.com/home, Sept. 21, 1999, at 1. RML Trading includes additional risk information on a form that customers must sign before training to day trade.

¹⁶⁰ Id.

¹⁶¹ "Frequently Asked Questions," www.thestockcam.com, Aug. 3, 1999, at 1.

¹⁶² Id.

ers.”¹⁶³ It is unclear which successful day traders RML Trading consulted, since in that same letter, RML Trading stated that it “does not have information, including internal or external reports, on the financial performance of the individuals who have completed the StockCam program.”¹⁶⁴ RML Trading also disclosed that it is undergoing NASD review.¹⁶⁵ RML Trading removed the above cited claims from its website shortly after it received the Subcommittee’s letter. The website’s risk disclosure is comprised of the following three sentences: “The 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.”¹⁶⁶

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.

D. 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, “very few Americans would think it prudent to quit their jobs or to cash in their retirement savings to become professional gamblers who support their families at a Las Vegas casino.”¹⁶⁷ Yet, a growing number of people are giving up their existing careers or withdrawing their savings to become full-time professional day traders. The Subcommittee’s investigation suggests that day trading closely resembles gambling for novice, undercapitalized traders. The Subcommittee 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,¹⁶⁸ 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.

¹⁶³ Letter from Ralph S. Jarvey, Counsel for RML Trading, Inc., to K. Lee Blalack, II, Chief Counsel & Staff Director for the Subcommittee, Sept. 29, 1999, at 2 (See hearing record Ex. 8).

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ “RML Trading,” www.thestockcam.com/home, Sept. 21, 1999, at 1. RML Trading’s training materials include an additional risk disclosure form which the customer must sign before trading online. Disclosure statement, Stockcam, Inc., at 1.

¹⁶⁷ Collins Statement at 3.

¹⁶⁸ Webster’s Third New International Dictionary at 932.

In 1998, Philip A. Feigin, Executive Director of NASAA, said that, “for 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.”¹⁶⁹ Peter C. Hildreth, President of NASAA, testified at the Subcommittee’s Overview Hearing that “the 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.”¹⁷⁰ 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 “some 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.”¹⁷¹

(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 “just wrong” when he called day trading gambling and that “if he went back and thought about it, he’d recant.”¹⁷² 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 “if 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.”¹⁷³ 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.¹⁷⁴ 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.¹⁷⁵

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 “day trading is not gambling.”¹⁷⁶ Mr. Cohen added that “it requires skill, state of the art technology and hard work.”¹⁷⁷ In its training manual, Cornerstone Securities also takes issue, at least in part, with the gambling analogy:

¹⁶⁹ NASAA Press Release, Nov. 25, 1998 (Feb. Hr’g Ex. 9).

¹⁷⁰ Prepared Statement of Peter C. Hildreth, President of NASAA, Overview Hearing, at 25 (“Hildreth Statement”).

¹⁷¹ Arthur Levitt, Jr., SEC Chairman, “Speech to the National Press Club,” May 4, 1999 (Feb. Hr’g Ex. 10).

¹⁷² Houtkin Dep. at 227.

¹⁷³ Brian Kunath “Day Trading: The ‘Dealerization’ of the Markets,” *Global Investment Magazine*, Dec. 1999, at 51.

¹⁷⁴ Lee Dep. at 82–86.

¹⁷⁵ *Id.*

¹⁷⁶ Prepared Statement of Saul S. Cohen, Consulting Counsel for ETA, Overview Hearing, at 179 (“Cohen Statement”).

¹⁷⁷ *Id.*

You may have heard comments equating trading to gambling. While this notion may apply 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 mastering risk have they been able to effectively stack the odds in their favor time and time again.¹⁷⁸

Instead, Cornerstone compares day trading to meteorology.¹⁷⁹ Cornerstone notes that, like day traders, weathermen rely “on systems and historical data to predict short-term, future movements in the weather.”¹⁸⁰ Though Cornerstone disputes what it calls the “gambling myth,” the firm’s training manual concedes that

[t]here will always be recreational gamblers, and, I suppose, there will always be traders that simply gamble. *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 well thought-out trading plan, they are left to the uncertainties of guessing, wishing, hoping, and of course gambling.¹⁸¹

(3) *Training Documents Frequently Refer to Gambling.* Despite the objections of many in the day trading industry to the comparison between day trading and gambling, day trading firms produced many documents to the Subcommittee which openly embraced the comparison. A training syllabus produced to the Subcommittee by the parents of Scott Webb, a young day trader and trainer who was killed in Momentum’s Atlanta branch office by Mark Barton on July 29, 1999, refers expressly to gambling as a trading technique. The syllabus lists three trading techniques: “1. Scalping; 2. Position trading; and 3. Gambling.”¹⁸² Similarly, a list of trading tips produced to the Subcommittee by Insider Trading offers the following advice:

Always take profits and cut losses. You must have a goal every day of the amount of money you want to make in the stock market. When you reach your goal, stop, and quit trading. Try not to get greedy and still trade. *Remember, you are gambling and most likely you will loss [sic] what you have made.*¹⁸³

Thus, Insider Trading blatantly states that day trading is gambling, and that the odds are against trading profitably.

(4) *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 com-

¹⁷⁸ Cornerstone Training Manual, Introduction, at 4.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.* (emphasis added).

¹⁸² Syllabus, “Professional Traders Group, Training Seminar,” Jan. 4, 1999—Jan. 29, 1999, at 2 (Feb. Hr’g Ex. 11).

¹⁸³ Insider Trading Inc., Training Manual, “Teachdaq School of Stock Market Training: Day Trading 301,” at Review Trading Rules (emphasis added) (Feb. Hr’g Ex. 12).

monly applied to craps.¹⁸⁴ Mr. McCall was quoted in the press as follows: “There 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.”¹⁸⁵

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.¹⁸⁶ 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.¹⁸⁷ He testified as follows:

Q: So to kind of take the analogy you’ve extended here, is it fair to say you believe that the house, essentially NASDAQ, and

A: And the brokerage industry.

Q: And the brokerage industry viewed you essentially as a card counter or a professional trader who was beating 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.¹⁸⁸

Don Bright, Chief Executive Officer of Bright Trading, which is appropriately based in Las Vegas, considers himself, like Mr. Houtkin, essentially a card-counter.¹⁸⁹ Mr. Bright is a professional gambler and day trader who said that his “traders don’t gamble, just like blackjack card counters don’t gamble. They only make a trade when they have an edge.”¹⁹⁰ Mr. Bright also said of day trading and gambling, “the discipline’s the same, the focus is the same, the edge is the same.”¹⁹¹

(5) *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 “lethal, toxic, and addictive” because so much money can be gained and lost so quickly.¹⁹² Mr. Anderson noted that this can produce a rush of excitement in the trader similar to that experienced by a gambler.¹⁹³ He added that, as losses mount, day traders often retreat to a fantasy world and increasingly chase their losses with more trades.¹⁹⁴ Another gambling counselor, Dr. Frederick Woolverton, Director of The Village Institute, told Subcommittee staff that, like addicted gamblers, traders often live in a fantasy world in which the next trade is the one that

¹⁸⁴ Marcia Vickers, “A School for Day Traders,” *Business Week*, Nov. 8, 1999, at 148.

¹⁸⁵ *Id.*

¹⁸⁶ Houtkin Dep. at 231, 236.

¹⁸⁷ *Id.* at 237.

¹⁸⁸ *Id.* at 237–38.

¹⁸⁹ Dugan, “For These Day Traders, Stock Market Is One Big Casino,” at A1.

¹⁹⁰ John G. Edwards, “Minute by Minute Man,” *Las Vegas Review Journal*, Mar. 28, 1999, at 1K.

¹⁹¹ Dugan, “For These Day Traders, Stock Market Is One Big Casino,” at A1.

¹⁹² Interview of Chris Anderson, Aug. 25, 1999, at 1 (“Anderson Int.”).

¹⁹³ *Id.*

¹⁹⁴ *Id.*

will propel them into wealth.¹⁹⁵ 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.¹⁹⁶

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: “Many of my associates curse the long weekends that keep them away from trading. Day trading is so exhilarating that it can become almost addictive.”¹⁹⁷ During his Subcommittee deposition, Mr. Houtkin elaborated on that statement, noting that, when his customers “start 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.”¹⁹⁸ Mr. Bright’s daughter, Tammy Bright, herself a day trader and blackjack dealer, described the feeling she gets from day trading as “a natural high; it’s wonderful.”¹⁹⁹ 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: “[T]rading is a heady experience and can be very addictive. Losers who drop money in the markets receive a tremendous entertainment value.”²⁰⁰

These statements echo the thrill-seeking motivation described by Ed Looney, Executive Director of the New Jersey Council on Problem Gambling, who said, “when 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.”²⁰¹ 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 day. *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 few if any trading opportunities. Overtrading is also the trader who has a string of losses and experience the overwhelming desire to keep trading (pushing a trade) in order to “get their money back,” without taking time to analyze what is really going on. A great technique to help you control the overtrading urge is to STOP trading when you feel this urge. Take some time, walk away for awhile until you regain your perspective.²⁰²

According to Mr. Looney, the ranks of day traders addicted to gambling are growing: “Last 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.”²⁰³ The hot line

¹⁹⁵ Interviews of Dr. Frederick Woolverton, Dec. 14, 1999 and Dec. 17, 1999, at 1 (“Woolverton Int.”).

¹⁹⁶ *Id.*

¹⁹⁷ Houtkin, *Secrets of the SOES Bandit*, at 3.

¹⁹⁸ Houtkin Dep. at 242.

¹⁹⁹ James Kim, “A new breed of traders: pizza guys to lawyers heed market’s siren song,” *USA Today*, May 22, 1998, at 1B.

²⁰⁰ *On-Site Trading, Inc.*, Training Manual, at 6 (Feb. Hr’g Ex. 13).

²⁰¹ Raymond Fazzi, “Day Trading: Boom or Bust?” Asbury Park Press, Sept. 26, 1999, at A11.

²⁰² Training Manual, “Trading Psychology,” The Stockcam Institute, Inc., at G-2 (emphasis added) (Feb. Hr’g Ex. 14).

²⁰³ Fazzi, “Day Trading: Boom or Bust?,” at A11.

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.²⁰⁴ 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.

The Subcommittee's investigation found one firm that has implemented precautionary measures to detect compulsive trading and provide counseling. At its expense, Broadway Trading, LLC ("Broadway") has hired Dr. Woolverton's The Village Institute to consult with its traders whenever they are in need of help.²⁰⁵ On some occasions, Broadway employees have suggested to day traders who appeared to be having problems that they visit Dr. Woolverton.²⁰⁶ 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.²⁰⁷ Dr. Woolverton added that Broadway has discussed potential group sessions for all its traders.²⁰⁸

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

The Subcommittee'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. The Subcommittee 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.* The Subcommittee has 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.²⁰⁹ 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.²¹⁰

In addition, All-Tech's Branch Office Surveys ("Surveys") from the Boca Raton and Seattle offices indicate that very few customers were turning a profit. In response to the survey question "what percentage of your customers are making money," the former man-

²⁰⁴ Vanessa Richardson, "Addictions: Trading the Day Away," Money, Sept. 1999, at 34.

²⁰⁵ Woolverton Int. at 2.

²⁰⁶ Id.

²⁰⁷ Id.

²⁰⁸ Id.

²⁰⁹ Deposition of Barry Parish, Nov. 30, 1999, at 45 ("Parish Dep."). Mr. Parish defined "enough to quit" as a relative term, based on each customer's capacity for loss, and noted that the customer sets the figure. Id.

²¹⁰ Houtkin Dep. at 199, 216-17.

ager of the Boca Raton Office wrote “0%”²¹¹ and the branch manager of the Seattle office wrote “>10%.”²¹² All-Tech’s Chicago office had the most successful traders, noting on the survey that “30%” of the traders were profitable.²¹³ In an interview with Subcommittee staff, the Seattle branch manager estimated that about 90 percent of his Seattle customers lost money.²¹⁴

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.²¹⁵ 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.²¹⁶ In fact, Mr. Moon estimated that the average day trading customer traded for approximately one month before quitting, and lost approximately \$50,000.²¹⁷ At his Subcommittee deposition, Mr. Fahman did not dispute Mr. Moon’s estimates.²¹⁸ He added that only a “couple” of day traders at Providential’s Oregon branch office were profitable and that a substantial majority lost money.²¹⁹

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.²²⁰ Mr. Bright added that about two-thirds of traders quit day trading during their first year.²²¹ In response to Subcommittee interrogatories, Direct Net Trading indicated that, as of June 30, 1999, “[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.”²²² In its training manual, Cornerstone stated that, “[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.”²²³

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 “70 percent of public traders will not only lose, but will almost certainly lose everything they invest.”²²⁴ In order to evaluate the profitability of day traders generally, NASAA commissioned a financial consultant to perform a

²¹¹ All-Tech’s Boca Raton “Branch Office Survey,” June 22–24, 1997, at 4 (Feb. Hr’g Ex. 15).

²¹² All-Tech’s Seattle “Branch Office Survey,” June 5, 1997, at 4 (Feb. Hr’g Ex. 16).

²¹³ All-Tech’s Chicago “Branch Office Survey,” June 4, 1997, at 4 (Feb. Hr’g Ex. 17).

²¹⁴ Interview of Michael Benson, Dec. 1, 1999, at 9 (“Benson Int.”).

²¹⁵ Fahman Dep. at 253.

²¹⁶ Letter from Susan H. Tregub, Counsel for Hahna Global Securities, to Wesley M. Phillips, Investigator for the Subcommittee, Dec. 3, 1999, at 4 (Feb. Hr’g Ex. 18).

²¹⁷ Interview of Tae Goo Moon, Dec. 9, 1999, at 5 (“Moon Int.”).

²¹⁸ Fahman Dep. at 256.

²¹⁹ Id.

²²⁰ Edwards, “Minute by Minute Man,” at K1.

²²¹ Id.

²²² Letter from Laurence Briggs, Chief Executive Officer of InvestIn.com Securities Corp., to K. Lee Blalack, II, Chief Counsel & Staff Director to the Subcommittee, Nov. 18, 1999, at 3 (Feb. Hr’g Ex. 19).

²²³ Cornerstone Training Manual, Psychology, at 5.

²²⁴ NASAA Report at 7.

limited study of day trading accounts at one day trading firm's branch office in Massachusetts. The consultant reviewed 30 randomly selected accounts at the branch office and found that 70% of them lost money, and would likely lose all the capital they traded.²²⁵ Based on that review, the consultant estimated that 70 to 90 percent of all day traders at that branch office lost money.²²⁶

The day trading industry roundly criticized the NASAA Report because it was based on a relatively small sample of day trading accounts.²²⁷ 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.²²⁸ He also stated that NASAA's consultant examined only four months of account activity.²²⁹ Former NASAA official David Shellenberger indicated, however, that the sample was actually taken during the two year period of 1997–1998, and that the four month statistic represented the average amount of time an account remained open. 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.²³⁰

The Subcommittee find that despite its heavy criticism, the study is somewhat instructive regarding profitability. The findings of the NASAA Report are generally consistent with the anecdotal evidence that the Subcommittee uncovered in this investigation as well as that of the 1999 Washington State Securities Division profitability analysis. Thus, the NASAA Report clearly has some probative value on the question of profitability. The Subcommittee agrees, 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 the Subcommittee's Overview Hearing That It Was Preparing A Broader Profitability Study But ETA Declined To Commission Such A Study.* During the Subcommittee's Overview Hearing, Mr. Cohen testified that ETA was "in the process of retaining KPMG to conduct a day trading profitability study," which was "expected to be completed" within two months of the hearing.²³¹ In January of this year, the Subcommittee inquired of ETA about the progress of the study. Through counsel, ETA advised the Subcommittee that it declined to pursue this study because the cost was prohibitive.²³² Mr. Lee, in testimony before the Subcommittee on February 25, 2000, reiterated this as the reason for not going forward with the study and added, "* * * there were also some internal conflict issues that [ETA] pinpointed in their ability to produce the study."²³³ Mr. Cohen's strong condemnation of NASAA's profitability analysis at the Subcommittee's overview hearing combined with and his declaration that ETA intended to commission an independent study "[t]o put the matter [of day trad-

²²⁵ Id. at 4.

²²⁶ Id.

²²⁷ Cohen Statement at 186.

²²⁸ Id.

²²⁹ Id.

²³⁰ Id.

²³¹ Id. at 188.

²³² Telephone call with Robert Bennett, Counsel for Momentum Securities, Inc., Jan. 24, 1999.

²³³ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

ing profitability] to rest,”²³⁴ and then ETA’s failure to pursue the study, undermine the level of confidence ETA really has in its survey.

(4) *Profitability Data From Day Trading Firms.* In response to Subcommittee document requests, several day trading firms produced profitability data to the Subcommittee, including Momentum, Tradescape, LLC (“Tradescape”), and Broadway. A cursory review of the data produced by these firms indicates that many of their traders are or were profitable. The Subcommittee concluded that the profitability data from Momentum,²³⁵ Tradescape²³⁶ and, to a lesser degree, Broadway²³⁷ did not provide an adequate nor probative picture of 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, the Subcommittee believes 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

²³⁴ Cohen Statement at 188.

²³⁵ Momentum provided the Subcommittee with data detailing the success of its day traders over a five month period at the end of 1998. Momentum has distanced itself from this data, declining to call it a “study” but instead labeling the analysis as an unscientific “survey.”

This data is limited for several reasons. For example, the Preliminary Results data covers trading activity for a five month period only, and reflects Momentum’s 107 Texas based traders, but not those at Momentum’s other branch offices including Atlanta, Chicago, Milwaukee and Irvine.

The Preliminary Data does not indicate how many traders survived the three to five month learning curve. In fact, Mr. Lee stated in his deposition that Momentum does not track how many accounts remain open and active for six months or longer. The Preliminary Data indicates that 70 percent of Momentum’s traders have been day trading for more than six months. As Mr. Lee confirmed in his deposition, this is not the same as saying that 70 percent of accounts that customers open at Momentum remain open after six months. Lee Dep. at 346.

²³⁶ Tradescape’s “Trader Performance Analysis,” Nov. 12, 1999 (“Tradescape Analysis”) Feb. Hr’g Ex. 20). Tradescape informed the Subcommittee that 85 percent of the traders included in the study traded at one Landmark Securities office located in New York City. The other 15 percent traded in equal numbers at four other Landmark offices located in Los Angeles, Denver, Miami and Boston. Tradescape’s internal study entitled the “Trader Performance Analysis” tracks gross and net profit and loss data over six months. This study is valuable because it provides six accurate snapshots of trader profitability. Monthly snapshots, however, only tell a portion of the profitability story and cannot be extrapolated to describe the industry as a whole. It is worth noting that, of these monthly snapshots, unprofitable traders outnumbered profitable traders during four of six months studied. The study suffers from several limitations. For example, the Tradescape study is largely limited to one Landmark branch office, which is a subsidiary of Tradescape and Co.

Furthermore, the Tradescape data is averaged over six months. Averaging the number of traders over the course of the six month period, as well as averaging the percentage of profitable and unprofitable accounts, conceals customer turnover. By averaging the account data, Tradescape counted profitable, repeat customers every month they traded. Thus, those accounts were given more weight. In contrast, Tradescape weighted those customers who stopped trading after one or two months less heavily. It should be noted, however, that even with this skewed picture of traders’ success, less than half the accounts were profitable: 48 percent were profitable as opposed to 52 percent that were unprofitable.

The more accurate method for determining overall customer profitability is to track each account separately and determine at the end of the six month period how many were profitable and how many were unprofitable. For example, given the data on Tradescape’s Trader Performance Analysis, it is impossible to know how many of the 163 traders trading in January, 1999 were among the 193 traders in February, 1999 or among the 211 traders trading in March, 1999. Those who quit day trading after January, 1999 were counted once in the average Tradescape provided, and those who quit in February, 1999 were counted twice, while those who continued to trade through June were counted six times.

To illustrate this point, the Subcommittee tracked the fortunes of twenty losing traders. Of this group of twenty, twelve had quit day trading by the end of the six month period, and five of those had stopped trading after three months. Of the eight who were still trading at the end of the six month period, only two had net profits.

²³⁷ “Trader Statistics,” www.broadwaytrading.com (Feb. Hr’g Ex. 21).

profitable from September 1998 through January 1999, and that 44 percent of inexperienced traders were profitable.²³⁸ By comparison, Tradescape reported that 48 percent of its traders were profitable over a six month average when commissions were included.²³⁹

Broadway posted useful data on its website charting the profitability of its traders in 1999, dividing them by branch office and by experience.²⁴⁰ 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.²⁴¹ 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.²⁴² 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,²⁴³ 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.²⁴⁴ The 1998 data shows that 53% of Broadway day traders lost money for the year.²⁴⁵

(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 the Subcommittee has seen to date.²⁴⁶ The Washington examiners analyzed the day trading account records at the seven day trading firms doing business in the State of Wash-

²³⁸ Momentum Survey at "Preliminary Results," Feb. 1999.

²³⁹ Feb. Hr'g Ex. 20.

²⁴⁰ Feb. Hr'g Ex. 21.

²⁴¹ Broadway traders represent some of the most well-capitalized traders in the day trading industry. Unlike the majority of firms that require \$25,000 to open a day trading account, Broadway requires \$75,000. This larger sum enables traders to survive the learning curve and take full advantage of trading opportunities.

²⁴² Feb. Hr'g Ex. 21.

²⁴³ Telephone Interview of Mark Peckman and Andrew Actman, Broadway Trading, Inc., Jan. 17, 2000.

²⁴⁴ Broadway Trading, Inc., Profitability Data for 1998 (Feb. Hr'g Ex. 22).

²⁴⁵ Id.

²⁴⁶ Securities Division, Washington State Department of Financial Institutions, Report to the United States Senate Permanent Subcommittee on Investigations: Day Trading Practices in Washington State, Feb. 10, 2000 ("Securities Division Report") (Feb. Hr'g Ex. 23). The Securities Division is part of the Washington Department of Financial Institutions. "Local Security Regulators for Washington," www.nasaa.org/regulatory/WA.html, Dec. 20, 1999.

ington.²⁴⁷ 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.²⁴⁸ At five of the firms, the examiners reviewed the records for every account.²⁴⁹ For All-Tech and Richmark Capital Corporation (“Richmark”), however, the examiners reviewed a sampling of accounts because the firms are so large.²⁵⁰

Based on this comprehensive analysis, the Washington examiners concluded that, net of commissions, 77 percent of the traders were unprofitable.²⁵¹ 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.²⁵² The Subcommittee finds 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.

At the Subcommittee’s hearing on February 25, 2000, Ms. Lori A. Richards, Director of the Office of Compliance, Inspections, and Examinations at the SEC further expounded on the effect high commissions have on the likelihood of success for day traders. Ms. Richards testified that given a medium fee structure, where commissions are \$16.70 per trade and additional services (data feeds, news, research) average \$150.00 per month, a day trader would have to generate \$16,850 each month just to break even.²⁵³ As Chairman Collins pointed out at the hearing, this means that given these figures, a day trader would have to earn in excess of \$200,000 a year just to pay commissions before incurring one cent of profit.²⁵⁴

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

At the Subcommittee’s Overview Hearing, Chairman Collins commented that, “[t]he technology revolution that is affecting so many aspects of American life is also changing, in a very fundamental way, the relationship between the ordinary investor and the mar-

²⁴⁷ Those firms are Daytrading, Bright Trading, Inc., Action II, Inc., On-Line Investment Services, Inc., Cornerstone Securities Corporation, Richmark Capital Corporation, and All-Tech Direct, Inc. Second Bortner, Int. at 1.

²⁴⁸ Id.

²⁴⁹ Id.

²⁵⁰ Id. At All-Tech, the examiners reviewed records for 34 for the 125 accounts and, for Richmark, they reviewed 23 of the 203 accounts. Id.

²⁵¹ Id.

²⁵² Id.

²⁵³ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

²⁵⁴ Id.

kets.”²⁵⁵ She noted that “[n]ew technology now allows investors to access the markets directly without the aid or advice of a broker-dealer, something that was previously limited to a relatively small number of professional traders.”²⁵⁶ This dramatic change in access raises profound questions for securities regulators, broker-dealers, and investors.²⁵⁷ The Subcommittee’s investigation determined that day trading has had both positive and negative effects on the securities markets, and that the negative developments warrant close scrutiny by regulators and policymakers. The Subcommittee emphasizes, however, that the evidence suggesting a correlation between day trading and market volatility is by no means conclusive and merits further study.

(1) *The Positive Impact of Day Trading.* The three developments that have made day trading possible are arguably very positive for investors. First, day traders have added liquidity to the markets. Indeed, at the Subcommittee’s Overview Hearing, Chairman Levitt testified that an argument could “be made that [day trading] does represent some modest increase in liquidity.”²⁵⁸ Given the growing numbers of day traders—and the increasing use of ECNs by day traders—there are more ready and willing buyers in the market than ever before. Thus, there is strong evidence that day trading has expanded liquidity. Second, the almost exponential growth in low-cost trading execution platforms has dramatically lowered commissions for investors as more broker-dealers lower commission costs to compete with online trading systems. Third, the new technologies of day trading have greatly expanded transparency, or access to financial information. All of these changes are positive for investors.

(2) *There Is Some Evidence That Day Trading May Be Contributing to an Increase in Volatility for Individual Stocks and the Market as a Whole, Particularly the Nasdaq.* During the Subcommittee’s Overview Hearing, Chairman Levitt indicated his opinion that day trading was not contributing to an increase in market volatility.²⁵⁹ Some day trading critics, however, contend that the strategies of day traders, such as buying in “up-trending” markets and selling in “down-trending” markets, increases price volatility.²⁶⁰ Market volatility is generally considered detrimental to investors because stock prices fluctuate for reasons unrelated to the business prospects of the company or the fair value of its shares.

As part of a 1998 analysis, the General Accounting Office (“GAO”) reviewed available studies on potential links between day trading and market volatility.²⁶¹ Based upon the available literature, GAO found that there was no conclusive evidence to support the contention that day trading results in market volatility. Although some studies found that there is a correlation, these studies did not establish whether day trading caused the volatility or whether other market factors contributed as well.²⁶² A study examined by GAO found mixed evidence about the impacts of day trad-

²⁵⁵ Collins Statement at 2.

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ Levitt Statement at 18.

²⁵⁹ *Id.*

²⁶⁰ GAO SOES Report at 14.

²⁶¹ *Id.*

²⁶² *Id.*

ing on market volatility.²⁶³ Consequently, GAO concluded that large volumes of day trading increased market volatility in the short-run, but contributed to lower volatility in the long-run.²⁶⁴

New data suggests that day trading may indeed be contributing to increased volatility. A recent New York Times report cited evidence that day trading had caused a dramatic decrease in the length of time investors are holding stocks.²⁶⁵ The new data show that Nasdaq stocks are the most popular with online investors who are trading heavily.²⁶⁶ Recent figures suggest that, among the 50 most traded Nasdaq stocks, investors held their shares, on average, for just three weeks.²⁶⁷ According to a study by the University of California at Davis of 60,000 households that traded shares through a discount broker from 1991 to 1997, those that traded most frequently earned an annual net return of 11.4 percent.²⁶⁸ This return contrasted to the 18.5 percent earned by those households that held their positions for a longer time.²⁶⁹ The New York Times report noted as follows:

The figures confirm what some market analysts have suspected for some time: the rapid-fire trading mentality of a very small group of hyperactive investors known as day traders has altered the behavior of large numbers of investors and is seeping into the overall market. The consequences are large, since studies show that investors who trade frequently get lower returns and heavy trading contributes to wide swings in the market.²⁷⁰

The effect of all of this trading, some theorize, is greater volatility in the markets. An investment firm in Minneapolis, the Leuthold Group, recently noted that price movements of two percent or more from the previous day's close occurred on the Nasdaq market on average, one out of every four days last year.²⁷¹ This change represents an increase of 21 percent from the previous year.²⁷² Moreover, the data shows that the Nasdaq experienced such large price swings only 3 percent of the time between 1971 and 1998.²⁷³

A recent Wall Street Journal article documented this shifting trend. For instance, Qualcomm's stock price rose during the week of January 4, 2000 from \$9.94 to \$150.²⁷⁴ The Wall Street Journal explained that, during Qualcomm's meteoric rise, many institutional investors that formerly led the markets followed the lead of day traders.²⁷⁵ The report noted as follows:

Through it all has been a role reversal taking shape at times between big investors and day traders. Not long ago,

²⁶³ Robert H. Battalio, Brian Hatch, and Robert Jennings, SOES Trading and Market Volatility Vol. 32, No. 2 (June 1997).

²⁶⁴ GAO SOES Report at 14.

²⁶⁵ Gretchen Morgenson, "Investing's Longtime Best Bet is Being Trampled by the Bulls," N.Y. Times, Jan. 15, 2000, at A1.

²⁶⁶ Id.

²⁶⁷ Id.

²⁶⁸ Id at B14.

²⁶⁹ Id.

²⁷⁰ Id.

²⁷¹ Id at A1.

²⁷² Id.

²⁷³ Id.

²⁷⁴ "Qualcomm Back Draft: Day Traders Bet on Look-Alikes," Wall Street Journal, Jan. 10, 2000, at C1.

²⁷⁵ Id.

institutional investors uniformly scoffed at the stocks being chased by day traders. These days, however, they increasingly are likely to jump on board a stock being favored by these frenetic individual investors rather than risk being left behind on another Internet stock's rapid ascent. They aren't waiting for stocks to become an Amazon.com or a Yahoo! before they begin to nibble.²⁷⁶

With an estimated ten to fifteen percent of Nasdaq trading volume attributable to day traders, their impact on the markets continues to grow. This new evidence suggests that day trading is beginning to affect the volatility of individual stocks and the overall markets. Though the volatility may be only partially a result of increased day trading, it seems clear that the psychology of day traders has infected the broader markets.²⁷⁷ Securities regulators and policymakers will need to diligently monitor these trends in order to react prudently to the swift changes underway in our stock markets.

G. Summary of Findings

During the course of this investigation, the Subcommittee discovered troubling evidence regarding the business practices of day trading firms. Some of these practices are illegal and in violation of state and federal securities laws. For instance, the Subcommittee found evidence that registered representatives of day trading firms forged customer documents and engaged in unauthorized trading. There is also evidence that day trading firms altered customer account documents to make customers appear more suitable for day trading than they actually were. In addition, the Subcommittee found evidence that day traders violated state laws requiring the registration as an investment adviser of persons who trade the account of another for compensation and that the day trading firms were willfully blind to the illegal conduct of their day trading customers. There is also some evidence that day trading firms sponsored misleading advertisements that mischaracterized the risks of day trading and/or failed to disclose the risks of this speculative activity. The Subcommittee has set forth a detailed exposition of this evidence in the three case studies that follow.

While the above findings pertain to potentially illegal conduct, the most disturbing evidence gathered by the Subcommittee relates to business practices that are—under the current regulatory framework—entirely legal. For instance, there is evidence that some day trading firms did not give their prospective customers any risk disclosure prior to opening their day trading accounts. For instance, in a written response to Subcommittee interrogatories, Andover Brokerage, LLC stated that it did not begin providing its day trading customers written risk disclosures until the end of 1998, even though the firm has been in operation since 1996.²⁷⁸ Indeed, the Subcommittee found that most day trading firms began giving their customers written risk disclosures in late 1998 or early 1999, and

²⁷⁶ *Id.*

²⁷⁷ Susan Pulliam, "Day Traders Power Fuel—Cell Stock Rise," *Wall Street Journal*, Feb. 16, 2000, at C2.

²⁷⁸ Letter from David Laurent, Chief Operating Officer for Andover Brokerage, LLC, to K. Lee Blalack, II, Chief Counsel & Staff Director for the Subcommittee, Nov. 15, 1999, at 1999, at 3 (Feb. Hr'g Ex. 24).

that they improved their risk disclosures expressly in response to increased regulatory scrutiny of day trading. Despite the improved written risk disclosures, the Subcommittee heard evidence from former customers of day trading firms who complained that the risk disclosures were undermined or contradicted by verbal promises of big profits or “can’t lose” systems.

Another troubling finding of this investigation was that many day trading firms have 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. Indeed, contrary to their own policies, many day trading firms have often failed to gather the information about their prospective customers that is necessary to determine whether those customers are suitable for day trading. Even more disturbing, some day trading firms do not maintain minimum financial requirements to open a day trading account. Thus, the Subcommittee discovered that some day trading firms have recently lowered their minimum financial requirements to compete with these firms that have no or very low thresholds for account opening. In doing so, the firms are now accepting customers that they formerly considered unsuitable.

The Subcommittee also found significant evidence that day trading firms allow and, sometimes even encourage, their clients to trade beyond their means. For instance, the Subcommittee uncovered circumstances where customers had their accounts closed for failure to meet margin calls and were assisted by registered personnel in establishing a second account under a fictitious name to allow the customer to continue trading. There was also disturbing evidence that day trading firms systematically encourage customers to obtain short-term loans from other customers for the purpose of satisfying margin calls. In most instances, the evidence indicates that the borrowing and lending customers did not know one another and did not communicate during the lending process. In fact, the day trading firms directed all ministerial and clerical functions pertaining to the servicing of these margin loans and apparently set their terms.

There was also evidence that day trading firms are poorly managed and supervised. As an initial matter, the Subcommittee found numerous examples where day trading firms hired personnel to serve as branch managers of their satellite offices who had little brokerage or managerial experience. The investigation also indicated that the firms then provided those branch managers little training followed by very poor supervision. As a result, it should not be surprising that the Subcommittee found that day trading customers often complained about the poor training that they received and the all too frequent malfunctions in the trading software offered by the firms. In short, there was overwhelming evidence that these firms, and especially their branch offices, were poorly managed and supervised.

In the case studies that follow pertaining to All-Tech, Providential and Momentum, the Subcommittee details the testimonial and documentary evidence collected over the last eight months of investigation to support the findings set forth above. The Subcommittee believes that these case studies provide a comprehensive factual record to justify the adoption of the suggested reforms that are explained at the end of this Subcommittee Report.

III. CASE STUDY: ALL-TECH DIRECT, INC.

A. Background of All-Tech Direct, Inc.

(1) *Founding of All-Tech.* All-Tech Direct, Inc. (“All-Tech or the “firm”)²⁷⁹ is a day trading firm that evolved on the heels of the stock market crash of 1987.²⁸⁰ Because of the market crash, Harvey Houtkin and his brother-in-law, Mark Shefts, closed the doors of Domestic Arbitrage Group, Inc. (“Domestic”), a broker-dealer they had been running since approximately 1979.²⁸¹ Messrs. Houtkin and Shefts voluntarily closed the firm and withdrew from the NASD because they did not possess sufficient capital and would have been operating in violation of net capital rules if they had not closed.²⁸² Although they had no trading capital after the liquidation of Domestic, Messrs. Houtkin and Shefts did have office space and equipment.²⁸³ Mr. Houtkin said that “the only thing that wasn’t there were the people.”²⁸⁴ In an effort to rebuild their business, they took over a small broker-dealer that a friend of Mr. Houtkin’s was planning to close, because they wanted a corporate entity without contingent liabilities.²⁸⁵ In approximately January 1988, Mr. Shefts purchased the brokerage firm called C.L. Dichter & Company.²⁸⁶ He opened the new firm under the name “All-State Investment Group” (“All-State”), and he was the only registered principal of the firm.²⁸⁷

According to Mr. Houtkin, the birth of All-State, which later evolved into All-Tech, represented the dawn of the “electronic trading revolution.”²⁸⁸ Initially, Mr. Houtkin did not register with All-State, but simply used the firm to day trade through SOES, Nasdaq’s “Small Order Execution System.”²⁸⁹ The firm grew as other traders started coming to All-Tech to trade.²⁹⁰ Before accepting these new traders, Messrs. Shefts and Houtkin required them to obtain training.²⁹¹ All-Tech first offered its training program through its holding company, Rushmore, and then later through an affiliate All-Tech Training Group, Inc.²⁹²

²⁷⁹ References to All-Tech (or the “firm”) include each of All-Tech’s predecessor firms including Allstate Investment Group, All-Tech Investment Group, Inc., Attain Direct, Inc. and All-Tech Director, Inc. In addition, unless separately identified, All-Tech Training Group, Inc. and its predecessor Rushmore Financial Services, Inc. (“Rushmore”) will be collectively referred to as “All-Tech.” Even though All-Tech Training Group is not registered as a broker-dealer and is a separate company from All-Tech, all of the All-Tech officers are also officers of All-Tech Training Group, Inc. Interview with Mark Shefts, Dec. 6, 1999, at 4 (“Shefts Inc.”). The common officers to both companies are Harvey Houtkin, Mark Shefts and Linda Lerner. In addition, Bob Varsalona, the Controller of All-Tech, is an officer of All-Tech Training Group. Id.

²⁸⁰ Houtkin Dep. at 29–31.

²⁸¹ Id. at 21–28.

²⁸² Mark Shefts Int. at 1.

²⁸³ Houtkin Dep. at 29.

²⁸⁴ Id.

²⁸⁵ Id. at 29–30, 40–41.

²⁸⁶ Shefts Int. at 2.

²⁸⁷ Houtkin Dep. at 30, 42.

²⁸⁸ Id. at 30–31.

²⁸⁹ Id. at 31, 34. At the time Mr. Houtkin started trading through SOES, the NASD Rules would not have permitted him to do so as a principal of the firm (in a firm account). Id. at 45. Mr. Shefts told Subcommittee staff that he and Mr. Houtkin were permitted to use the SOES system once they were no longer a part of the securities industry. Shefts Int. at 2. Mr. Houtkin denied acting as a customer rather than an owner of the firm as a way to get around the rules. Houtkin Dep. at 45. Mr. Houtkin called it pure “coincidence” that he opted not to register as a principal of the firm and, therefore, could freely trade through SOES. Id. at 45–47.

²⁹⁰ Shefts Int. at 2.

²⁹¹ Id.

²⁹² Id.

Mr. Houtkin and his traders used SOES as an instrument to compel market makers to honor quoted prices of stocks. He soon became known as the “SOES Bandit,” a nickname that Mr. Houtkin claims he never liked but also did not contest since it gave him and the other “bandits” a “Robin Hood-like image.”²⁹³ So-called SOES bandits, including Mr. Houtkin, challenged the established securities industry and the regulators to gain what they perceived as fair access to the securities markets for themselves and the average investor. All-Tech claims that its initiative in March 1988 to use SOES to execute client orders helped to create “Electronic Day Trading” on Wall Street.²⁹⁴ Mr. Houtkin’s crusade included filing suit against the SEC to contest certain SOES rules²⁹⁵ and attempting to narrow spreads (i.e., the difference between the inside bid and inside offer) on Nasdaq securities.²⁹⁶

In what appears to be an All-Tech marketing document touting All-Tech’s Attain computer system, Mr. Houtkin explained his crusade as follows:

After eight years of fighting with market makers, regulators and the established financial community and spending millions of dollars on legal fees, I am proud to say we have finally been instrumental in creating an environment where the average person can now compete on a level playing field with the market professionals.²⁹⁷

Mr. Houtkin and All-Tech were some of the first challengers to the traditional market maker structure of the Nasdaq. Indeed, the evidence suggests that, in the early 1990s, Mr. Houtkin and All-Tech contributed positively to the Department of Justice’s (“DOJ”) efforts to break up the price-fixing schemes of certain Nasdaq market makers. Mr. Houtkin and All-Tech were also instrumental in helping ordinary investors gain access to the same technology and information available to sophisticated traders on Wall Street.

(2) *All-Tech Today*. According to All-Tech’s website, the firm currently has twenty-three offices across the country, including its main office in Montvale, New Jersey (the “main office”).²⁹⁸ All-Tech has expanded rapidly in the 1990s through the opening of branch offices across the nation. Each branch office is managed by one or more All-Tech employees who have paid an initial fee to open the office.²⁹⁹ A “Branch Office Management Agreement” between All-Tech and the branch manager sets for the duties and responsibilities of the branch and home offices.³⁰⁰ In general, the branch offices pay the main office a fee for every trade executed by

²⁹³ Houtkin, et al., *Secrets of the SOES Bandit*, at 177.

²⁹⁴ “All-Tech Direct—Daytrading through the Attain ECN,” www.attain.com/about/history.cfm, Jan. 5, 2000.

²⁹⁵ Houtkin, *Secrets of the SOES Bandit*, at 174–75.

²⁹⁶ “All-Tech Direct—Daytrading through the Attain ECN,” www.attain.com/about/history.cfm, Jan. 5, 2000.

²⁹⁷ Generic letter from Harvey Houtkin, undated, bates number 4071 (Feb. Hr’g Ex. 25).

²⁹⁸ “All-Tech Direct—Daytrading through the Attain ECN,” www.attain.com/about/branches.cfm, Jan. 5, 2000.

²⁹⁹ All-Tech’s fees have varied between \$50,000 and \$100,000 per office. Branch Office Management Agreement between All-Tech, Frederick M. Benson and David Niederkrome, May 8, 1998, at “Rider” (“Portland Branch Agreement”); Branch Office Management Agreement between All-Tech and David Niederkrome, Feb. 1, 1997, at “Rider” (“Seattle Branch Agreement”); Branch Office Management between All-Tech and Fred Zayas, Dec. 6, 1996, at 5 (“Watertown Branch Agreement”); Branch Office Management Agreement between All-Tech, Barry Parish and Rogert Luecke, Nov. 11, 1996, at 5 (“San Diego Branch Agreement”).

³⁰⁰ See, e.g., Portland Branch Agreement; Seattle Branch Agreement; Watertown Branch Agreement; and, San Diego Branch Agreement.

their customers, which ranges from \$12.50 to \$15.00 per trade.³⁰¹ The remaining commission paid by the customer covers overhead expenses with the balance used as revenue for the branch managers' gross payroll.³⁰²

Between January 1, 1998 and November 12, 1999, the firm opened 1,421 customer accounts.³⁰³ For the first quarter of Fiscal Year 1999, All-Tech had gross revenues of \$9,176,000 and net income of \$1,009,800.³⁰⁴ For Fiscal Year 1998, the firm had \$18,295,849 in gross revenues and \$492,863 in net income.³⁰⁵ For Fiscal Year 1997, the firm had \$16,063,816 in gross revenues and \$937,436 in net income.³⁰⁶ In 1998 alone, Mr. Houtkin's total compensation from All-Tech was approximately \$919,231, and Mr. Shefts' compensation for that year was \$943,363.³⁰⁷

All-Tech is headed by Mr. Houtkin, who serves as Chairman and Chief Executive Officer, and Mr. Shefts, who is the President, Chief Operating Officer and Chief Financial Officer.³⁰⁸ From the time he became a principal of All-Tech until March 1999, Mr. Houtkin served as the Chief Compliance Officer for the firm.³⁰⁹ In March 1999, All-Tech replaced Mr. Houtkin with Franklin Ogele who currently serves as the firm's Chief Compliance Officer and Associate General Counsel.³¹⁰

Both Messrs. Houtkin and Shefts have several disclosable incidents on their CRDs, including actions by regulators.³¹¹ For example, most recently, the Securities Division of the Commonwealth of Massachusetts filed an administrative action alleging, among other things, that All-Tech, Messrs. Houtkin, Shefts and Harry Lefkowitz³¹² failed to supervise the operation of their Watertown, Massachusetts Branch Office, then managed by Fred Zayas.³¹³ All-Tech settled the matter in May 1999.

In 1990, the New Jersey Bureau of Securities ("New Jersey Bureau") settled an action it had initiated against All-Tech and Mr. Shefts, alleging that Mr. Shefts failed to supervise Mr. Houtkin on behalf of All-Tech and permitted Mr. Houtkin to act as an unregistered agent and undisclosed principal of the firm.³¹⁴ In 1990, the

³⁰¹ Portland Branch Agreement, at 4; Seattle Branch Agreement, at 4; Watertown Branch Agreement, at 4; San Diego Branch Agreement, at 4. Mr. Shefts and former San Diego Branch Manager, Barry Parish, stated that the fee is \$12.50. Shefts Int. at 5; Parish Dep. at 35.

³⁰² Shefts Int. at 5.

³⁰³ Letter from Stephanie Rosenblatt, Counsel for All-Tech, to K. Lee Blalack, II, Chief Counsel & Staff Director for the Subcommittee and Linda J. Gustitus, Minority Chief Counsel and Staff Director for the Subcommittee, Nov. 12, 1999, at 1 ("All-Tech Letter, Nov. 12, 1999") (Feb. Hr'g Ex. 26).

³⁰⁴ Letter from Stephanie Rosenblatt, Counsel for All-Tech, to K. Lee Blalack, II, Chief Counsel & Staff Director for the Subcommittee, and Linda J. Gustitus, Minority Chief Counsel and Staff Director for the Subcommittee, Jan. 20, 2000, at 1 ("All-Tech Letter, Jan. 20, 2000") (Feb. Hr'g Ex. 27).

³⁰⁵ Id.

³⁰⁶ Id.

³⁰⁷ Houtkin Dep. at 81-82.

³⁰⁸ All Tech Investment Group Corporate Organization Chart, Aug. 16, 1999 (Feb. Hr'g Ex. 28).

³⁰⁹ Houtkin Dep. at 79.

³¹⁰ Shefts Int. at 6; Houtkin Dep. at 79; Ex. 28.

³¹¹ Harvey I. Houtkin CRD #251066 ("Houtkin CRD") (Feb. Hr'g. Ex. 29); Mark David Shefts CRD #709147 ("Shefts CRD") (Feb. Hr'g Ex. 30).

³¹² Mr. Lefkowitz is the firm's Senior Vice President of Operations. Feb. Hr'g Ex. 28.

³¹³ Feb. Hr'g Ex. 29; Feb. Hr'g Ex. 30. This enforcement action will be discussed in detail in section E, 2.

³¹⁴ In re: All-Tech Investment Group, Inc. and Mark Sheets [sic], 1990 N.J. Sec. LEXIS 171, No Number (June 25, 1990), at *1 (Feb. Hr'g Ex. 31). Mr. Shefts and All-Tech neither admitted nor denied the allegations. Id. The terms of the settlement included, among other things, that

New Jersey Bureau also settled a related action it had initiated against Domestic and Mr. Houtkin, alleging that Domestic had filed a false and misleading application for registration as a broker-dealer.³¹⁵ In his Subcommittee deposition, Mr. Houtkin claimed that the New Jersey action “was a smear campaign against Harvey Houtkin to prevent me from putting forward direct access.
* * *”³¹⁶

In July 1989, the NASD District Business Conduct Committee alleged that Mr. Houtkin violated the NASD’s Rules of Fair Practice. According to Mr. Houtkin’s CRD, most of the charges were dismissed on appeal, but Mr. Houtkin and his firm had to pay \$1,000 plus costs for violating certain record keeping requirements.³¹⁷ In January 1989, Mr. Shefts was censured and fined \$10,000 for violation of the NASD Rules of Fair Practice.³¹⁸ In 1985, the NASD District Business Conduct Committee alleged that Mr. Houtkin had violated the NASD’s Rules of Practice regarding his participation in SOES.³¹⁹ The NASD found Mr. Houtkin guilty and fined him \$2,000, and assessed costs against him of \$400.³²⁰

When All-Tech sought to open a branch office in Florida in 1993, the Division of Securities of the Florida Department of Banking and Finance (“Division”) agreed to approve the application for registration only under certain conditions.³²¹ Among other things, the Division required All-Tech and Mr. Shefts to agree that Mr. Shefts would be All-Tech’s registered principal and that Mr. Houtkin would not have any involvement “in the trading, purchase, or sale of securities prior to the registration of Mr. Houtkin as an associated person in Florida.”³²²

Mr. Houtkin testified that all of these regulatory actions against him and All-Tech were based on either unfounded or exaggerated charges.³²³ Mr. Houtkin cited no credible evidence of collusion by state regulators and the NASD, nor did the Subcommittee’s investigation uncover any such evidence. When asked at his deposition whether he believed that the state securities regulators in New Jersey, Florida and Massachusetts were part of an outright conspiracy with the NASD and its member firms to undermine All-Tech and day trading, Mr. Houtkin stated that he did not “believe they got in a room, but [he did] believe they have all too much con-

All-Tech would withdraw its registration as a broker-dealer in New Jersey and would not reapply for registration for three years. *Id.* at *2. In addition, Mr. Shefts agreed that he would not apply for registration or act as an agent, broker-dealer, investment adviser, or issuer in New Jersey or act as a principal of a broker-dealer registered in New Jersey for three years. *Id.*

³¹⁵ *In re: Domestic Securities, Incorporated*, 1989 N.J. Sec. LEXIS 404, No Number, at *4 (Apr. 25, 1989) (Feb. Hr’g Ex. 32). Mr. Houtkin was apparently added as a respondent in order to resolve the matter *In re: Domestic Securities, Incorporated and Harvey I. Houtkin*, 1990 N.J. Sec. LEXIS 170, OAL Docket No. BOS 03957-89, at *1 (June 26, 1990) (Feb. Hr’g Ex. 33). Domestic and Mr. Houtkin neither admitted nor denied the allegations but agreed, among other things, that Domestic would pay \$50,000 to the New Jersey Bureau as reimbursement for the costs and expenses of the investigation; that Domestic would withdraw its broker-dealer registration application and not reapply for three years; and that, Mr. Houtkin would not apply for registration or act as an agent, broker-dealer, investment adviser or issuer in New Jersey or as a principal in a broker-dealer registered in New Jersey for three years. *Id.* at *2-*3.

³¹⁶ Houtkin Dep. at 131-32.

³¹⁷ Feb. Hr’g Ex. 29.

³¹⁸ Feb. Hr’g Ex. 30.

³¹⁹ Feb. Hr’g Ex. 29.

³²⁰ *Id.*

³²¹ *Re: Approval of the pending application for registration of All-Tech*, 1993 Fla. Sec. LEXIS 49, Admin. No. 93.471.DOS (Dec. 7, 1993) (Feb. Hr’g Ex. 34).

³²² *Id.* at 4.

³²³ Houtkin Dep. at 127-45.

tact. It's very incestuous. All regulation is incestuous.”³²⁴ He added to this sentiment at the Subcommittee's hearing on February 25, 2000, when he stated, “* * * if you are looking to regulate and close down this type of activity, let me tell you there will not be a business left in this country.”³²⁵

B. All-Tech Allowed Unsuitable Customers to Day Trade

All-Tech has failed to consistently and vigilantly apply its own guidelines concerning the opening of day trading accounts, and All-Tech management has failed to communicate those guidelines to the branch offices where many of the accounts were held. In addition, All-Tech recently lowered the minimum amount of capital required to open a day trading account to \$25,000, even though Mr. Houtkin admits that “\$50,000 is a limiting minimum.”³²⁶ Thus, All-Tech is now opening accounts for new day traders that Mr. Houtkin considered unsuitable just one year ago. Mr. Houtkin was asked by Senator Levin about this discrepancy at the Subcommittee's hearing on February 25, 2000.

Q: But is it not fair to say that even though you believed that \$50,000 was the minimum for successful day trading, you lowered yours to \$25,000 in order to meet the competition? Is that a fair statement?

A: My personal opinion in the book, it was written by myself, I believe \$50,000 would be an appropriate minimum. There are other people in the firm and we have other contributing opinions into what we had to do to maintain a competitive business. It was not just my decision to drop it. It was a decision of—

Q: Your firm.

A: Of the firm.

Q: Are you not CEO of this firm?

A: Yes, but I am not a dictator.

Q: You may or not be that, but you are the CEO of a firm.

A: Yes, I am.

Q: And that firm has now got a minimum lower than what its CEO said was a minimum needed for successful day trading. That is, I believe, a fact. And you can say you have done that in order to meet what your competitors are doing. That is well and good, but you are also then taking people and their money and you're doing it, although you believe the \$25,000 is less than what is a minimum necessary for them to be successful. * * *³²⁷

(1) *All-Tech Employees Did Not Know or Did Not Apply the Minimum Standards for Opening New Accounts.* In response to Subcommittee interrogatories, All-Tech stated that, in order to open a day trading account, a potential customer must have a minimum

³²⁴ Id. at 150.

³²⁵ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

³²⁶ Houtkin, *Secrets of the SOES Bandit*, at 42.

³²⁷ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

net worth of \$100,000 and \$25,000 in risk capital.³²⁸ In addition, the \$25,000 initial deposit may not exceed “75% of net worth for individuals, 50% of net worth for married persons, and 25% of net worth for persons with dependents.”³²⁹ All-Tech implemented the net worth standard in approximately 1997,³³⁰ prior to which there were no written minimum standards for opening new accounts.³³¹

Even now there seems to be uncertainty among All-Tech employees concerning what the minimum standards are for opening new accounts. Mr. Lefkowitz told Subcommittee staff that, in addition to a minimum net worth of \$100,000, a customer must have an income of \$50,000 to open a day trading account.³³² All-Tech’s written response to the Subcommittee’s interrogatories made no reference to a minimum income standard. To add to the confusion, Lisa Esposito, who works for Mr. Lefkowitz, stated that, at one point, the minimum net worth required to open a new day trading account was \$150,000.³³³

This lack of uniformity concerning both the existence of standards and the nature of the standards appears to have been pervasive at All-Tech’s branch offices as well. The “Branch Procedures” section of the All-Tech Branch Office Manual states that, in opening a new account, the branch office must ensure that “[n]ew account information is complete” and determine the “[s]uitability of [the] client.”³³⁴ However, the former Branch Manager of All-Tech’s San Diego office, Barry Parish, testified that the main office did not discuss minimum net worth or minimum income requirements with him.³³⁵ As far as Mr. Parish was concerned, a customer was suitable to day trade so long as he or she had \$50,000 to open a day trading account.³³⁶ Mr. Parish testified in his deposition, however, that in September 1998, All-Tech only required a minimum deposit of \$25,000 to open a day trading account.³³⁷ Then on February 24, 2000, Mr. Parish provided testimony before the Subcommittee further illustrating the minimum standard confusion. He stated, “So there was a time it was as little as \$10[,000]. It started at \$50[,000]. It went to \$25[,000]. It came down to \$10[,000]. And then it went back to \$25[,000].”³³⁸

Frederick Michael Benson, another branch manager for All-Tech, informed the Subcommittee that there are certain minimum income and net worth standards for day trading accounts, but that

³²⁸ Feb. Hr’g Ex. 26.

³²⁹ Id.

³³⁰ Id.

³³¹ Interview of Harry Lefkowitz, Dec. 6, 1999, at 2 (“Lefkowitz Int.”).

³³² Id. Until Mr. Ogele joined the firm in March 1999, Mr. Lefkowitz was responsible for opening new accounts at All-Tech. Id.

³³³ Deposition of Lisa Esposito, Nov. 29, 1999, at 49 (“Esposito Dep.”). Ms. Esposito was Mr. Lefkowitz’s assistant in 1996 or 1997, and was responsible for ensuring that new account forms were filled out properly before passing them along to Mr. Lefkowitz for final approval. Id. at 46–47. Ms. Esposito is currently a supervisor in the Margins Department, and although she only recently obtained that title, Ms. Esposito has been the director of the Margins Department for the past two years. Lefkowitz Int. at 2. According to Ms. Esposito, her supervisors are Messrs. Shefts, Lefkowitz and Houtkin. Esposito Dep. at 33.

³³⁴ All-Tech Branch Office Manual (“Branch Office Manual”) “Branch Procedures” at 2 (Feb. Hr’g Ex. 35).

³³⁵ Parish Dep. at 43.

³³⁶ Id. at 44. Mr. Parish added the caveat that he would have considered individual circumstances when determining whether a person was suitable, but he provided no concrete standards. Id.

³³⁷ Id. at 70.

³³⁸ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

he did not know what they were.³³⁹ Sean Strawbridge, who was a branch manager for the Beaverton, Oregon office between July 1998 and November 1998, said that he did not pay much attention to a customer's disclosed income or net worth—customers simply needed to have \$50,000 to open a day trading account.³⁴⁰ Fred Zayas, formerly the branch manager of the Watertown, Massachusetts office, said that account applications had to show that a customer possessed between \$25,000 and \$50,000 in cash.³⁴¹ Yet, when Mr. Zayas was a branch manager, All-Tech purportedly required a minimum opening deposit of \$50,000.³⁴²

In some instances, the Subcommittee found that potential customers filled out new account forms indicating that they had \$50,000 of risk capital even though they opened their accounts with far less.³⁴³ Subcommittee staff interviewed a significant number of former All-Tech customers who also indicated that they opened accounts with less than the required \$50,000 minimum deposit and, in most instances, those funds could not be characterized as risk capital.³⁴⁴ In fact, Mr. Shefts stated that he does not care about the source of a potential customer's capital, so long as the person could sustain the loss of the funds without it affecting their lives.³⁴⁵

All-Tech employees also told Subcommittee staff that it would be inappropriate for a person whose account objective was anything other than, "short term growth with high risk," to open a day trading account.³⁴⁶ All-Tech, however, has opened accounts for customers who indicated on their new account forms that their objectives were other than high risk. For example, former San Diego customer Carmen Margala initially indicated on her new account form that her investment objectives were "income" as well as "short term growth with high risk."³⁴⁷ Within the securities industry, these two objectives are commonly understood to be at odds with each other. Ms. Margala's new account form also indicates that the check mark next to "income" was crossed out at some point.³⁴⁸ At his Subcommittee deposition, Mr. Parish testified that it is very possible that Ms. Margala checked the box and then crossed it out after he told her that income could not be her objective if she want-

³³⁹ Benson Int. at 7 ("Benson Int."). Mr. Benson is the co-owner of All-Tech's Beaverton, Oregon and Seattle, Washington offices. Id. at 2-3. Mr. Benson claims to have no title, id. at 3, although the branch office management agreement governing the Portland office designates Mr. Benson and David Niederkrome as the branch managers. Portland Branch Agreement, at "Rider" incorporated by reference. In addition, Mr. Houkin testified that Mr. Benson is the branch manager of the Beaverton office and has been since it opened. Houtkin Dep. at 226.

³⁴⁰ Telephone Interview of Sean Strawbridge, Dec. 14, 1999, at 3, 5 ("Strawbridge Int."). Mr. Strawbridge told Subcommittee staff that he had a verbal partnership agreement with Messrs. Benson and Niederkrome but that he later realized that they considered him an employee. Id. at 2.

³⁴¹ Deposition of Fred A. Zayas, Dec. 16, 1999, at 98 ("Zayas Dep.").

³⁴² Mr. Zayas was employed by All-Tech from April 30, 1996 to November 20, 1998. Zayas CRD #2816153 at "Previous Employment" (Feb. Hr'g Ex. 36).

³⁴³ Experienced Customer Letter of Understanding for Carmen Margala, Sept. 10, 1998 ("Margala Experienced Letter") (Feb. Hr'g Ex. 37); Customer Letter of Understanding for Yusef Liberzon, Oct. 12, 1998 ("Liberzon Customer Letter") (Feb. Hr'g Ex. 38).

³⁴⁴ Telephone Interview of Georgia Bovee, Nov. 2, 1999, at 1 ("Bovee Int."); Interview of Fred Cook, Oct. 5, 1998, at 3 ("Cook Int."); Interview of Golina Gogenko, Nov. 10, 1999, at 1 ("Gogenko Int."); Interview of Carmen Margala, Oct. 6, 1999, at 3 ("Margala Int.").

³⁴⁵ Shefts Int. at 9.

³⁴⁶ Interview of Franklin Ogele, Dec. 1, 1999, at 2 ("Ogele Int."); Esposito Dep. at 49; Parish Dep. at 43-44.

³⁴⁷ New Account Approval-B for Carmen Margala, Sept. 11, 1998 ("Margala New Account Form") (Feb. Hr'g Ex. 39).

³⁴⁸ Id.

ed to be a day trader.³⁴⁹ The Subcommittee reviewed over 300 new account forms for All-Tech day trading accounts that contained objectives other than, or in addition to, “short term growth, with high risk.”

All-Tech willingly accepts customers who are totally unsophisticated concerning the markets and have no previous experience investing, other than perhaps through a full-service brokerage firm. In fact, All-Tech actively markets itself to unsophisticated investors. For example, the following All-Tech document called “Frequently Asked Questions” makes clear that the firm considers prior investment experience to be a hindrance to successful day trading:

5. Do I have to know anything about the stock market?

NO! As a matter of fact, in many instances, the less you know means the less baggage you have to discard when learning the new trading techniques that we teach.³⁵⁰

Mr. Parish testified that prior trading experience was not a prerequisite to opening a day trading account.³⁵¹ Rather, the firm will teach the customer how to day trade.³⁵² All-Tech does not require new customers to take its training course, however, so long as they complete a form stating that they have prior experience.³⁵³ For example, Mr. Parish did not insist that Carmen Margala take All-Tech’s training course, even though Ms. Margala told Mr. Parish that she had never heard of day trading before.³⁵⁴ According to Ms. Margala, Mr. Parish recommended that she take the course, but when she opted not to do so, Mr. Parish simply provided her with a packet of forms to complete.³⁵⁵ Mr. Parish did so even though Ms. Margala, as she testified to the Subcommittee on February 24, 2000, was not employed and had no income.³⁵⁶ The forms included an “Experienced Customer Letter of Understanding,” which represents that the customer has “more than one year of experience in active short-term trading of OTC securities.”³⁵⁷ Ms. Margala signed the All-Tech form even though her past experience in the securities markets consisted of equity investments in a Quick & Reilly account and owning some shares of a mutual fund.³⁵⁸ Additionally, Ms. Margala told Subcommittee staff that Mr. Parish asked her to complete an additional form that asked for her understanding of certain terms, such as “market makers,” “crossed markets,” and “hedges.”³⁵⁹ Ms. Margala said she had no idea what the

³⁴⁹ Parish Dep. at 79–80.

³⁵⁰ “Frequently Asked Questions,” at 2 (Feb. Hr’g Ex. 40). Mr. Houtkin testified that he believed this document was previously on All-Tech’s website and was prepared by an All-Tech employee who handles advertising. Houtkin Dep. at 252-53. Mr. Houtkin was uncertain whether the document was still on the website. Id.

³⁵¹ Parish Dep. at 44.

³⁵² Id.

³⁵³ Shefts Int. at 5.

³⁵⁴ Margala Int. at 2. Ms. Margala lost approximately \$45,000 day trading as an All-Tech customer between September 1998 and January 1999. Id. at 1. At the time Ms. Margala opened her account at All-Tech, she had no income that year, and her income from the previous year was approximately \$20,000. Id. She had heard about All-Tech through a television advertisement that Mr. Parish wrote and produced, Parish Dep. at 161, and her impression was that All-Tech might be a good opportunity to start a new career and make a lot of money. Margala Int. at 2.

³⁵⁵ Margala Int. at 2.

³⁵⁶ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

³⁵⁷ Feb. Hr’g Ex. 37.

³⁵⁸ Margala Int. at 1.

³⁵⁹ Id. at 2; All-Tech “Experience Trader Qualification,” undated (Feb. Hr’g Ex. 41).

terms meant, and that Mr. Parish never commented on her lack of knowledge; nor did he ever explain to her the meanings of the terms.³⁶⁰ At the Subcommittee's hearing in February, Ms. Margala testified, "Mr. Parish nor anyone else ever discussed risk or my tolerance for risk, my background, goals, or objectives, past experiences, my financial position, or anything else other than how much money I could deposit in the All-Tech account."³⁶¹

Subcommittee staff interviewed various All-Tech customers who were clearly unsuitable for day trading based on All-Tech's own internal standards. These customers lost significant amounts of money day trading at All-Tech. For example, All-Tech allowed Ms. Margala to open a day trading account with an initial deposit of only \$20,000,³⁶² \$10,000 of which she obtained through the sale of stock given to her by her parents.³⁶³ At the time Ms. Margala opened her account, the All-Tech minimum requirement was \$50,000. As noted above, however, the branch manager of the San Diego office, Mr. Parish, testified that he was not aware of that \$50,000 minimum but understood the required minimum deposit to be only \$25,000.³⁶⁴

In addition, Georgia Bovee lost about \$22,000 day trading in the Beaverton, Oregon All-Tech office.³⁶⁵ Even though the minimum capital for account opening at the time was \$50,000, Ms. Bovee told Subcommittee staff that All-Tech personnel advised her that she could open the account with \$40,000.³⁶⁶ Ms. Bovee eventually opened her account with between \$38,000 and \$40,000 and was permitted to day trade just like any customer who had the requisite minimum.³⁶⁷ Mr. Benson, the branch manager, told Subcommittee staff that he knew Ms. Bovee had less than the \$50,000 minimum deposit.³⁶⁸ Mr. Benson explained that Ms. Bovee was determined to open an account at All-Tech so he allowed her to do so.³⁶⁹ However, Ms. Bovee's new account form makes clear that Mr. Benson knew that Ms. Bovee was not funding her day trading account with risk capital. Ms. Bovee wrote a notation on the bottom of the new account form that said, "Please draw \$1,500.00 from my Visa account # [number provided on form] Expiration date 10/00, and put into my day trading account."³⁷⁰

Ms. Bovee claims that she attempted to use her Visa credit card on two separate occasions to fund her day trading activities.³⁷¹ Ms. Bovee said that, on one occasion, All-Tech processed the request and, on the second occasion, Ms. Esposito informed Ms. Bovee that All-Tech would not permit her to use funds from a credit card for

³⁶⁰ Margala Int. at 2.

³⁶¹ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

³⁶² Feb. Hr'g Ex. 39; Margala Int. at 3.

³⁶³ Margala Int. at 3.

³⁶⁴ Parish Dep. at 70.

³⁶⁵ Bovee Int. at 1.

³⁶⁶ Id.

³⁶⁷ Id.

³⁶⁸ Benson Int. at 4-5. He estimated that Ms. Bovee funded her account with \$42,000. Id. at 5.

³⁶⁹ Id. at 5.

³⁷⁰ New Account Approval-B for Georgia Sweet Bovee, July 13, 1998 ("Bovee New Account Form") (Feb. Hr'g Ex. 42).

³⁷¹ Bovee Int. at 1-2.

day trading.³⁷² Mr. Benson stated that there was no way for him to know whether she used a credit card to fund the account.³⁷³ Ms. Esposito testified that she could not remember ever taking \$1,500 from a credit card to fund a new account.³⁷⁴ Ms. Esposito admitted, however, that she had customers who opened accounts with less than \$50,000.³⁷⁵ She said that Mr. Lefkowitz, Mr. Shefts or Linda Lerner retained final authority to open new accounts below the minimum requirements.³⁷⁶

Subcommittee staff interviewed the spouses of three victims of Mark Barton's shooting rampage at All-Tech's Atlanta office, all of whom lost money day trading at All-Tech. Yusef Liberzon, who was shot in the head by Mark Barton, opened his day trading account with the family's "life savings" of about \$25,000, according to his wife, Golina Gogenko.³⁷⁷ Mr. Liberzon's new account form indicates that he opened his day trading account in October 1998, when All-Tech's policy required a minimum deposit of \$50,000 of risk capital.³⁷⁸ Ms. Gogenko stated that she is a cosmetologist with an income of \$25,000 per year and that her husband, an immigrant from the Ukraine, previously drove a taxi cab and earned about \$30,000 per year.³⁷⁹ Mr. Liberzon lost about \$9,000 at All-Tech before he was shot by Mark Barton.³⁸⁰

Subcommittee staff also interviewed Gulshan Harjee, whose husband, Dean Delawalla, was killed by Mark Barton. Ms. Harjee has learned since her husband's death that the funds he used for day trading derived from his retirement fund, their children's trust funds, and a construction loan that he obtained to build their new home.³⁸¹ Similarly, Jamshid Havash, who was killed by Barton, lost about \$10,000 day trading at All-Tech's Atlanta Office.³⁸² Mr. Havash apparently funded his day trading account of \$75,000 with a \$130,000 loan that he allegedly obtained at the "urging of All-Tech" employees in Atlanta.³⁸³

As this evidence indicates, the Subcommittee's investigation found that All-Tech personnel, even senior management, did not have a clear and consistent understanding of All-Tech's account opening standards for new traders. The evidence shows that this confusion was particularly acute among branch office personnel. Consequently, it should not be surprising that All-Tech frequently opened accounts for new customers who did not provide the financial information necessary to evaluate their suitability for day trading or, even worse, disclosed financial information that did not satisfy All-Tech's minimum standards.

(2) *All-Tech Employees Altered New Account Forms.* All-Tech employees sometimes changed information on new account forms that

³⁷² Id. at 2.

³⁷³ Benson Int. at 5.

³⁷⁴ Esposito Dep. at 97-98.

³⁷⁵ Id. at 99.

³⁷⁶ Id. Ms. Lerner is All-Tech's General Counsel. Feb. Hr'g Ex. 28.

³⁷⁷ Interview of Golina Gogenko, Nov. 10, 1999, at 2 ("Gogenko Int."). According to Ms. Gogenko, Mr. Liberzon can no longer speak due to his severe injuries. Id.

³⁷⁸ New Account Approval-B Form for Yusef Liberzon, Oct. 12, 1998 ("Liberzon New Account Form") (Feb. Hr'g Ex. 43). The earliest account statement that Ms. Gogenko provided to the Subcommittee is for the period February 26, 1999 to March 26, 1999. The Subcommittee is unclear as to when Mr. Liberzon actually commenced day trading with All-Tech.

³⁷⁹ Gogenko Int. at 2.

³⁸⁰ Id.

³⁸¹ Interview of Gulshan Harjee, Nov. 10, 1999, at 2 ("Harjee Int.").

³⁸² Interview of Raira Masta, Nov. 10, 1999, at 1 ("Masta Int.").

³⁸³ Id.

were incomplete or disclosed financial information that was below All-Tech's minimum standards for opening new day trading accounts. Mr. Zayas, the former branch manager for All-Tech's Woburn, Massachusetts office, testified under oath at a Subcommittee deposition that Ms. Esposito instructed him to change numbers on the new account forms to make customers appear more suitable for day trading.³⁸⁴ When asked whether he changed the numbers as instructed by Ms. Esposito, Mr. Zayas refused to answer the question, asserting his Fifth Amendment right against self-incrimination.³⁸⁵ But when posed the same question at the Subcommittee's hearing on February 24, 2000, Mr. Zayas conceded, "Yes."³⁸⁶

Ms. Esposito testified that, during the time period when she was helping to open new accounts, her job was to review new account forms for completeness and to ensure that the figures listed on the forms satisfied All-Tech's internal standards.³⁸⁷ She would then pass the forms along to Mr. Lefkowitz for final review and approval.³⁸⁸ According to Ms. Esposito, there were occasions when she received new account forms that were missing necessary information or the information supplied did not meet All-Tech's minimum criteria.³⁸⁹ Ms. Esposito said that, on such occasions, she would speak with the branch manager or the customer concerning the missing or insufficient information.³⁹⁰ Ms. Esposito testified that, in some cases, she would change the information on the form or insert the missing information.³⁹¹ Ms. Esposito testified that, in other cases, the branch manager would change the information on the form.³⁹²

Ms. Esposito claimed that she never changed or inserted any information on new account forms without first speaking with either the customer or the branch manager, whom she told to speak with the customer.³⁹³ The reason for speaking with the customer was purportedly to determine whether the information, which was missing or did not meet the standards, was accurate.³⁹⁴ Ms. Esposito testified that she would tell the branch managers, "that if the customer didn't meet these criteria, [she] couldn't open [the account]."³⁹⁵ At her Subcommittee deposition, Ms. Esposito explained the procedure as follows:

Q: Was there ever a time when you saw a new account form that didn't meet the standards and you told the branch manager that the numbers needed to be changed?

A: I told them that the numbers are too low and I can't open accounts according to the numbers. They knew what

³⁸⁴ Zayas Dep. at 103.

³⁸⁵ Id.

³⁸⁶ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

³⁸⁷ Esposito Dep. at 47.

³⁸⁸ Id.

³⁸⁹ Id. at 50. Ms. Esposito stated that the standards she applied were \$150,000 in net worth, \$50,000 of income, and a stated investment objective of "short-term growth with high risk." Id. at 49.

³⁹⁰ Id. at 53.

³⁹¹ Id. at 51-53.

³⁹² Id. at 51-52.

³⁹³ Id. at 53-55, 68-69.

³⁹⁴ Id. at 51-52.

³⁹⁵ Id. at 51.

my criteria was, that it had to be 50,000 or 150. So they in turn would—I mean, I would gather they went to the customer, and then if they called me back and said the numbers are wrong, he makes 100,000 a year and his net worth is 300,000, then I would change it or fax it to him. He'd change it, initial it. Either way, he'd have to initial that he knew the change was going or the customer would have to sign a new form, a change form, and sign off on the new information.³⁹⁶

Yet, Ms. Esposito stated that there were two instances when, after speaking with the customers, she inserted numbers into the net worth column of the new account forms that she believed were false.³⁹⁷ Ms. Esposito claimed that, in both instances, she informed either Mr. Lefkowitz or Ms. Lerner that she did not believe the customers were suitable for day trading. In those cases, Ms. Esposito said Mr. Lefkowitz or Ms. Lerner opened each of the accounts anyway.³⁹⁸ Ms. Esposito said the following regarding one of those cases: “[I] handed [the account form] over to Harry [Lefkowitz], and, I believe, Linda [Lerner], and they discussed it and they said they approved the account.* * *”³⁹⁹

The testimony of Mr. Zayas and Ms. Esposito is very disturbing because it suggests that All-Tech deliberately altered the financial information provided by prospective day trading customers in order to justify the opening of an account that was otherwise unsuitable under the firm's minimum standards. If true, Mr. Zayas' charge would be a profound indictment of All-Tech. While Ms. Esposito denies the substance of Mr. Zayas' charge that she instructed him to change new account forms to comport with firm policies, Ms. Esposito willingly acknowledges that she instructed branch managers to advise potential customers that, if they wanted to open a day trading account, the information disclosed by the customer on the new account form would have to be changed to satisfy All-Tech's minimum standards. Ms. Esposito's testimony suggests that All-Tech may have performed its suitability analysis with a “wink and a nod” that encouraged unsuitable customers to inflate their financial condition to satisfy All-Tech's standards.

(3) *All-Tech Lowered Its Minimum Capital Requirement to \$25,000.* In response to competitive pressures from other day trading firms with lower minimum standards, All-Tech lowered the minimum capital required to open a day trading account from \$50,000 to \$25,000—a 50% decrease.⁴⁰⁰ All-Tech made this policy change in early 1999.⁴⁰¹ Mr. Lefkowitz said that the decision was a concession to branch managers who wanted to remain competitive with other day trading firms.⁴⁰² All-Tech lowered its minimum requirements despite Mr. Houtkin's public statements that a minimum of \$50,000 is required to have a reasonable chance of success at day trading. In fact, just about the time All-Tech lowered its

³⁹⁶ Id. at 51–52.

³⁹⁷ Id. at 58.

³⁹⁸ Id. at 58–60.

³⁹⁹ Id.

⁴⁰⁰ Houtkin Dep. at 187–88; Shefts Int. at 8; Lefkowitz Int. at 2.

⁴⁰¹ Feb. Hr'g Ex. 26.

⁴⁰² Lefkowitz Int. at 2.

minimum standard to \$25,000, Mr. Houtkin published his second book on day trading which stated as follows:

Before the market was booming to new, record-setting highs every other day and stock prices were uniformly lower, you could have had success trading with \$50,000 on margin. *Today, probably \$150,000 is the most advantageous amount of capital for trading, \$100,000 is adequate, and \$50,000 is a limiting minimum.* These sums are based on the availability of margin under Regulation T of the Federal Reserve Board.⁴⁰³

At his Subcommittee deposition, Mr. Houtkin was asked whether the recommended deposit for opening a day trading account at All-Tech was still \$100,000. He responded, “I still think a day trader, an active day trader, should have \$100,000 on deposit, but once again, I discussed with you before, there are competitive aspects of the business that we have to be cognizant of.”⁴⁰⁴ Thus, All-Tech now allows customers to commence day trading with one-half the amount of risk capital that Mr. Houtkin considers to be a “limiting minimum” for success, a point he conceded at the Subcommittee’s hearing on February 25, 2000.⁴⁰⁵ Messrs. Shefts and Lefkowitz also acknowledged that the amount of risk capital available to a day trader is directly related to the trader’s likelihood of success.⁴⁰⁶ Mr. Lefkowitz said that the more risk capital day traders have at their disposal the greater their chances of success.⁴⁰⁷ Mr. Shefts told Subcommittee staff that, if someone trades with less than \$100,000, their chance of success decreases because they cannot make as much with less capital.⁴⁰⁸

Given the significance that All-Tech officials assign to possessing adequate risk capital and Mr. Houtkin’s view that “\$50,000 is a limiting minimum,” it is disturbing that All-Tech has elected to accept new day trading customers who have amounts of risk capital that All-Tech considers inadequate. In fact, under the old \$50,000 standard, All-Tech’s policy restricted a customer’s ability to trade in his or her account, aside from liquidating positions, if the customer’s account equity dropped below \$30,000.⁴⁰⁹ Before the customer could begin trading again, the equity in the customer’s account had to be raised to \$40,000.⁴¹⁰ Thus, All-Tech now accepts new day trading customers whose beginning risk capital is below the amount at which it formerly restricted a customer’s ability to trade. By doing so, All-Tech is now aggressively competing for the commission revenue generated by day traders who All-Tech knows will probably fail. Whether or not the customers make money, however, All-Tech earns a commission on every trade.

⁴⁰³ Houtkin, *Secrets of the SOES Bandit*, at 42 (emphasis added).

⁴⁰⁴ Houtkin Dep. at 182.

⁴⁰⁵ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

⁴⁰⁶ Lefkowitz Int. at 2; Shefts Int. at 8.

⁴⁰⁷ Lefkowitz Int. at 2 .

⁴⁰⁸ Shefts Int. at 8.

⁴⁰⁹ Feb. Hr’g Ex. 35, Section 4, “Re: Day Trading Account Guidelines,” May 13, 1997.

⁴¹⁰ *Id.*

C. All-Tech Enabled Customers to Trade Beyond Their Means

All-Tech uses several devices that allow customers to continue day trading, even when that might be inappropriate for their financial circumstances. Because All-Tech's business model depends upon high volume trading, the firm employs these devices to allow customers to pursue trading strategies that require more capital than customers actually possess and to avoid regulatory limits that might curtail continued trading.

(1) *All-Tech May Have Allowed Customers Whose Day Trading Accounts Were Closed for Failure to Meet Margin Calls to Open New Accounts to Allow Continued Trading.* The first of these techniques involved the use of multiple accounts by a single customer to evade the constraints of margin rules. In his most recent book, Mr. Houtkin discusses at length the "learning curve" associated with day trading, noting that "one should almost expect to have losses on the outset of trading."⁴¹¹ Mr. Houtkin's book explains, however, that "[o]ne of the self-cleansing effects of [day] trading is that if, for some reason, you do not do well and your capital is reduced, you *must* replenish it or you cannot continue to trade. Margin requirements are a fail-safe mechanism."⁴¹² The Subcommittee's investigation found evidence, however, that All-Tech employees undermined the "fail-safe mechanism" of the margin rules by allowing customers whose accounts were closed for failure to meet margin calls to open new accounts and continue day trading.

Mr. Zayas, the former branch manager of All-Tech's Watertown office, and Mr. Parish, the former branch manager of the San Diego office, both testified that All-Tech employees allowed customers to open new accounts to continue day trading after their initial accounts had been closed for failure to meet margin calls. Mr. Zayas testified as follows:

A: Well, what generally would happen is the account would be closed up and that account would be liquidated and shut off, so they could no longer trade in that account, so they wanted to trade, so they needed to open up another account.

* * * * *

Q: [d]id you assist people in opening new accounts when you knew that other accounts, one or more, that they had been closed or liquidated because they couldn't meet margin calls in those accounts?

A: Well, if an account would get closed up and the customer would say to me, "What do I do? What do I do," I would talk to the Montvale office and say, "Can this account get reopened," and sometimes they would say yes and sometimes they would say no, and I don't know what determined that; but if the answer was no, they would then tell me, "Just have them open up another account under a relative's name or—"

Q: Who told you that?

A: Lisa.

Q: Isposito? [sic]

⁴¹¹Houtkin, *Secrets of the SOES Bandit*, at 44.

⁴¹²*Id.* at 45 (emphasis in original).

A: Yes.

Q: And did you do that for customers?

A: Sure. Yes.⁴¹³

When asked whether he “encourage[d] customers to open new accounts under fictitious names when they had their old accounts closed or liquidated because of failure to meet margin calls,” Mr. Zayas asserted his Fifth Amendment right and declined to answer.⁴¹⁴ At the Subcommittee’s hearing on February 24, 2000, Mr. Zayas, when asked the same question, once again asserted his Fifth Amendment right and did not answer.⁴¹⁵

Mr. Parish testified that customers whose accounts were closed for failure to meet maintenance calls were allowed to open other accounts with All-Tech so that they could continue to day trade.⁴¹⁶ When asked whether he encouraged customers to open additional accounts, Mr. Parish answered, “[i]f they wanted to keep trading sometimes, yes.”⁴¹⁷ Mr. Parish confirmed that the home office in Montvale had to approve the opening of the second account for the customers.⁴¹⁸

This testimony is disturbing because it indicates that All-Tech management, acting through Ms. Esposito who was the Margins Department Supervisor, willfully disregarded the margin rules that are designed to protect both All-Tech and its customers from becoming over-extended. The testimony of Messrs. Parish and Zayas suggests that the “fail-safe mechanism” that Mr. Houtkin described in his book may be broken at All-Tech.

(2) *All-Tech Employees Arranged Loans Between Customers.* All-Tech has allowed, and even encouraged, customers to trade beyond their means by arranging loans for customers to satisfy margin and maintenance calls.⁴¹⁹ In the typical scenario, the loan remained in the borrowing customer’s account overnight and was then transferred back to the lending customer the next day. In many instances, the borrowing customer paid an exorbitant fee to the lending customer for the use of the funds.

All-Tech claims that its written policy prohibits the firm’s employees from arranging customer loans, but All-Tech acknowledges that this practice occurred in the past.⁴²⁰ The Subcommittee requested that All-Tech produce all documents pertaining to such policies. In its review of All-Tech’s documents, the Subcommittee found no policy prohibiting All-Tech employees from “arranging” loans between customers for the purpose of satisfying margin calls. The Subcommittee did find an All-Tech policy stating that “[n]o employee, relative of an employee or entity owned by either is per-

⁴¹³ Zayas Dep. at 144–46.

⁴¹⁴ Id. at 146.

⁴¹⁵ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

⁴¹⁶ Parish Dep. at 156–57.

⁴¹⁷ Id. at 157.

⁴¹⁸ Id. at 158.

⁴¹⁹ There are three types of margin calls that may have applied to customers at All-Tech: Regulation T initial margin calls; maintenance margin calls; and special maintenance margin calls for day trading (“day trading calls”). The Subcommittee does not know for certain, and neither does All-Tech, whether the lending practices implicated each of these kinds of calls. All-Tech provided to the Subcommittee no written firm policy or documentation to support the assertion that these inter-customer loans were limited to day trading calls.

⁴²⁰ Feb. Hr’g Ex. 26.

mitted to lend money to any customer.”⁴²¹ As is evident, this policy does not address employees arranging loans between customers. Indeed, the Subcommittee discovered that the practice of All-Tech employees arranging loans for customers to meet margin calls was common-place until very recently.⁴²² Several former customers told Subcommittee staff that All-Tech branch managers either assisted them in obtaining a customer loan or solicited them to provide loans to customers they did not know.

For example, according to former customers in the San Diego office, Mr. Parish arranged and attempted to arrange numerous loans for customers. Former San Diego customer Fred Cook said that Mr. Parish would act as a “middleman” to arrange loans.⁴²³ Mr. Cook also said that Mr. Parish sometimes called out to the trading room to see if anyone could loan another customer money.⁴²⁴ Mr. Cook borrowed money once from another customer and loaned money twice.⁴²⁵ He stated that \$100 was the normal fee for the margin loans.⁴²⁶

Ms. Margala informed Subcommittee staff that some of the loans Mr. Parish solicited were for customers in other branch offices.⁴²⁷ According to Ms. Margala, Mr. Parish occasionally approached individual customers and told them how much they had in their accounts, and asked them to make specific loans to others.⁴²⁸ Ms. Margala recalled an incident in which Mr. Parish solicited customers to lend \$100,000 to another day trader.⁴²⁹ In addition to borrowing funds from customers in the San Diego office, Ms. Margala received loans from customers in other branch offices whom she did not know.⁴³⁰ Ms. Margala informed Subcommittee staff that lending customers sometimes charged a fee of \$50.00 for the overnight use of the funds.⁴³¹ Former San Diego customer Sandra Harlacher told Subcommittee staff that an All-Tech employee approached her and asked her to loan another customer \$100,000.⁴³² Ms. Harlacher said that she was uncomfortable with the solicitation but agreed to make the loan.⁴³³ She apparently knew the borrowing customer and felt that she could not refuse.⁴³⁴ Ms. Harlacher said that she did not charge a fee for the loan.⁴³⁵

Another former San Diego customer, Marilyn Sherman, allowed Mr. Parish to use her account to make loans on a routine basis.⁴³⁶ Ms. Sherman decided to take a respite from day trading, but left funds in her inactive account.⁴³⁷ Mr. Parish asked Ms. Sherman if

⁴²¹ Feb. Hr’g Ex. 35, “Operations Memorandum,” Memorandum from Mark Shefts, to All Employees, re “Loans to Customers,” Feb. 11, 1999.

⁴²² According to Mr. Shefts, All-Tech now requires the customer’s signature authorizing loan transfers to be notarized and the original journal authorization must be sent to the main office. Shefts Int. at 7. Ms. Esposito said that, as of January 1999, All-Tech no longer permits lending between customers from different branch offices. Esposito Dep. at 111–12.

⁴²³ Cook Int. at 5.

⁴²⁴ Id.

⁴²⁵ Id.

⁴²⁶ Id.

⁴²⁷ Margala Int. at 4.

⁴²⁸ Id.

⁴²⁹ Id.

⁴³⁰ Id.

⁴³¹ Id.

⁴³² Interview of Sandra Harlacher, Oct. 6, 1999, at 4 (“Harlacher Int.”).

⁴³³ Id.

⁴³⁴ Id.

⁴³⁵ Id.

⁴³⁶ Interview of Marilyn Sherman, Oct. 6, 1999, at 4 (“Sherman Int.”).

⁴³⁷ Id.

she would make her account available to loan money to customers—on an as needed basis—to meet margin calls.⁴³⁸ Ms. Sherman agreed.⁴³⁹

Mr. Parish admitted that he had customer accounts available to him, as in the case of Ms. Sherman, for the purposes of lending funds to customers to meet margin calls.⁴⁴⁰ According to Mr. Parish, his secretary, Sue Paine, would telephone Ms. Sherman to inform her of the need for a loan, and Ms. Paine would then send an authorization to Ms. Sherman for her signature.⁴⁴¹ Ms. Sherman provided Subcommittee staff with twelve authorizations to journal a total of \$168,640 from her account to the accounts of other customers between June and August 1998.⁴⁴² On at least one occasion, however, Ms. Sherman stated that All-Tech transferred funds out of her account without her authorization.⁴⁴³ Mr. Parish testified that Ms. Paine forged Ms. Sherman's signature on the journal authorization form because she could not reach Ms. Sherman and the deadline to cover the margin call was approaching.⁴⁴⁴ Though he approved the transfer, Mr. Parish claims that he did not know that the signature was forged until after the transfer occurred and Ms. Sherman's husband called to complain.⁴⁴⁵ However, Mr. Parish never reported the forgery to the All-Tech main office, nor did he fire or discipline Ms. Paine.⁴⁴⁶

Ms. Bovee told Subcommittee staff that Mr. Benson, Beaverton's Branch Manager, frequently arranged loans for her when she had margin calls.⁴⁴⁷ She said that Mr. Benson would bring her blank journal authorization forms to sign, authorizing the receipt and repayment of the loan through journal transfers.⁴⁴⁸ Ms. Bovee stated that, when funds were journaled out of her account to repay the loans, All-Tech deducted a fee of \$25 to \$100 for the lender.⁴⁴⁹ Ms. Bovee said she never knew which particular customer loaned her money.⁴⁵⁰ Mr. Benson, on the other hand, characterized his role in the lending process differently. He told Subcommittee staff that he facilitated loans merely by informing day traders in need of funds that he knew of customers who had accounts available for lending.⁴⁵¹ Mr. Benson claimed that he did not call other All-Tech offices to locate lenders.⁴⁵² Mr. Benson acknowledged, however, that Ms. Esposito called him on two separate occasions on behalf of traders in need of loans.⁴⁵³

In fact, at her Subcommittee deposition, Ms. Esposito admitted that there were two accounts at her disposal from which she could make loans to customers in need of funds to meet margin calls.⁴⁵⁴ The first account was held by former All-Tech employee and co-au-

⁴³⁸ Id.

⁴³⁹ Id.

⁴⁴⁰ Parish Dep. at 95–96.

⁴⁴¹ Id.

⁴⁴² Sherman Journal Authorizations, June 1999 to Aug. 1999 (Feb. Hr'g Ex. 44).

⁴⁴³ Sherman Int. at 4–A.

⁴⁴⁴ Parish Dep. at 97.

⁴⁴⁵ Id. at 97–100.

⁴⁴⁶ Id. at 99–101.

⁴⁴⁷ Bovee Int. at 3.

⁴⁴⁸ Id.

⁴⁴⁹ Id.

⁴⁵⁰ Id.

⁴⁵¹ Benson Int. at 7.

⁴⁵² Id.

⁴⁵³ Id.

⁴⁵⁴ Esposito Dep. at 113–14, 116.

thor of “Secrets of the SOES Bandit”, David Waldman.⁴⁵⁵ According to Ms. Esposito, Mr. Waldman signed a blank journal authorization form which Ms. Esposito photocopied and repeatedly used to make loans at her discretion.⁴⁵⁶ Ms. Esposito said she had access to Mr. Waldman’s account from May 1998 until September 1998, and used it to make loans as large as \$100,000.⁴⁵⁷ Through Ms. Esposito, Mr. Waldman charged customers \$40 for obtaining the loan and, for every \$10,000 of principal, he received a fee of \$10.⁴⁵⁸ Ms. Esposito also had discretionary access to an account belonging to the sister of the branch manager of All-Tech’s Edison, New Jersey office, which was held in the name of “Z-Tech.”⁴⁵⁹ The Edison branch manager, Ralph Zulferino, initiated the use of the Z-Tech account to cover customer margin calls.⁴⁶⁰

Ms. Esposito said that, prior to the action by the Commonwealth of Massachusetts against All-Tech’s Watertown office, Messrs. Lefkowitz and Shefts knew that Ms. Esposito had been using these two accounts to loan money to customers to meet margin calls.⁴⁶¹ She did not believe, however, that Mr. Shefts knew the extent to which she used the accounts to make loans.⁴⁶² Ms. Esposito testified that Mr. Lefkowitz was completely aware of this lending activity because “[h]e signed all the journals. He knew David had the account and that we were using it to cover margin calls.”⁴⁶³ Mr. Lefkowitz claimed, however, that he did not learn about Ms. Esposito’s involvement in arranging the loans until 1999.⁴⁶⁴ Mr. Lefkowitz said that, when he learned of her actions, it bothered him because it was wrong for All-Tech to be facilitating these loans.⁴⁶⁵ Given Ms. Esposito’s testimony and the extent of this lending practice at the various branch offices, Mr. Lefkowitz’s claimed ignorance strains credibility.

The evidence shows that All-Tech systematically—and quite affirmatively—promoted the extension of short term credit from its better capitalized day trading customers to those customers who needed additional funds to satisfy margin and maintenance calls. While there is nothing inappropriate about customers lending money to one another, All-Tech’s role as a middleman in the process is problematic. The Subcommittee’s investigation shows that customers loaned money to other customers without even knowing the borrowing customer’s name much less the borrower’s credit worthiness. In some instances, the lending customer had no role whatsoever in the process since, as Ms. Esposito testified, she exercised discretionary access over two accounts in which the lender was not even consulted on a transaction-by-transaction basis. These loan programs are also highly susceptible to unauthorized

⁴⁵⁵ Mr. Waldman is a lawyer who worked for All-Tech for several months. Houtkin Dep. at 176. He helped Mr. Houtkin write his book and he then worked for All-Tech as Mr. Houtkin’s “right-hand man.” Id. at 177. Several branch managers told Subcommittee staff that Mr. Waldman had been actively involved in hiring them as branch managers. Benson Int. at 2; Parish Dep. at 25–28. In addition, Mr. Shefts stated that Mr. Waldman negotiated most of the branch agreements. Shefts Int. at 6.

⁴⁵⁶ Esposito Dep. at 113–14.

⁴⁵⁷ Id. at 115.

⁴⁵⁸ Id. at 116.

⁴⁵⁹ Id.

⁴⁶⁰ Id. at 116–17.

⁴⁶¹ Id. at 118–19.

⁴⁶² Id. at 119.

⁴⁶³ Id. at 118–19.

⁴⁶⁴ Lefkowitz Int. at 3.

⁴⁶⁵ Id.

journaling of funds, as occurred in the case of Ms. Sherman. Thus, it is encouraging that All-Tech appears to be discontinuing the practice of facilitating customer-to-customer loans, though the Subcommittee has seen no written statement of firm policy to support that contention.

(3) *All-Tech Employees Recommended Stocks to Customers*. The day trading industry contends that existing NASD suitability rules do not apply to day trading because a trader executes his or her own trades directly rather than submitting those orders to a broker. In addition, because day traders theoretically buy and sell securities without the guidance or recommendation of a broker, the industry argues that day trading firms have no legal obligation to evaluate the suitability of day trading for their customers or the suitability of particular stocks that their customers might trade. The Subcommittee's investigation found evidence, however, that All-Tech brokers recommended to their customers the purchase and sale of specific stocks, at specific prices, and at specific times. This evidence may support the application of *existing* suitability rules.⁴⁶⁶

Several former customers of All-Tech's San Diego office indicated that Mr. Parish, the former branch manager, recommended that they purchase and sell specific stocks.⁴⁶⁷ Most of the customers asserted, and Mr. Parish admitted, that he frequently used the term "load to buy" to advise customers to prepare to buy a certain stock.⁴⁶⁸ The following exchange occurred during Mr. Parish's Subcommittee deposition:

Q: You said load to buy to your customers, didn't you?

A: Yes. I said, get ready.

Q: And you gave them specific stocks at specific prices that they should load to buy, didn't you?

A: Yes.

Q: You did this on a frequent basis?

A: Oh, yes.⁴⁶⁹

Mr. Parish claimed that this practice does not violate All-Tech policy prohibiting its licensed personnel from recommending securities to customers.⁴⁷⁰ During his deposition, Mr. Parish was asked whether All-Tech's management discouraged these recommendations:

Q: Did [Mr. Ogele] specifically say you should not be recommending stocks to customers?

A: We don't believe that's a recommendation. It's a trade. You see, there's a difference between me telling you to buy Dell at 47 and hold on to it. I recommend that you buy the stock. All we do as traders is try to teach people that have no experience how to recognize an entry point to get in and get out. It's not a recommendation. If I rec-

⁴⁶⁶As explained in Section VI, the NASD has proposed a new rule for day trading firms that would resolve this ambiguity by requiring member firms to evaluate the "appropriateness" or "suitability" of a day trading strategy for their prospective customers before opening a day trading account.

⁴⁶⁷Cook Int. at 4; Harlicher Int. at 5; Margala Int. at 3; Sherman Int. at 5; Interview of Rodney Haseltine, Oct. 5, 1999, at 2-3 ("Haseltine Int.").

⁴⁶⁸Cook at 4; Haseltine at 2-3; Margala Int. at 3; Sherman Int. at 5; Parish Dep. at 115.

⁴⁶⁹Parish Dep. at 115.

⁴⁷⁰Id. at 120-21.

ommend a stock to you, you assume I know something about the company, right? I know nothing about almost any of these companies.⁴⁷¹

Mr. Parish said that his recommendations were based simply on “very short-term technical analysis.”⁴⁷² As for the stocks he recommended, Mr. Parish testified that he knew, “[a]bsolutely nothing. Most of the time, I don’t even know what they do. Half the time, I don’t even know the name of them. I just know the four-letter symbol. So I don’t look at them as recommendations. They’re strictly trades.”⁴⁷³

Ms. Bovee told Subcommittee staff that Mr. Benson made verbal recommendations to buy specific stocks and another employee, Angus Beal, issued written stock pick recommendations.⁴⁷⁴ According to Ms. Bovee, Mr. Benson would sit at the branch manager’s computer and yell out recommendations to the trading room.⁴⁷⁵ Mr. Beal frequently sent e-mail messages that listed his stock picks to several customers who traded remotely.⁴⁷⁶ When asked about making stock recommendations, Mr. Benson indicated that, in a roomful of traders, it is only natural to have conversations about stocks and that he would discuss various securities and what the market was doing.⁴⁷⁷ He claimed to have no idea if customers made trades based upon those “conversations.”⁴⁷⁸ Mr. Benson was aware that Mr. Beal sent stock picks to customers.⁴⁷⁹ Mr. Strawbridge admitted that he posted in the office the “plays of the day” from Mr. Beal.⁴⁸⁰

Stock picks were not limited to the Beaverton and San Diego offices of All-Tech. Dr. Leslie Levine, who was a customer at All-Tech’s Montvale office, told Subcommittee staff that there was a board in the office that listed stock recommendations for the day, usually containing ten stock picks.⁴⁸¹ Dr. Levine understood the stock pick instructions to mean that, if the stock whose symbol was listed reached the stated price, then customers should buy it.⁴⁸²

This evidence casts significant doubt on the claims of many day traders, including Mr. Houtkin, that day trading firms do not recommend the purchase and sale of specific securities. Though Mr. Houtkin takes the extreme view that it is “impossible” for a day trading firm to give a solicited recommendation that would implicate the existing NASD suitability rules,⁴⁸³ a strong argument can be made that All-Tech employees issued recommendations to their day trading customers that would have required a basic suitability analysis.

⁴⁷¹ Id.

⁴⁷² Id. at 121.

⁴⁷³ Id.

⁴⁷⁴ Bovee Int. at 2. Mr. Beal was a registered representative who was ultimately fired by All-Tech for making unauthorized trades in a customer’s account. Ogele Int. at 3.

⁴⁷⁵ Bovee Int. at 2.

⁴⁷⁶ Id.; E-mail messages from Beal to Bovee, et al. (Feb. Hr’g Ex. 45). In addition to trading on-site, Ms. Bovee also day traded remotely from her home. Bovee Int. at 3.

⁴⁷⁷ Benson Int. at 6.

⁴⁷⁸ Id.

⁴⁷⁹ Id. at 3–4.

⁴⁸⁰ Strawbridge Int. at 6.

⁴⁸¹ Telephone Interview of Dr. Leslie Levine, Nov. 1, 1999, at 1 (“Levine Int.”).

⁴⁸² Id.

⁴⁸³ Houtkin Dep. at 325.

(4) *All-Tech Encouraged Customers to Trade Heavily*. A sign hangs outside the door of All-Tech's trading room in Montvale, New Jersey, which reads as follows:

It's better to be boldly decisive
And risk being wrong
Than to agonize at length
And to be right too late.⁴⁸⁴

This sign captures All-Tech's trading philosophy, which encourages "clicking the mouse" and thereby placing as many orders as possible. Indeed, All-Tech instructs customers, through its training programs, to trade heavily. At the Subcommittee's hearing on February 24, 2000, Ms. Harlacher testified, "Mr. Parish was constantly harassing me and others, often making suggestions regarding which stocks to buy and sell, including when to buy and sell. When I was hesitant to trade, he would egg me on, telling me that I would never get experience or learn how to trade or make up my losses unless I traded often."⁴⁸⁵ Another telling example is one of All-Tech's training documents that cites "REASONS TO INITIATE A TRADE," and states:

Knowing when to pull the trigger. * * * Do not hesitate! When confident a stock is going to make a move, do not be afraid to pull the trigger! If you wait until it looks picture perfect, you will never get the price you're looking for, and you will always pay up or down. By paying up or down, this will cost any trader a substantial amount of money. I REPEAT!! DO NOT HESITATE!!!⁴⁸⁶

Similarly, when questioned about "paper trading," which is simulated trading that All-Tech uses to train new customers, Mr. Parish testified that it was "just to teach you how to click, click, click, click. It's an exercise like the solitaire game in Microsoft Windows. It's to teach you how to use the mouse. It's not to teach you how to trade."⁴⁸⁷ The following colloquy illustrates Mr. Parish's view of the connection between heavy trading and commission revenue:

Q: Is it really to encourage you to click the mouse?

A: Yes. How else are you going to learn? You've got to do a trade to learn how to trade.

Q: And you also have to do a trade for All-Tech to get a profit, isn't that true?

A: Yes.

Q: And for you to get a profit, for that matter.

A: That's right. I'm not in business to lose money.⁴⁸⁸

Mr. Zayas, the former branch manager in Watertown, Massachusetts, testified that All-Tech's training was "horrible" because it "did not teach you how to trade," only how to generate commissions.⁴⁸⁹ Ms. Harlacher, a former customer from the San Diego of-

⁴⁸⁴ E-mail message from Stephanie Rosenblatt, Counsel for All-Tech, to Deborah Field, Counsel for the Subcommittee, Jan. 18, 2000 (Feb. Hr'g Ex. 46).

⁴⁸⁵ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

⁴⁸⁶ "Reasons to Initiate a Trade" (Feb. Hr'g Ex. 47).

⁴⁸⁷ Parish Dep. at 145.

⁴⁸⁸ Id. at 145-46.

⁴⁸⁹ Zayas Dep. at 86.

fice, agreed with this characterization, noting that the emphasis during All-Tech's training program was to encourage customers to trade as much as possible in order to "rack up commissions."⁴⁹⁰ When asked to evaluate All-Tech's training program at the Subcommittee's hearing on February 24, 2000, Ms. Harlacher described it as, "* * * totally inadequate. All it really taught you to do was operate the software and to make as many trades as possible and rack up as many commissions as possible for All-Tech * * *."⁴⁹¹ Indeed, Dr. Levine, a customer in the Montvale office, said that there was great pressure to trade heavily.⁴⁹² Dr. Levine said that one day an All-Tech employee told him that, because he was not trading enough, he would have to leave the Montvale office, but that he could trade at another office or trade remotely from home.⁴⁹³

This testimony is troubling because it indicates that All-Tech promoted heavy trading by its novice customers even when high volume trading might have resulted in the customer becoming overextended. All-Tech, of course, generates commission revenue whether or not the customers who pursue high volume trading are successful.

D. All-Tech's Risk Disclosure Was Often Ineffective and the Firm's Advertising Was Occasionally Misleading

(1) Verbal Representations and Some Advertising Undermined All-Tech's Written Risk Disclosure.

(a) *Advertising.* Although All-Tech provides its customers with good written risk disclaimers,⁴⁹⁴ the firm may have undermined those disclosures with advertising that failed to disclose the risks of day trading and by verbal representations from employees that contradicted those warnings. Mr. Cook and Ms. Harlacher were both attracted to All-Tech by commercials on CNBC that Ms. Harlacher said made it seem like day trading was easy and simple.⁴⁹⁵ Mr. Cook was impressed by the advertisements and told Subcommittee staff that they created a "very positive presentation of a way to make a living starting off with \$25,000."⁴⁹⁶

Shortly before Mr. Cook began day trading at All-Tech's San Diego office, Mr. Parish produced an advertisement that featured Mr. Cook smiling in apparent triumph, receiving a congratulatory hand shake from Mr. Parish, and then grinning broadly. At that

⁴⁹⁰ Harlacher Int. at 3.

⁴⁹¹ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

⁴⁹² Levine Int. at 1.

⁴⁹³ Id. The fee for remote trading is \$250 per month, which can be waived if the customer makes 200 trades per month. Feb. Hr'g Ex. 35, Section 1, "Operations Memorandums" from Mark Shefts to All Employees, re "Remote Pricing," Feb. 25, 1999. Dr. Levine did not identify the name of the All-Tech employee who allegedly made the statement.

⁴⁹⁴ Among the forms customers must complete when seeking to open an account is a "Customer Letter of Understanding" requires day trading customers to acknowledge that, among other things, their losses could exceed their initial investment and that their capital is risk capital. In addition, it appears that All-Tech provided customers who took the training courses a risk disclosure document in connection with the registration forms. "Customer Letter of Understanding" (Feb. Hr'g Ex. 38). "Rushmore Financial Service, Inc.—Disclosure Statement" (Feb. Hr'g Ex. 49); "All-Tech Training Group, Inc.—Disclosure Statement" (Feb. Hr'g Ex. 50). All-Tech also sends a very good risk disclosure letter to customers whose accounts have experienced a significant decline in equity. Account Decline Letter from Mark Shefts to Sandra Harlacher [sic], Nov. 28, 1997, bate number 4049 (Feb. Hr'g Ex. 51).

⁴⁹⁵ Harlacher Int. at 1.

⁴⁹⁶ Cook Int. at 2. At the time Mr. Cook joined All-Tech, however, the new account minimum was \$50,000.

point, however, Mr. Cook had not yet started live trading with All-Tech.⁴⁹⁷ Ironically, Mr. Cook eventually lost \$175,000 day trading at the firm and has filed an NASD arbitration claim against All-Tech.⁴⁹⁸ At the Subcommittee's hearing in February, all Mr. Parish could offer in evaluating the impetus behind Mr. Cook's losses was that he, "*** made bad investments."⁴⁹⁹ In that particular commercial, Mr. Parish touts All-Tech as a good place to "start a whole new full or part-time career" and he states that, "if you have \$10,000 or more in working capital along with the will and desire to take advantage of the incredible opportunities offered by day trading, you need to call All-Tech Investment Group today!"⁵⁰⁰ The commercial, however, fails to mention the risks of day trading. Ms. Margala told Subcommittee staff that she saw the commercial featuring the enthusiastic Mr. Cook and that it prompted her to contact All-Tech.⁵⁰¹ She said that the commercial left her with the impression that she could learn how to day trade and make a lot of money.⁵⁰²

According to All-Tech's Branch Office Manual, and the deposition testimony of Mr. Houtkin, all advertising must be approved by the main office.⁵⁰³ Mr. Parish testified that, as required by firm policy, Linda Lerner and Richard Raciti from the main office approved the commercial containing the ebullient Mr. Cook.⁵⁰⁴ Mr. Parish said that no one at the main office ever informed him that the commercial should contain a risk disclosure.⁵⁰⁵ Mr. Houtkin admitted in his deposition that he was not aware of any risk disclaimers that All-Tech makes on any of its television advertisements.⁵⁰⁶ He claimed, however, that there is some kind of risk disclosure for print advertisements.⁵⁰⁷ Mr. Houtkin also testified that All-Tech's advertising, especially in the last few years, has been limited to promoting the benefits of its Attain trading system rather than the strategies of day trading.⁵⁰⁸ He said, "[w]e do not advertise day trading * * * [s]o we really don't have to show a disclaimer because we're not making any claims, other than come see the Attain trading system and the power of the Attain system."⁵⁰⁹

⁴⁹⁷ Parish Dep. at 163.

⁴⁹⁸ Cook Int. at 1. In May 1999, Mr. Cook, Ms. Margala and Judith Payne Cook filed a claim in arbitration against All-Tech, Mr. Parish, Southwest Securities, Mr. Shefts and Mr. Houtkin. *Cook v. All-Tech Investment Group, Inc.*, NASD Arbitration Claim No. 99-02325, filed May, 1999. On December 28, 1999, the arbitration claim was amended to add claimants Ms. Harlacher, Neil Harlacher, and Ms. Sherman and certain additional allegations. *Cook v. All-Tech Investment Group, Inc.*, Case No. 90-00515, filed Dec. 28, 1999.

⁴⁹⁹ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

⁵⁰⁰ Advertisement for San Diego office featuring Barry Parish.

⁵⁰¹ Margala Int. at 2.

⁵⁰² Id. Ms. Margala stated that, when she first went to All-Tech, she wanted to open her account with \$10,000, as specified in the commercial, but Mr. Parish told her that she needed \$20,000. Id. at 3. Mr. Parish said that the \$10,000 mentioned in the commercial was only for an "investment account," not a day trading account. Id. At least three radio advertisements for All-Tech's Beaverton, Oregon office also stated that the minimum account balance was \$10,000. All of these radio advertisements purport to be for day trading at All-Tech even though the initial minimum deposit at the time was \$50,000. Radio Copy, "Open House #28 Portland," 7/23/98; Radio Copy, "Open House #30P," 8/14/98; Radio Copy, "New Class #31P," 8/17/98.

⁵⁰³ Ex. 35, "Branch Procedures," Sections 3(A) at 3, and 3(B) at 3; Houtkin Dep. at 288.

⁵⁰⁴ Parish Dep. at 162. According to Mr. Parish, Ms. Lerner and Mr. Raciti were responsible for reviewing all advertisements. Id. at 161-62.

⁵⁰⁵ Id. at 162-63.

⁵⁰⁶ Houtkin Dep. at 289-90.

⁵⁰⁷ Id. at 290.

⁵⁰⁸ Id. at 288-89.

⁵⁰⁹ Id.

However, the following All-Tech radio commercial featuring a monologue by Mr. Houtkin, is directly at odds with this statement:

Never in history has the stock market presented such tremendous opportunity, especially for traders. Trading is now becoming the most sought after new career. But how does one learn to be a day trader? Simple observation and imitation doesn't cut it. I'm Harvey Houtkin, and for the past four years I have been teaching people to compete in today's volatile markets using proven trading techniques and the state-of-the-art Attain Trading System. Hundreds of students have successfully completed my program and are actively trading for themselves at home or any one of my many offices nationwide. If you have always wanted to trade for a livelihood, or are unhappy in your present occupation, training to be a trader may be perfect for you. How much did you spend sending your kids to college? Isn't it time to do something for yourself? Day trading is exciting, fun and potentially incredibly profitable. [Tag line follows.]⁵¹⁰

This commercial promotes not only the Attain trading system, but also day trading itself. Mr. Houtkin stresses that day trading could be incredibly profitable but says nothing about its risks and perils. Ironically, Mr. Houtkin testified during his deposition that, "if I came out and said, become a day trader because it's a great way to make a living and it's fun and could be profitable, I think we would definitely put a disclaimer on, especially in today's environment, absolutely."⁵¹¹

Much of All-Tech's advertising describes the Attain System as the best software for day-trading and makes the following claims about day trading through Attain:

"Real-Time Level II Quotes"
 "Instantaneous Order Entry"
 "Instantaneous Cancellation"
 "Control How, When & Where Your Orders are Entered"
 "No busy signals, No Delays, No Stories, No Excuses"
 "Direct Instant Order Processing"

However, several former All-Tech customers told Subcommittee staff that the Attain System malfunctioned frequently and contributed to their losses. For example, Mr. Cook said that the system was slow and often did not provide current quotes—sometimes for as long as thirty minutes.⁵¹² Ms. Margala testified at the Subcommittee's hearings that such delays were prevalent and that, "the inaccurate quotes resulted in losses in my All-Tech account."⁵¹³ Though the customers' systems were often down, Mr. Parish's computer continued to provide accurate quotes during

⁵¹⁰All-Tech radio commercial. Mr. Houtkin also implies in this commercial that he has trained hundreds of students who have become successful day traders. When the words are examined closely, it becomes clear that Mr. Houtkin is merely boasting that hundreds of students have completed his training program, hardly an exacting standard.

⁵¹¹Houtkin Dep. at 293.

⁵¹²Cook Int. at 4. The problem apparently started in the fall of 1998. Margala Int. at 4; Sherman Int. at 3.

⁵¹³Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

those time periods.⁵¹⁴ Consequently, Mr. Parish would yell out quotes to the trading room, thus earning him the nickname “Quote God.”⁵¹⁵ According to the former San Diego customers, Mr. Parish acknowledged that there were problems with the timeliness of quotes, and he and other All-Tech officials said that the problem would be fixed.⁵¹⁶

(b) *Verbal Representations.* In some cases, alleged statements by All-Tech employees may have contradicted the written risk disclaimers that All-Tech provided its customers. For example, Ms. Harlacher said that no one at All-Tech ever discussed risk with her personally but that “wealth and riches” were stressed.⁵¹⁷ Ms. Margala told Subcommittee staff that Mr. Parish did not directly discuss risk with her and that he stated, “day trading is easy; who would sit here if it was hard?”⁵¹⁸ Ms. Margala said that she asked Mr. Parish if people made money day trading and he responded by pointing to Mr. Cook—the customer who eventually lost \$175,000—as someone who was making money.⁵¹⁹

In addition, both Ms. Harlacher and Ms. Bovee attended seminars given by Mr. Houtkin. Ms. Harlacher said that Mr. Houtkin made day trading seem as “easy as pie.”⁵²⁰ Ms. Bovee said Mr. Houtkin made it seem as though a person could make a lot of money day trading.⁵²¹ She said Mr. Houtkin did mention a learning curve, but she does not recall Mr. Houtkin discussing risk and, if he did, she claimed it was a very minor part of the seminar.⁵²²

(2) *All-Tech Fails to Warn Customers of Low Profitability Rates.* Another important component of an effective risk disclosure program relates to informing prospective customers about their chances of success. The Subcommittee’s investigation shows that All-Tech employees generally do not advise customers about the low profitability of its day traders. At his Subcommittee deposition, Mr. Parish testified that 80 to 90 percent of the people who start trading with the San Diego office lose enough money within the first six months to quit day trading all together.⁵²³ When asked what would constitute “enough to quit,” Mr. Parish said “[t]hat’s a relative number. You, if you’re a waitress, maybe you would say to yourself, if I lose \$10,000, I’ll keep \$40,000 and quit. If I lose \$20,000, I’ll keep \$30,000 and quit. You set the number, I don’t. I just warn you.”⁵²⁴ Indeed, Mr. Parish testified that starting six to eight months after he became the branch manager, he told every customer who came into the San Diego office that 80 to 90 percent of the people who day trade lose their money within six months.⁵²⁵ However, the former San Diego customers who spoke with Subcommittee staff did not mention Mr. Parish giving such a warning. At the Subcommittee’s hearing on February 25, 2000, Mr. Houtkin was asked by Senator Levin whether All-Tech tells its customers that one in three will be profitable. “Absolutely,” Mr. Houtkin re-

⁵¹⁴ Cook Int. at 4; Margala Int. at 4; Sherman at 3–4.

⁵¹⁵ Cook Int. at 4; Margala Int. at 4.

⁵¹⁶ Margala Int. at 4; Haseltine Int. at 2; Sherman Int. at 4.

⁵¹⁷ Harlacher Int. at 2.

⁵¹⁸ Margala Int. at 2.

⁵¹⁹ Id.

⁵²⁰ Harlacher Int. at 2.

⁵²¹ Bovee Int. at 1.

⁵²² Id.

⁵²³ Parish Dep. at 45.

⁵²⁴ Id.

⁵²⁵ Id. at 46.

sponded. “We probably tell them worse than that. We definitely warn people.”⁵²⁶ But when asked to provide the Subcommittee with written verification of such warnings, Mr. Houtkin failed to do so.

In 1997, All-Tech asked its branch offices to complete surveys regarding their operations, and one question on those surveys related to customer profitability. The surveys returned by the the Boca Raton, Seattle and Chicago offices indicated that profitability was extremely low. For example, in response to the question “what percentage of your customers are making money,” Michael Zindman, former branch manager of the Boca Raton office, wrote “0%.”⁵²⁷ Mr. Benson of the Seattle office wrote “>10%.”⁵²⁸ In addition, when asked about the progress of his customers, Mr. Benson wrote the following: “Overall Good! We need to have a couple of people making money.”⁵²⁹ When interviewed by Subcommittee staff, Mr. Benson said that about 10 percent of the day traders in the Seattle office were profitable.⁵³⁰ Though no profitability study has been conducted for the Beaverton office, Mr. Benson also estimated that slightly more than 10% of the day traders in that office were profitable.⁵³¹ William Demas, the branch manager of the Chicago office, wrote in his Branch Office Survey that 30% of his customers were making money.⁵³² Furthermore, Mr. Zayas testified that, out of his 40 to 50 customers in the Watertown office, only one customer was profitable through day trading.⁵³³ Mr. Zayas said that Ms. Esposito told him, “[w]hy would you want to be in this business? You know all of these people lose money.”⁵³⁴

Mr. Shefts told Subcommittee staff that only about three of ten day traders will be successful.⁵³⁵ In his Subcommittee deposition, Mr. Houtkin offered a similar estimate, commenting that only about one-third of the customers who open day trading accounts will become full-time traders.⁵³⁶ Given the extremely low customer profitability reported by most of the All-Tech branch offices, Mr. Houtkin’s already low estimate may be optimistic.

What is clear, however, is that All-Tech knows and anticipates that a significant percentage of its new customers who open day trading accounts will fail within six months. As a result, it is incumbent on the firm, even if it does not advise prospective customers about low profitability rates, to present a fulsome risk disclosure that is balanced in its presentation and that is not undermined by deceptive oral statements or misleading advertising.

(3) *Contrary to Its Claims, All-Tech’s Training May Not Equip Customers With The Skills And Knowledge to Successfully Day Trade.* There are currently two types of training courses offered by All-Tech Training Group, Inc. There is a four-week course offered

⁵²⁶ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

⁵²⁷ Feb. Hr’g Ex. 15, at 4.

⁵²⁸ Feb. Hr’g Ex. 16, at 4.

⁵²⁹ Id.

⁵³⁰ Benson Int. at 8.

⁵³¹ Id.

⁵³² Feb. Hr’g Ex. 17, at 4.

⁵³³ Zayas Dep. at 78. Mr. Zayas estimated that, in the day trading industry overall, only about 5 percent of day traders are profitable. Id. at 80.

⁵³⁴ Id. at 84.

⁵³⁵ Shefts Int. at 8.

⁵³⁶ Houtkin Dep. at 199.

in Montvale and Seattle which costs \$5,000, and a one week course at the branch offices for \$3,000.⁵³⁷ The program at the branch offices is often referred to as a “boot camp.”⁵³⁸ After the formal training is completed, customers may continue to paper trade for as long as they wish.⁵³⁹

All-Tech claims that it can teach customers all they need to know to trade effectively. For example, All-Tech’s “Frequently Asked Questions” encourages inexperienced traders to learn everything they need to know from the training course:

5. Do I have to know anything about the stock market?

NO! As a matter of fact, in many instances, the less you know means the less baggage you have to discard when learning the new trading techniques that we teach.⁵⁴⁰

In one of the training manuals produced by All-Tech Training Group, Inc., the introductory letter describes the training program as comprehensive and effective:

The training program has been designed to cater to the cross section of society. The prerequisites needed for our training are discipline, confidence, and the desire for success and independence.

* * * * *

All-Tech Investment Group, Inc. and All-Tech Training Group, Inc. provides [sic] all of the resources to become an effective day trader, you must possess the discipline to become a successful day trader.⁵⁴¹

Some of the former customers interviewed by Subcommittee staff disputed All-Tech’s claim that the training program equipped them to trade successfully. For example, Ms. Harlacher took the “boot camp” training course in San Diego, which was taught by Jai Ramoutar from the Montvale office.⁵⁴² Ms. Harlacher said that Mr. Ramoutar promised to teach her all she needed to know to trade effectively, and “being naive and gullible I believed.”⁵⁴³ Ms. Harlacher told Subcommittee staff that All-Tech showed her how to operate the computer and the software, but she did not learn about the markets or how to perform technical analysis.⁵⁴⁴ Ms. Harlacher said that much of the training was over her head.⁵⁴⁵ Although Mr. Ramoutar discussed certain technical terms involving the actions of market makers, she said that the training did not equip her to understand how those actions affected prices.⁵⁴⁶

⁵³⁷ Shefts Int. at 5. If a trainee subsequently becomes a client of All-Tech, the customer receives a rebate of \$2.50 per trade until he or she recoups the entire tuition charge. Id.

⁵³⁸ Parish Dep. at 173. At one point, boot camps lasted one weekend each. Ex. 35, 9A. “All-Tech Training Camp, Inc. Training Program and Weekend Boot Camp.”

⁵³⁹ Shefts Int. at 5. Paper trading is simulated trading without the use of real money.

⁵⁴⁰ Ex. 40, at 2.

⁵⁴¹ All-Tech Training Group, Inc. Manual, “Welcome to All-Tech Training Group,” at 5 (Feb. Hr’g Ex. 52).

⁵⁴² Harlacher Int. at 2.

⁵⁴³ Id.

⁵⁴⁴ Id. Ms. Sherman, who also took a “boot camp” training course, stated that the trainer from the Montvale office taught the students the mechanics of executing trades but not why or when they should trade. Sherman Int. at 2.

⁵⁴⁵ Harlacher Int. at 2.

⁵⁴⁶ Id.

After losing about \$100,000 in four months of day trading, Ms. Harlacher left All-Tech.⁵⁴⁷ She subsequently studied for, and passed, the Series 6, 7, and 63 securities exams.⁵⁴⁸ Ms. Harlacher told Subcommittee staff that she obtained these licenses because she wanted to finally understand the markets and “conquer” the material that she had not understood while at All-Tech.⁵⁴⁹ Ms. Harlacher said that, after getting her licenses in the securities industry, she believes that All-Tech set her up for failure through a lack of education, experience, and market knowledge.⁵⁵⁰ She affirmed that sentiment at the Subcommittee’s hearings in February, 2000, when she testified, “My education after leaving All-Tech made me realize how little All-Tech had taught me. I was trading at All-Tech, but did not know enough to realize that I really did not know what I was doing.”⁵⁵¹ Further, Ms. Harlacher commented that, in retrospect, she is “shocked” that she day traded at All-Tech because she did not know what she was doing 90 percent of the time.⁵⁵² Ms. Harlacher added that there is no system at All-Tech to test a customer’s knowledge.⁵⁵³

In his Branch Office Survey, Mr. Parish also criticized All-Tech’s training program for failing to teach trading skills and focusing excessively on the use of the computer and software. In response to the question, “[w]hat can Rushmore do to improve their current teaching procedure,” Mr. Parish wrote, “[t]each how to actually trade. Too many traders chase the stock and get jiggled out after.”⁵⁵⁴ Mr. Parish acknowledged in his deposition that All-Tech taught primarily computer mechanics, and that he wanted the course to teach more specifics about when to buy and sell.⁵⁵⁵

The last part of the training program is called “paper trading.” This allows the customers to make simulated trades with an “inputter” from the main office on the other side of the trades.⁵⁵⁶ Many former customers told Subcommittee staff that paper trading did not portray a realistic picture of live trading. For example, Ms. Sherman, Ms. Margala, and Mr. Haseltine said that orders were filled during paper trading that would not necessarily have been filled if an actual order in the market had been placed.⁵⁵⁷ Mr. Parish confirmed that orders are usually filled in paper trading, whereas in live trading, “[p]eople have orders that don’t get filled all the time.”⁵⁵⁸ Mr. Parish called paper trading an “imprecise” simulation of live trading.⁵⁵⁹

Given the testimony of these former customers—and even former branch managers—it appears that All-Tech may have overstated

⁵⁴⁷ Id. at 1, 3.

⁵⁴⁸ Id. at 1.

⁵⁴⁹ Id. at 6.

⁵⁵⁰ Id.

⁵⁵¹ Day Trading: Everyone Gambles but the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong. 49 (Feb. 24, 2000) (hearing transcript).

⁵⁵² Harlacher Int. at 5.

⁵⁵³ Id. at 5–6.

⁵⁵⁴ San Diego “Branch Office Survey,” Aug. 4, 1997, at 6 (Feb. Hr’g Ex. 53).

⁵⁵⁵ Parish Dep. at 176. Mr. Parish admitted, however, that a trainer he hired for the San Diego office without All-Tech’s approval, also only taught computer mechanics. Id. at 130, 176. All-Tech management forced him to shut down the program when it learned, through a customer complaint, that Mr. Parish was offering unsanctioned training. Shefts Int. at 5; Parish Dep. at 130–31.

⁵⁵⁶ Parish Dep. at 143.

⁵⁵⁷ Sherman Int. at 3; Margala Int. at 2–3; Haseltine Int. at 2.

⁵⁵⁸ Parish Dep. at 143.

⁵⁵⁹ Id. at 144.

the quality of its day trading instruction, something that All-Tech CEO Harvey Houtkin described at the Subcommittee's hearing on February 25, 2000 as, "one of the best training programs in the industry."⁵⁶⁰ If so, All-Tech should take steps to moderate its claims about the training with appropriate disclaimers.

E. All-Tech's Failure to Supervise its Employees

1. *General Lack of Supervision.* The Subcommittee's investigation found that All-Tech's management has not exercised sufficient supervision of its employees and branch offices. Mr. Houtkin was the Chief Compliance Officer for All-Tech from the time he became an All-Tech principal in June 1991 until March 1999, when the firm hired Franklin Ogele as its Chief Compliance Officer and Associate General Counsel.⁵⁶¹

All-Tech provided a one page document to the Subcommittee entitled "Supervision," which states the following:

All registered employees listed below shall report to Harvey Houtkin, except as otherwise noted. In his absence all registered employees shall report to Harry Lefkowitz or Mark Shefts. All non-registered [sic] employees in the Montvale Office shall report to Mark Shefts. In his absence all non-registered [sic] shall report to Harvey Houtkin or Harry Lefkowitz. All specific matters related to options and municipal business shall report to Harvey Houtkin.⁵⁶²

According to Mr. Shefts, Mr. Houtkin delegated many of his compliance duties to various members of management.⁵⁶³ Mr. Houtkin testified that, in performing the function of Chief Compliance Officer, he frequently "delegated almost all aspects [of compliance] to people who were competent in that area."⁵⁶⁴ Mr. Houtkin explained that, even though he was Chief Compliance Officer for All-Tech, his other responsibilities required that he delegate compliance duties as much as possible.⁵⁶⁵ He stated, "I basically am what you'd probably call the rainmaker. I go out and I handle the public relations * * * and it worked out pretty well. So while I didn't formally do it full-time, whatever had to be done was done."⁵⁶⁶

In practice, however, Mr. Houtkin's delegation of his compliance duties worked poorly. For instance, Mr. Shefts said that he visited branch offices regularly, but it does not appear that there was a formal audit process in place until Mr. Ogele joined the firm in March 1999.⁵⁶⁷ Mr. Shefts stated that, during his visits, he reviewed documents at the branch offices and completed a one-page questionnaire concerning his visit.⁵⁶⁸ There is no documentary evi-

⁵⁶⁰Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

⁵⁶¹Shefts Int. at 6; Houtkin Dep. at 79; Feb. Hr'g Ex. 28.

⁵⁶²Schedule 1B, "Supervision," Aug. 23, 1999 at 1 (Feb. Hr'g Ex. 54). Messrs. Parish, Benson, Niederkrome and Esposito appear on the list of registered personnel that follows. Id. at 1, 3. Mr. Zayas testified that Mr. Lefkowitz and Ms. Esposito seemed to have responsibility for oversight of the Watertown office. Zayas Dep. at 51.

⁵⁶³Shefts Int. at 6.

⁵⁶⁴Houtkin Dep. at 313.

⁵⁶⁵Id. at 313-15.

⁵⁶⁶Id. at 315.

⁵⁶⁷Shefts Int. at 7.

⁵⁶⁸Id. Mr. Shefts stated, however, that the questionnaires did not actually represent what he did during his visit to the branch offices. Id.

dence, however, of actual audits until Mr. Ogele was hired last year.⁵⁶⁹

Mr. Zayas testified that no one from All-Tech ever audited the Watertown office while he was the branch manager.⁵⁷⁰ When asked whether his office had ever been audited, Mr. Parish testified that he thought so because Messrs. Houtkin and Shefts had visited his office before.⁵⁷¹ Mr. Parish acknowledged, however, that he had never seen a formal audit document for any of those visits.⁵⁷² The testimony of Messrs. Zayas and Parish seems consistent with that of Mr. Houtkin. When asked whether he visited every All-Tech branch, Mr. Houtkin said, “[n]o, there were just too many. I’d be out of the office all the time. We had about 25 offices. I’d never be there.”⁵⁷³

(2) *The Massachusetts Action.* On December 10, 1998, the Securities Division for the Commonwealth of Massachusetts (“Securities Division”) filed an administrative complaint against All-Tech, Mr. Shefts, Mr. Houtkin, Mr. Zayas and two of Mr. Zayas’ customers, Isaac Belbel and John L. Powell.⁵⁷⁴ On May 3, 1999, the Securities Division amended its complaint to add Mr. Lefkowitz as a respondent.⁵⁷⁵ The Securities Division alleged that All-Tech and Messrs. Houtkin, Shefts and Lefkowitz failed to reasonably supervise Mr. Zayas in his operation of the Watertown office.⁵⁷⁶ The underlying allegations against Mr. Zayas included that he

exercised discretion in day trading customers’ accounts without written authorization; commingled funds of customers and failed to comply with customers’ instructions; forged customers’ signatures to authorization forms, and used these forms to have funds transferred among customers [sic] accounts, without their authorization or knowledge; made misrepresentations to the Division during the examination; cooperated in the creation of fraudulent accounts; and encouraged and cooperated in the unlawful activities of unregistered investment advisers, including preying upon customers of All-Tech.⁵⁷⁷

The Securities Division settled the matter with each of the respondents on May 3, 1999.⁵⁷⁸ During his Subcommittee deposition,

⁵⁶⁹The Subcommittee requested “[a]ll internal and external audit reports, including, without limitation, those audit reports that apply to All-Tech’s branch offices nationwide.” Letter from K. Lee Blalack, II, Chief Counsel & Staff Director for the Subcommittee and Linda J. Gustitus, Minority Chief Counsel & Staff Director for the Subcommittee, to Mark D. Shefts, President of All-Tech, Aug. 5, 1999, at Sched. A, #15. All-Tech did not provide any audit documents prepared by Mr. Shefts or Mr. Houtkin. Rather, All-Tech provided a handful of “Branch Office Surveys” that were completed by the branch managers themselves and typed reports of several branch audits conducted by Mr. Ogele in mid-1999.

⁵⁷⁰Zayas Dep. at 52. He said that an All-Tech sales person visited his office to perform an evaluation at some point but that the visit was geared more towards sales issues. Id.

⁵⁷¹Parish Dep. at 160.

⁵⁷²Id. at 160–61.

⁵⁷³Houtkin Dep. at 317.

⁵⁷⁴Commonwealth of Massachusetts, Securities Division, “Administrative Complaint,” Docket No. R–98–77, Dec. 10, 1998, at 1 (“Complaint”) (Feb. Hr’g Ex. 55a).

⁵⁷⁵Commonwealth of Massachusetts, Securities Division, “Amendment to Administrative Complaint,” Docket No. R–98–77, May 3, 1999, at 2 (“Amended Complaint”) (Feb. Hr’g Ex. 55b).

⁵⁷⁶Feb. Hr’g Ex. 55a at ¶ 162; Feb. Hr’g Ex. 55b at ¶ 3.

⁵⁷⁷Feb. Hr’g Ex. 55a at 2.

⁵⁷⁸Commonwealth of Massachusetts, Securities Division, “Stipulated Order,” Docket No. R–98–77, May 3, 1999 (for Respondents All-Tech, Messrs. Shefts, Houtkin and Lefkowitz) (“Stipulated Order 1”) (Feb. Hr’g Ex. 56); Commonwealth of Massachusetts, Securities Division, “Stipulated Order,” Docket No. R–98–77, May 19, 1999 (for Respondents Messrs. Zayas, Belbel and Powell) (“Stipulated Order 2”) (Feb. Hr’g Ex. 57).

Mr. Houtkin denied that All-Tech acted improperly with respect to the office in Watertown, claiming that Mr. Zayas was simply a rogue broker.⁵⁷⁹ Moreover, Mr. Houtkin believes that the action was initiated because, “the State of Massachusetts had an agenda to close down day trading, active trading operations, we had a few bureaucrats there who decided they wanted to get their name in the paper and who started coming out.”⁵⁸⁰

When Subcommittee staff questioned Mr. Zayas concerning the substance of these allegations, he declined to answer on the basis of his Fifth Amendment right against self-incrimination. For example, when Subcommittee staff asked whether he exercised discretion in a customer’s account over which he did not have written authorization, Mr. Zayas took the Fifth Amendment.⁵⁸¹ Mr. Zayas also took the Fifth Amendment with regard to whether he forged a customer’s name on a form purportedly authorizing the transfer of funds out of her account into the account of another customer.⁵⁸² When asked whether he made or effected transfers of funds through the use of forged documents and whether he forged documents to make account transfers for the purpose of meeting margin calls, Mr. Zayas again took the Fifth Amendment.⁵⁸³ Finally, Mr. Zayas took the Fifth Amendment when asked whether he ever encouraged customers to open new accounts under fictitious names after their old accounts were closed or liquidated because of a failure to meet margin calls.⁵⁸⁴

The Securities Division made a specific finding in the “Stipulated Order” that Harry “Lefkowitz failed reasonably to supervise the operation of the Watertown office.”⁵⁸⁵ All-Tech and Messrs. Shefts, Houtkin, and Lefkowitz agreed to the following conditions for settlement:

- All-Tech will not open or operate a branch office in Massachusetts for two years;
- All-Tech will not open any new accounts for Massachusetts customers for two years;
- All-Tech will send a copy of the Offer of Settlement and the Stipulated Order to the owners of all the Massachusetts accounts;
- All-Tech will not allow impermissible journaling and/or lending of funds to, from, between or among accounts of Massachusetts customers beyond that permitted under Regulations T and U;
- All-Tech will not permit any Massachusetts customer to effect transactions for third parties nor will it permit third parties to have trading authorizations for any Massachusetts customer for two years;
- All-Tech will hire, within three months of the Order, a compliance officer who meets the following criteria;
- All-Tech will pay \$50,000 to the Massachusetts Investors Protection Trust Fund;

⁵⁷⁹ Houtkin Dep. at 145.

⁵⁸⁰ Id. at 145–46.

⁵⁸¹ Zayas Dep. at 55.

⁵⁸² Id. at 73.

⁵⁸³ Id. at 74.

⁵⁸⁴ Id. at 146.

⁵⁸⁵ Feb. Hr’g Ex. 57, at 1. Like Mr. Houtkin, Mr. Lefkowitz described Mr. Zayas as a “rogue broker.” Lefkowitz Int. at 3

- Lefkowitz will withdraw from Massachusetts as an agent, and will not reapply to the Division for registration in any capacity for two years; and
- Lefkowitz consents to the finding concerning him and the sanction against him set forth in the Order.⁵⁸⁶

Thus, as part of the settlement, All-Tech agreed to “hire * * * a compliance officer who meets [certain enumerated] criteria.”⁵⁸⁷ In March 1999, Mr. Ogele joined All-Tech as its Chief Compliance Officer, Vice President and Associate General Counsel.⁵⁸⁸ Mr. Ogele confirmed to Subcommittee staff that he was hired as a result of the problems that were uncovered at the Watertown office.⁵⁸⁹ Mr. Houtkin stated that, by the time of the settlement with the Massachusetts Securities Division, All-Tech had already been searching for a new Chief Compliance Officer because the events in the Watertown office prompted All-Tech to pursue a “much tighter compliance environment than [it] had previously.”⁵⁹⁰

Upon his arrival at All-Tech, Mr. Ogele identified compliance areas that required improvement, including revision and expansion of the firm’s supervisory procedures manual.⁵⁹¹ In his audits of various branch offices, which appear to be the first formal audits conducted by All-Tech, Mr. Ogele documented a host of problems.⁵⁹² For example, in his review of the Detroit, Michigan and Falls Church, Virginia offices, Mr. Ogele noted that records were “maintained [in] a haphazard manner,” and that there was “no evidence that whatever few records maintained were being reviewed and signed off on by the [Branch Manager].”⁵⁹³ In addition, in his write-up of the Seattle Branch Audit, Mr. Ogele listed forty customers whose files needed to be reviewed because the majority of them were missing either “check logs” or “account opening documents that [we]re not properly signed.”⁵⁹⁴

Though Mr. Ogele has made tremendous progress in improving All-Tech’s compliance program and internal controls, it is troubling that his hiring was precipitated by the apparent misconduct of All-Tech employees in the Watertown office. Though Mr. Lefkowitz at-

⁵⁸⁶ In re All Tech, Docket No. R-98-77, “Offer of Settlement,” May 3, 1999, at 1-3; In re All-Tech, Docket No. R-98-77, “Stipulated Order,” May 3, 1999. Mr. Zayas also settled with the Securities Division by agreeing that “he will not apply for registration with the Division in any capacity until after January 1, 2002.” In re All-Tech, Docket No. R-98-77, “Offer of Settlement,” May 10, 1999, at 1 (Feb. Hr’g Ex. 58b); Ex. 57.

⁵⁸⁷ In re All-Tech Investment Group, Inc., Offer of Settlement, Docket No. R-98-77, May 3, 1999, at 2.

⁵⁸⁸ Ogele Int. at 1.

⁵⁸⁹ Id.

⁵⁹⁰ Houtkin Dep. at 329-30.

⁵⁹¹ Ogele Int. at 1.

⁵⁹² In response to a Subcommittee request, All-Tech produced certain reports of audits conducted by Mr. Ogele as Chief Compliance Officer. All-Tech declined, however, to produce eight of those reports based on a claim of “attorney/client” privilege, and for five of them, All-Tech also claimed that there is a “self-evaluative” privilege that applies to the documents. Letter from Stephanie Rosenblatt, Counsel for All-Tech, to Deborah Field [sic], Counsel to the Subcommittee, Jan. 4, 2000, at 1-2 (Feb. Hr’g Ex. 59); Letter from Stephanie Rosenblatt, Counsel to All-Tech, to Deborah Field, Counsel to the Subcommittee, Jan. 18, 2000 (Feb. Hr’g Ex. 60). The attorney-client privilege, however, has never been formally recognized by Congress, and the Subcommittee is unaware of a bona fide privilege known as the “self-evaluative privilege.” The Subcommittee intends to pursue these withheld documents in due course where appropriate.

⁵⁹³ Internal Memorandum from Franklin I. Ogele, Chief Compliance Officer for All-Tech, to Steven Plotnick, Branch Office Manager, re: Detroit Branch Audit, May 6, 1999, at 3 (“Detroit Office Audit”) (Feb. Hr’g Ex. 61); Internal Memorandum from Franklin I. Ogele, Chief Compliance Officer for All-Tech, to Fabian Norwood and Frederick Vetter, re: Falls Church, VA Branch Audit, June 28, 1999, at 3 (“Falls Church Office Audit”) (Feb. Hr’g Ex. 62).

⁵⁹⁴ Internal Memorandum from Franklin I. Ogele, Chief Compliance Officer for All-Tech, to David Niederkrome (BOM) and Michael Benson, Branch Office Manager, re: Seattle Branch Audit, July 27, 1999, at 6-7 (“Seattle Office Audit”) (Feb. Hr’g Ex. 63).

tributed All-Tech's difficulties to a "rogue" broker, the Securities Division found that Mr. Lefkowitz failed in his duty to supervise Mr. Zayas. Thus, the Subcommittee concludes that, until Mr. Ogele's hiring, All-Tech was often deficient in its legal duty to supervise its registered personnel, particularly those operating branch offices. It is particularly unfortunate that state securities regulators felt compelled to demand, as a condition of settling their action against All-Tech, that the firm retain an experienced chief compliance officer. The evidence suggests that Mr. Houtkin was too focused on marketing and paid insufficient attention to the internal controls that are necessary to ensure that registered personnel heed not only securities laws and regulations but also firm policies.

(3) *All Tech Lacked Appropriate Qualifications For Hiring Branch Managers and Trainers.* All-Tech has no apparent minimum qualifications for hiring branch managers and course trainers. In fact, candidates for both positions do not need a securities background, and need not need to demonstrate past success in day trading. Mr. Houtkin testified that there was no prerequisite for branch managers or trainers to have been successful day traders.⁵⁹⁵ Mr. Zayas, in fact, had almost no experience day trading before he became an All-Tech branch manager and certainly was never a profitable day trader. Overall, Mr. Zayas lost between \$40,000 and \$60,000 from his trading experience at All-Tech before Mr. Houtkin offered him the position as the branch manager of the Watertown office.⁵⁹⁶ Moreover, Mr. Zayas said that he personally only made one trade in his account before becoming a branch manager, and he lost \$1,000 to \$1,500 as a result.⁵⁹⁷ Similarly, neither Mr. Benson nor Mr. Niederkrome had ever day traded when they first opened the Seattle office of All-Tech.⁵⁹⁸ Mr. Zayas did not possess a single securities license when Mr. Houtkin agreed to let him open the Watertown branch office,⁵⁹⁹ and Mr. Benson worked for All-Tech for an entire year before obtaining his license.⁶⁰⁰ Mr. Zindman, the former branch manager of the Boca Raton office, told Subcommittee staff that he was an unsuccessful proprietary trader at All-Tech for about six to ten months prior to becoming a branch manager.⁶⁰¹

Even more troubling than the poor qualifications and experience of several All-Tech branch managers is evidence that Mr. Houtkin offered his customers branch offices as consolation for the money they lost day trading. For example, a secretly taped conversation between former Montvale customer, Jon Olson,⁶⁰² and Mr. Houtkin recorded Mr. Houtkin trying to appease Mr. Olson by offering him the chance to open an All-Tech branch office.⁶⁰³ Earlier in that tape recorded conversation, Mr. Olson can be heard informing Mr.

⁵⁹⁵ Houtkin Dep. at 302.

⁵⁹⁶ Zayas Dep. at 40. Mr. Zayas' losses stemmed largely from the trading losses and fees generated by a third-party who was trading his account. Id. at 39. Mr. Zayas was introduced to the trader by All-Tech. Id. at 34.

⁵⁹⁷ Id. at 32-33.

⁵⁹⁸ Benson Int. at 2.

⁵⁹⁹ Zayas Dep. at 46.

⁶⁰⁰ Benson Int. at 2.

⁶⁰¹ Interview of Michael Zindman, Oct. 27, 1999, at 1 ("Zindman Int."). Proprietary traders are employed by the firm to trade on behalf of the firm.

⁶⁰² Mr. Olson was an All-Tech customer from about May 1997 until about August 1998. Telephone Interview of Jon Olson, Nov. 2, 1999, at 1 ("Olson Int.").

⁶⁰³ Computer Disc of conversation between Jon Olson and Harvey Houtkin taped on Dec. 9, 1998 and produced to the Subcommittee under subpoena, at approx. 51:35.

Houtkin that he had lost \$227,000 day trading at All-Tech.⁶⁰⁴ Mr. Olson told Subcommittee staff that the running joke at All-Tech was that, if you lost money, Mr. Houtkin would offer you a job.⁶⁰⁵

Mr. Zayas testified that Mr. Houtkin made similar appeals to him. He stated as follows:

Q: Did [Mr. Houtkin] offer for you to open the branch office as a consolation for your significant losses?

A: Yes. Basically, he said, "I'm sorry that Jody lost the money for you, and what I'll do is I will charge you—I will discount the initial fee that we charge to open up a branch office."⁶⁰⁶

During his Subcommittee deposition, Mr. Houtkin denied that he would have offered a branch manager position to a customer as a consolation for losses, but he acknowledged the possibility that he offered branch manager positions to people who had lost money day trading at All-Tech.⁶⁰⁷

All-Tech also occasionally hired trainers who were unsuccessful day traders. According to Mr. Zayas, for example, Don Traponese was first a customer of All-Tech and then an instructor.⁶⁰⁸ Mr. Zayas said that Mr. Traponese was not a profitable trader and that he blamed his losses on inadequate trading capital.⁶⁰⁹ In addition, Ms. Sherman told Subcommittee staff that, when she asked her training instructor Mr. D'Adamo why he did not trade for himself, he told her that he was not good at it.⁶¹⁰

(4) *All-Tech Failed to Adequately Train Branch Managers.* Given the very limited experience and qualifications of many of All-Tech's branch managers, it was particularly imperative that All-Tech give its branch managers high quality training. The Subcommittee's investigation indicates, however, that the training for branch managers may have been limited and ineffective.

Although Mr. Benson said that All-Tech trained him to be a branch manager,⁶¹¹ the Subcommittee learned that some branch managers apparently received little or no training prior to opening their branch offices. For example, Mr. Zayas, who had no previous experience as a professional in the securities industry, summed up his branch manager training as follows:

Q: Were you supposed to get any training?

A: Well, it was supposed to be included. The \$50,000 I paid, I was supposed to receive a week of training in my office. I was told to come down to New Jersey, to the New Jersey office for the training. I went down for three days. It was three-day training period. I was there for probably four hours, and basically, I was introduced to various people within the office that I would be dealing with in the margin, and I was given a couple of manuals and told to read them; and if I had any questions, to ask them.

⁶⁰⁴ Id. at approximately 3:45.

⁶⁰⁵ Olson Int. at 1.

⁶⁰⁶ Zayas Dep. at 45. Jody Krajack is the trader who Mr. Houtkin allegedly found to trade Mr. Zayas' account. Id. at 34–35.

⁶⁰⁷ Houtkin Dep. at 307–309.

⁶⁰⁸ Zayas Dep. at 36, 51.

⁶⁰⁹ Id. at 37.

⁶¹⁰ Sherman Int. at 2–3.

⁶¹¹ Benson Int. at 2. His training apparently consisted of a four-week day trading course and meeting with management at All-Tech to discuss aspects of the business. Id.

Q: And that was the sum total of your training?

A: That was it.⁶¹²

Mr. Parish testified that All-Tech trained him to be a branch manager but, when questioned about the details, it became apparent that All-Tech trained Mr. Parish primarily on how to use the computer system, not how to manage a branch office.⁶¹³ Mr. Parish claimed that he already knew “[a]ll of the administrative things that it takes to run a branch.”⁶¹⁴ Mr. Strawbridge conceded that the training he received to be a branch manager was limited.⁶¹⁵ He said that he traveled to the All-Tech main office for several days where he spent some time with Ms. Lerner, Mr. Lefkowitz and Ms. Esposito.⁶¹⁶ Other than that, Mr. Strawbridge said he “mirrored” Mr. Niederkrome in the Seattle office for one week.⁶¹⁷

(5) *All-Tech Allowed Persons To Act As Branch Managers Prior to Being Registered*. All branch managers, for both Offices of Supervisory Jurisdiction (“OSJ”) and non-OSJ offices, must register with the NASD.⁶¹⁸ Branch managers for non-OSJ offices may register as representatives or principals, while branch managers for OSJ offices must register as General Sales Supervisors or principals qualified for the activities they will be supervising.⁶¹⁹ Thus, for a non-OSJ branch, the manager must have passed either the Series 62 or Series 7 licensing exams,⁶²⁰ and for OSJ branches, the Series 8 or Series 24 exams.⁶²¹

Mr. Benson told Subcommittee staff that he joined All-Tech in or about mid 1997, and his CRD indicates that he started working for All-Tech on March 10, 1997.⁶²² In the Branch Office Management Agreement governing the office, dated May 8, 1998, he is designated as a branch manager.⁶²³ Mr. Houtkin testified that Mr. Benson has been the branch manager of the Beaverton office since it opened.⁶²⁴ Mr. Benson, however, did not pass his Series 62 exam until November 9, 1998,⁶²⁵ which means that he was not a registered representative until at least that date. Thus, Mr. Benson worked for All-Tech from March 1997 until November 1998, over 1½ years, without being licensed, and acted as a branch manager for six months without a license.

Mr. Benson stated that he worked at All-Tech for an entire year without receiving any salary due to the fact that he did not yet have his Series 62 license.⁶²⁶ When asked how many hours per

⁶¹² Zayas Dep. at 50.

⁶¹³ Parish Dep. at 40–41.

⁶¹⁴ Id. at 42.

⁶¹⁵ Strawbridge Int. at 8.

⁶¹⁶ Id.

⁶¹⁷ Id.

⁶¹⁸ “An Explanation of the NASD Registration and Qualification Requirements,” Oct. 1999, at 14 (“NASD Registration and Qualification”). An OSJ branch office is one where one or more certain enumerated functions occur, including, for example, final approval of new accounts or supervision of branch office employees. NASD Rule 3010(g).

⁶¹⁹ NASD Registration and Qualification at 14.

⁶²⁰ The Series 7 is the “General Securities Representative” exam, Id. at 3, and the Series 62 is the “Corporate Securities Limited Representative” exam. Id. at 4.

⁶²¹ Id. at 14. The Series 8 is the “General Securities Sales Supervisor” exam, and the Series 24 is the “General Securities Principal” exam. Id. at 2, 14.

⁶²² Frederick M. Benson, CRD # 2876856, at “Employment History” (“Benson CRD”) (Feb. Hr’g Ex. 64).

⁶²³ Portland Branch Agreement, at Rider.

⁶²⁴ Houtkin Dep. at 226.

⁶²⁵ Feb. Hr’g Ex. 64, at “Exam History.” Mr. Benson failed the Series 62 exam the first time he took it on May 24, 1997. Id.

⁶²⁶ Benson Int. at 2.

week he worked for no pay, he said “eighty.”⁶²⁷ Even if his claim is true, it does not relieve Mr. Benson and All-Tech from the NASD registration requirement. The NASD requires “[e]very securities professional associated with a member firm that will engage in securities transactions [to] register with the NASD as a registered representative or principal.”⁶²⁸ Mr. Benson claimed that he only worked on the “business” half of the office rather than the broker-dealer side of the business and that his primary function was to market the business and attract new clients.⁶²⁹ He acknowledged that he frequently answered questions for day traders but claimed that he never executed trades for them.⁶³⁰

The Subcommittee, however, obtained Georgia Bovee’s typed notes from September 22, 1998, indicating that Mr. Benson executed trades for her because her computer was not functioning correctly.⁶³¹ Ms. Bovee wrote:

CALLED MIKE BENSON AND HAD HIM BUY AN-
OTHER STOCK GENZ FOR ME. HE BOUGHT IT FOR
ME * * * I IMMEDIATELY HAD MIKE SELL IT FOR
ME AT MARKET. HE DID THE BEST HE COULD AND
SOLD IT FOR 127/16. THAT CAUSED ME TO LOSE
\$143.00 WITH COMMISSION.⁶³²

Mr. Strawbridge claimed that Mr. Benson ran the trading floor and acted “as a guide for traders.”⁶³³ Mr. Strawbridge also alleged that Mr. Benson told him and his customers that he was licensed when, in fact, he was not.⁶³⁴ Mr. Benson said that customers may have viewed him as a branch manager because he was a part owner of the office.⁶³⁵

In addition, Mr. Benson inserted in his name as “Branch Manager” on the Branch Office Survey for the Seattle Office.⁶³⁶ During a Subcommittee interview, however, he claimed that it was a mistake.⁶³⁷ Mr. Benson admitted that he may have also signed new account forms and journal forms prior to obtaining his Series 62 license.⁶³⁸ Ms. Bovee told Subcommittee staff that she first learned from Mr. Strawbridge that Mr. Benson was not licensed.⁶³⁹ Ms. Bovee claimed that she confronted Mr. Benson with that information, both in writing and personally, and that Mr. Benson tried to explain how he was doing his job without possessing a license.⁶⁴⁰

It appears that Mr. Zayas also worked as a branch manager prior to being fully licensed. Although Mr. Zayas obtained his Series 7 license prior to opening the Watertown office,⁶⁴¹ he did not obtain his Series 63 license,⁶⁴² required by the Commonwealth of

⁶²⁷ Id. Mr. Benson claimed he did this to protect his investment in All-Tech. Id.

⁶²⁸ NASD Registration and Qualification at 1.

⁶²⁹ Benson Int. at 3, 5.

⁶³⁰ Id. at 3.

⁶³¹ Typed notes, Sept. 22, 1998, produced by Georgia Bovee (Feb. Hr’g Ex. 65).

⁶³² Id.

⁶³³ Strawbridge Int. at 3.

⁶³⁴ Id.

⁶³⁵ Benson Int. at 5.

⁶³⁶ Feb. Hr’g Ex. 16, at 1.

⁶³⁷ Benson Int. at 5.

⁶³⁸ Id.

⁶³⁹ Bovee Int. at 4.

⁶⁴⁰ Id.

⁶⁴¹ Zayas Dep. at 46.

⁶⁴² Zayas CRD #2816153 at “Exam History.” The Series 63 exam is the “Uniform Securities Agent State Law Examination” which is required by some states in addition to the NASD’s requirements. NASD Registration and Qualification Requirements at 9.

Massachusetts, until August 6, 1997, well after he opened the office.⁶⁴³ The Branch Office Agreement that governed the Watertown office refers to Mr. Zayas as “the Manager,” and is dated December 6, 1996.⁶⁴⁴ Mr. Zayas claimed that he was not the branch manager between March and September 1997, because he did not have his Series 63 license during that time period.⁶⁴⁵ In fact, Mr. Zayas stated that no one at All-Tech ever told him that he would need to obtain a Series 63 license until about three weeks before he was scheduled to open the office.⁶⁴⁶ Mr. Zayas testified that a broker named Allen Sloane was the branch manager in the Watertown office until Mr. Zayas passed the Series 63 exam.⁶⁴⁷ Yet, in a document called Boston Branch Office Survey Results, dated June 18, 1997, Mr. Zayas is listed as the “Branch Manager” and Mr. Sloane is listed as the “Assistant Manager.”⁶⁴⁸

Mr. Zayas’ explanation of whether or not he was the branch manager at this time was inconsistent. First, he testified that he does not know why his name appeared as Branch Manager.⁶⁴⁹ Yet, he said “yes” in response to the question, “[w]ere you told at the time, even though you hadn’t taken the Series 63, that you were going to be the branch manager during that time frame?”⁶⁵⁰ Then, Mr. Zayas testified that he was the branch manager, and in the same answer stated that Allen Sloane was the branch manager.⁶⁵¹ Finally, in response to the question, “[a]t the time this was prepared, which is June 1997, regardless of whatever licenses you had, were you acting as the branch manager of this office,” Mr. Zayas took the Fifth Amendment.⁶⁵²

The evidence strongly suggests that, for some period of time, both Messrs. Benson and Zayas acted as the branch managers for their respective offices and did so without obtaining the necessary securities licenses. Even more problematic, however, is the evidence that All-Tech allowed Messrs. Benson and Zayas to operate branch offices without the requisite securities licenses. Indeed, All-Tech’s failure to perform this most rudimentary oversight and supervisory function is probative of the large weaknesses in its compliance structure before the arrival of Mr. Ogele.

(6) *All-Tech May Have Allowed Certain Persons to Act as Unregistered Investment Advisers in Violation of State Laws.* In general terms, and with certain exceptions, an “investment adviser” is a person who advises others for compensation, concerning the value of securities or the advisability of investing in, purchasing or selling securities.⁶⁵³ Under the National Securities Markets Improvement Act of 1996 (“NSMIA”), Title III of which is the Investment Advisers Supervision Coordination Act, responsibility of investment adviser oversight is divided between the states and the federal gov-

⁶⁴³ Zayas Dep. at 46–47, 130.

⁶⁴⁴ Watertown Agreement at 1.

⁶⁴⁵ Zayas Dep. at 130–31.

⁶⁴⁶ Id. at 130.

⁶⁴⁷ Id. at 130–31.

⁶⁴⁸ Boston “Branch Office Survey Results,” June 18, 1997, at 2 (“Boston Branch Survey”) (Feb. Hr’g Ex. 66). Mr. Zayas testified that this document was filled out by Richard Raciti, a sales manager at All-Tech. Zayas Dep. at 172.

⁶⁴⁹ Zayas Dep. at 172.

⁶⁵⁰ Id. at 173.

⁶⁵¹ Id.

⁶⁵² Id. at 174.

⁶⁵³ Investment Advisers Act of 1940, Section 202(a)(11), Codified at 15 U.S.C. § 80b–2(a)(11).

ernment.⁶⁵⁴ In very general terms, an investment adviser with less than \$25 million of assets under management is required to register with the state unless he or she is exempt from registration and investment advisers with more than \$25 million of assets under management are required to register with the SEC.⁶⁵⁵ 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.⁶⁵⁶

All-Tech customers are permitted to give another day trader the authority to trade for them through the use of an authorization form completed by the customer.⁶⁵⁷ In fact, former branch manager Fred Zayas said that Mr. Houtkin helped to organize arrangements where a third party would trade a customer's account.⁶⁵⁸ Mr. Zayas said that Mr. Houtkin located a trader for Mr. Zayas' personal account when he first became a customer of All-Tech, because at the time there was no office geographically convenient to Mr. Zayas.⁶⁵⁹ According to Mr. Zayas, Mr. Houtkin found a few potential traders for Mr. Zayas to interview before making his selection. Mr. Zayas testified that the "rules" of these third-party trading arrangements included that Mr. Zayas would pay the trader a draw of \$1,000 per week and that Mr. Zayas and the trader would split profits and losses 50/50 against which the \$1,000 draw would be applied.⁶⁶⁰ Mr. Zayas said that, to his knowledge, the day trader who traded his account was not registered as an investment adviser.⁶⁶¹ When asked whether he was aware that one of his customers was trading for others and whether that person was registered as an investment adviser, Mr. Zayas asserted his Fifth Amendment right and refused to answer the questions.⁶⁶²

Allowing—and especially constructing—third party trading arrangements means that All-Tech might be permitting persons to trade illegally as unregistered investment advisers. Thus, All-Tech requires day traders who seek to trade the accounts of other customers to complete a form on which they represent that they are registered as investment advisers.⁶⁶³ In his audit of the Dallas Branch Office, Mr. Ogele stated as follows:

As with the other branches, the Dallas branch has customers who have designated other traders to trade their account pursuant to a limited trading authority. The State of Texas does not have a *de minimis* [sic] exemption for investment advisers; consequently, anybody that trades another person's account must register as an investment adviser. As a matter of policy, All-Tech does not gather de-

⁶⁵⁴ "Memorandum of Understanding Concerning Investment Advisers and Investment Adviser Representatives," adopted Apr. 27, 1997, www.nasaa.org/iaoversight/iamou.html, at 1.

⁶⁵⁵ *Id.*

⁶⁵⁶ National Securities Markets Improvement Act of 1996, National Pub. L. No. 104-290 (Oct. 11, 1996); Mass. Regs. Code tit. 950, § 12.205; Cal. Corp. Code § 25202.

⁶⁵⁷ Feb. Hr'g Ex. 35, Section 4(B), Sample Forms (1) "Trading Authorization Limited to Purchases and Sales of Securities and Commodities;" (2) "Full Trading Authorization with Privilege to Withdraw Money and/or Securities."

⁶⁵⁸ Zayas Dep. at 171.

⁶⁵⁹ *Id.* at 34.

⁶⁶⁰ *Id.* at 35.

⁶⁶¹ *Id.* at 36.

⁶⁶² *Id.* at 77-78.

⁶⁶³ Feb. Hr'g Ex. 35, Section 4(B), Sample Forms: Instructions for Investment Advisor Representation Letter and Letter.

tailed information from such traders as to whether they are registered but obtains only a representation from the traders that they are currently registered as investment advisers.⁶⁶⁴

Because All-Tech does not independently verify that a day trader is registered as an investment adviser, it is impossible for the firm or the customers whose accounts are being traded to be certain that third-party traders are not in violation of state laws governing the registration of investment advisers. At a minimum, All-Tech should take affirmative steps to ensure that, when it facilitates a third-party trading arrangement for one of its customers, as it did for Mr. Zayas, the selected trader is either registered as an investment adviser or is exempt from the registration requirement.

IV. CASE STUDY: PROVIDENTIAL SECURITIES, INC.

Providential Securities, Inc. (“Providential”) offers retail brokerage and day trading services to its approximately 5,000 clients at offices in California, Oregon, and New York.⁶⁶⁵ The firm focuses its marketing and customer recruitment efforts on the Vietnamese community, particularly in the “Little Saigon” area of Southern California.⁶⁶⁶

A. *Providential’s Founding and Corporate Structure*

Providential President Henry D. Fahman is a 46 year-old Vietnamese immigrant who told Subcommittee staff that he worked for several brokerage firms prior to opening Providential in March 1993.⁶⁶⁷ Mr. Fahman said that he decided to open Providential because he saw a tremendous opportunity to provide brokerage services to the Vietnamese community in Southern California.⁶⁶⁸ These traditional services include providing investment advice and stock recommendations, executing trades, and offering investment options, such as mutual funds, to clients. Mr. Fahman said that the original incorporators of Providential were himself, his wife, and two close friends and that his total initial investment was about \$20,000.⁶⁶⁹ Mr. Fahman noted that he served as the sole officer of Providential during its first years of operations.⁶⁷⁰ Mr. Fahman holds the following securities licenses: Series 3, 4, 7, 24, 53, and 63.⁶⁷¹

Providential’s headquarters is located in Fountain Valley, California, and Mr. Fahman is the President and Chief Executive Officer of the firm.⁶⁷² He told Subcommittee staff that Providential currently has offices located in the following California municipalities: Alhambra, Encino, Glendale, Lake Forest, and Laguna Hills.⁶⁷³ Providential had a branch office in Los Angeles until No-

⁶⁶⁴ Internal Memorandum from Franklin I. Ogele, Chief Compliance Officer for All-Tech, to David Thompson, Branch Manager for Dallas Branch, re: Dallas Branch Audit, June 25, 1999, at 2 (“Dallas Office Audit”) (Feb. Hr’g Ex. 67).

⁶⁶⁵ Fahman Dep. at 72, 188–89.

⁶⁶⁶ Id. at 32, 34.

⁶⁶⁷ Id. at 6, 18, 21–24, 32.

⁶⁶⁸ Id. at 34.

⁶⁶⁹ Id. at 35, 37.

⁶⁷⁰ Id. at 36.

⁶⁷¹ Id. at 27–28.

⁶⁷² Id. at 70, 106.

⁶⁷³ Id. at 67.

vember 1999.⁶⁷⁴ Further, Mr. Fahman said that Providential has a branch office in Beaverton, Oregon and a branch office in New York City.⁶⁷⁵ According to Mr. Fahman, Providential also has an office in Phoenix, Arizona which it is in the process of closing.⁶⁷⁶

Mr. Fahman said that about 5,000 customers currently maintain accounts with Providential.⁶⁷⁷ In 1998, Providential's gross revenues were \$3,702,357 and the firm made a profit of \$154,940,⁶⁷⁸ most of which Mr. Fahman said he reinvested in the firm's operations.⁶⁷⁹ In 1999, Providential had gross revenues of \$5,315,205 but incurred a loss for the year of \$379,334.⁶⁸⁰ Mr. Fahman estimated that his salary ranged from \$45,000 in 1998 to \$55,000 in 1999.⁶⁸¹

(1) *Providential's Senior Officers and Compensation System for Registered Representatives.* In addition to serving as Providential's President and Chief Executive Officer, Mr. Fahman said that he was the firm's Chief Compliance Officer from its founding until late 1999.⁶⁸² Mr. Fahman said that he hired Richard J. Ponce as Providential's new Chief Compliance Officer in late 1999, and he hired Stephen M. Rubenstein to serve as the Vice President of Clearing Services.⁶⁸³ According to Mr. Fahman, Mr. Ponce has more than ten years experience as an SEC and NASD examiner and Mr. Rubenstein is a former Chief Executive Officer of J.B. Oxford, which is a self-clearing firm.⁶⁸⁴ Mr. Fahman testified that these two individuals will report directly to him and will manage other officers and employees within the firm.⁶⁸⁵ Mr. Fahman said that one of the reasons he hired Mr. Ponce was to "provide stricter supervision over [the] day trading operation" and to bring on board compliance personnel "with more experience and knowledge to oversee and supervise the growing day trading business."⁶⁸⁶

Among Providential's senior officers, Mr. Fahman said that his brothers, Timothy D. Fahman and Theodore Fahman, are key figures in the firm and that they serve as the Operations Manager and Financial and Operations Principal, respectively.⁶⁸⁷ According to Mr. Fahman, Timothy Fahman is not a registered representative and is responsible for managing Providential's back office support systems.⁶⁸⁸ Mr. Fahman said that his brother Theodore essentially serves as Providential's chief financial officer in his role as the Financial Operations Principal.⁶⁸⁹ In addition, Mr. Fahman testified that Theodore serves other key roles at the firm, such as reviewing and approving new customer account forms.⁶⁹⁰

⁶⁷⁴ Moon Int. at 2.

⁶⁷⁵ Fahman Dep. at 68.

⁶⁷⁶ Id.

⁶⁷⁷ Id. at 189.

⁶⁷⁸ Letter from Providential Securities, Inc. to Wesley Phillips, Investigator for the Subcommittee, undated (Feb. Hr'g Ex. 68).

⁶⁷⁹ Fahman Dep. at 189-190.

⁶⁸⁰ Feb. Hr'g Ex. 68.

⁶⁸¹ Fahman Dep. at 189, 191.

⁶⁸² Id. at 138-39. Mr. Fahman testified that he relinquished his role as Chief Compliance Officer shortly before his deposition by Subcommittee staff on December 15, 1999. Id. at 138.

⁶⁸³ Id. at 106-107.

⁶⁸⁴ Id. at 106.

⁶⁸⁵ Id. at 108.

⁶⁸⁶ Id. at 22, 139, 140.

⁶⁸⁷ Id. at 108, 110.

⁶⁸⁸ Id. at 40.

⁶⁸⁹ Id. at 110.

⁶⁹⁰ Id. at 143-44. According to Mr. Fahman, Theodore Fahman is a registered representative. Id. at 40.

Mr. Fahman said that about 20 individuals work at Providential's Fountain Valley headquarters and those persons are actually employees of the firm and provide support services to the various Providential offices.⁶⁹¹ In his Subcommittee deposition, however, Mr. Fahman explained that the registered representatives who work in Providential's branch offices are independent contractors rather than employees of the firm.⁶⁹² Under the contracts that Providential signs with its registered personnel, the brokers retain about 85 to 90 percent of their gross commissions to cover virtually all of their operating expenses, including compensation for branch office employees, rent, and telephones.⁶⁹³ Mr. Fahman testified that Providential retains the remaining ten to fifteen percent of the commissions.⁶⁹⁴ In return for paying these funds to Providential, Mr. Fahman said that Providential provides various services to the branch offices, such as compliance procedures, stock order execution systems, and stock quotation services.⁶⁹⁵ According to Mr. Fahman, Providential's compensation plan is superior to that of larger brokerage firms because it encourages the brokers to generate additional business, thereby benefitting both the brokers and Providential.⁶⁹⁶

(2) *History of Providential's Day Trading Business.* According to Mr. Fahman, Providential first began to offer day trading services to its customers through its Los Angeles branch office.⁶⁹⁷ The branch manager of Providential's Los Angeles office was Tae Goo Moon.⁶⁹⁸ Mr. Fahman said that he first met Mr. Moon in late 1996, after Mr. Moon had read an article about Providential in a brokerage industry trade magazine.⁶⁹⁹ Mr. Fahman testified that, in late 1996 or early 1997, he hired Mr. Moon to work as a full-service broker in Providential's former headquarters in Huntington Beach, California.⁷⁰⁰ Mr. Fahman said that about 50 of Mr. Moon's customers, who were mainly of Korean descent, transferred their accounts to Providential when Mr. Moon joined the firm.⁷⁰¹

According to Mr. Fahman, Mr. Moon opened the Los Angeles branch office under the name "Hahna Global Securities" as a dba of Providential.⁷⁰² Mr. Fahman said that he entered into a verbal agreement with Mr. Moon in which Mr. Moon and the other personnel at the Los Angeles office would be independent contractors of Providential.⁷⁰³

According to Mr. Fahman, in June or July 1997, Mr. Moon suggested that the Los Angeles office begin offering day trading services to its clients in addition to traditional retail brokerage serv-

⁶⁹¹ Id. at 93.

⁶⁹² Id. at 50.

⁶⁹³ Id. at 51-52, 94.

⁶⁹⁴ Id. at 55.

⁶⁹⁵ Id.

⁶⁹⁶ Id. at 50-51.

⁶⁹⁷ Id. at 78-80.

⁶⁹⁸ Id. at 42-43.

⁶⁹⁹ Id. at 45. At the time of their meeting, Mr. Moon was the President of Hanmi Securities ("Hanmi") in Los Angeles.

⁷⁰⁰ Id. at 43, 45.

⁷⁰¹ Id. at 49.

⁷⁰² Id. at 54. Mr. Moon told Subcommittee staff that the name "Hahna" means "first" or "unique" in the Korean language. Moon Int. at 3.

⁷⁰³ Fahman Dep. at 55. Mr. Fahman explained that this arrangement was similar to the independent contractor agreements he uses for Providential's other branch offices. Id.

ices.⁷⁰⁴ Mr. Fahman said, however, that Providential's clearing firm, Bear Stearns, was not equipped to provide day trading services at that time.⁷⁰⁵ Mr. Fahman testified that Mr. Moon was eager to enter the day trading business, so Mr. Moon entered into an agreement with another broker-dealer, Go Trading, which was prepared to immediately provide day trading services through its clearing firm, Penson Financial.⁷⁰⁶ According to Mr. Fahman, the Los Angeles branch office provided day trading services to its clients under the supervision of Go Trading from June or July 1997 until July 1998, when Providential changed clearing firms and acquired the capacity to offer day trading services.⁷⁰⁷ Providential purportedly supervised Mr. Moon's day trading operation from that date until the Los Angeles branch office closed in November 1999.⁷⁰⁸

Mr. Fahman testified that, between July 1997 and July 1998, Providential continued to supervise all of the Los Angeles office's retail brokerage operations but he insisted that Providential had no responsibility to supervise Mr. Moon's handling of the day trading business, since Mr. Moon had a separate arrangement with Go Trading.⁷⁰⁹ Mr. Fahman claimed that California law allows a registered representative to be licensed with more than one broker-dealer.⁷¹⁰ Based on this understanding of California law, Mr. Fahman testified that he had no obligation to supervise Mr. Moon's day trading operation before July 1998, when Mr. Moon ceased doing business with Go Trading.⁷¹¹ Mr. Fahman conceded that, even during Mr. Moon's relationship with Go Trading, Providential was still obligated to supervise Mr. Moon's retail brokerage operations.⁷¹²

While dual licensing of registered representatives is permitted by applicable securities laws, it does not—contrary to Mr. Fahman's claim—relieve broker-dealers of the obligation to supervise all registered representatives who are licensed with their firms. SEC officials interviewed by Subcommittee staff indicated that, while a branch office could be affiliated with more than one broker-dealer, neither firm could avoid the legal responsibility to supervise the operations of the branch office.⁷¹³ In other words, Mr. Fahman and Mr. Moon could not agree to relieve Providential of the legal responsibility to supervise the Los Angeles office's day trading operation as long as the registered personnel in that office were licensed with Providential.

Mr. Fahman said that Providential's next foray into the day trading business started in October or November 1997, when his childhood friend, Tony Nguyen, expressed an interest in offering day trading services to clients of Providential's branch office in Oregon.⁷¹⁴ Mr. Nguyen told Subcommittee staff that, in 1997, he became interested in day trading as a result of reading an article

⁷⁰⁴ Id. at 80.

⁷⁰⁵ Id.

⁷⁰⁶ Id. at 80, 82.

⁷⁰⁷ Id. at 83, 92.

⁷⁰⁸ Id. at 92; Moon Int. at 2.

⁷⁰⁹ Fahman Dep. at 84.

⁷¹⁰ Id. at 82–83.

⁷¹¹ Id.

⁷¹² Id. at 84.

⁷¹³ Subcommittee Interview with SEC senior officials, Dec. 17, 1999.

⁷¹⁴ Fahman Dep. at 19, 84.

about a day trading firm called Block Trading.⁷¹⁵ Mr. Fahman testified that Providential opened the Oregon office primarily to offer day trading services rather than retail brokerage services.⁷¹⁶ Mr. Fahman said that, much like Mr. Moon's relationship with Go Trading, the Oregon office initially cleared its day trading transactions through a firm called Choice Investments.⁷¹⁷ Mr. Fahman testified that the Oregon office cleared its day trading business through Choice Investments from October or November 1997 until July or August 1998, when Providential began offering day trading services of its own.⁷¹⁸

Mr. Nguyen said that he does not have a Series 24 license, which is necessary to manage a branch office designated as an OSJ branch.⁷¹⁹ However, several former customers identified Mr. Nguyen as the branch manager of the Oregon office. Mr. Nguyen said that Mr. Fahman's brother, Theodore, is technically responsible for overseeing the Oregon office because he has a Series 24 license.⁷²⁰ Mr. Nguyen said that Theodore Fahman travels periodically from Fountain Valley to Oregon for one to two weeks at a time to oversee its operations.⁷²¹ Mr. Nguyen said, however, that he is generally responsible for directing the activities of the Oregon office, including all dealings with prospective customers and ensuring that the computer system is operating correctly.⁷²²

Henry Fahman testified that Providential offers day trading services to customers at its California offices in Fountain Valley, Alhambra, Glendale, Encino, and Lake Forest as well as the Oregon branch office.⁷²³ Mr. Fahman said that, on any given trading day, about seven to ten customers day trade at Providential's offices.⁷²⁴ In response to Subcommittee Interrogatories, Providential indicated that approximately 200 customers opened day trading accounts at the firm between July 1997 and October 1, 1999.⁷²⁵

(3) *Key Providential Officials Have Committed Securities Violations or Settled Securities Litigation.* Several key Providential officials have been cited for securities violations or have settled litigation asserting such allegations. The following summarizes the alleged securities violations and the settlements of these allegations against Henry D. Fahman, Tae Goo Moon, and Keith Kim:

Henry D. Fahman—On September 25, 1998, NASDR approved a letter of acceptance by Henry D. Fahman and Providential to resolve outstanding allegations of securities violations. Specifically, these allegations were that Providential, acting under the supervision of Mr. Fahman, effected transactions in securities or attempted to do so without sufficient net capital. Further, NASDR alleged that Providential, acting through Mr. Fahman, failed to

⁷¹⁵ Interview of Tony Nguyen, Dec. 9, 1999, at 2 ("Nguyen Int.").

⁷¹⁶ Fahman Dep. at 64.

⁷¹⁷ Id. at 84–85.

⁷¹⁸ Id. at 86–87.

⁷¹⁹ Nguyen Int. at 2.

⁷²⁰ Id.

⁷²¹ Id.

⁷²² Id.

⁷²³ Fahman Dep. at 79.

⁷²⁴ Id. at 95.

⁷²⁵ Letter from Henry D. Fahman, President of Providential Securities, Inc. to Wesley M. Phillips, Investigator for Subcommittee, Dec. 3, 1999, at 2 (Feb. Hr'g Ex. 69). Providential provided day trading customer account forms to the Subcommittee. The Subcommittee identified 234 day trading customer accounts among these Providential records.

disclose to public customers by written notice or confirmation the price securities were purchased from and sold to customers and the firm's contemporaneous offsetting purchase or sales price to or from a market maker. NASDR censured Mr. Fahman and Providential and issued a fine of \$28,500. In addition, NASDR ordered Mr. Fahman to requalify by examination as a financial operations principal.⁷²⁶ On August 11, 1999, a panel of NASD arbitrators also found Providential's Los Angeles office liable in connection with an NASD complaint filed by Amy Le. Providential paid an award of \$12,500 to Ms. Le on behalf of Mr. Moon and the Los Angeles branch office. In that case, which is discussed in detail later in this report, the arbitration panel sanctioned Providential for failing to comply with discovery orders and ordered the firm to pay \$450.⁷²⁷ Mr. Fahman and Providential also recently settled an NASD complaint filed by a former day trading customer named Brenda Richardson.⁷²⁸ In the NASD complaint, Ms. Richardson alleged that the respondents, among other things, engaged in deceptive practices and made false and misleading statements.⁷²⁹ While denying the allegations, Providential and its clearing firm recently agreed to settle the matter, paying Ms. Richardson a significant sum of money for her losses.⁷³⁰

Tae Goo Moon—A former client named Hee Young Kim filed an NASD complaint against Mr. Moon when he was the President of Hanmi, before he joined Providential. Mr. Moon said that Mr. Kim sued him and Hanmi for making unsuitable stock recommendations that cost Mr. Kim money. Mr. Moon said that Hanmi settled the NASD complaint for \$60,000 in 1995.⁷³¹ As explained above, an NASD arbitration panel found Mr. Moon liable in the Amy Le case on August 11, 1999.⁷³² The arbitration panel ordered Mr. Moon to pay \$12,500 in connection with his role as branch manager of Providential's Los Angeles office.⁷³³ As with Mr. Fahman and Providential, Mr. Moon also recently settled the NASD complaint brought by Ms. Richardson.⁷³⁴

Keith Kim—In August 1997, Mr. Moon hired Keith Kim as a Senior Vice President at Providential's Los Angeles branch office. In January 1998, Mr. Kim faced allegations of failure to supervise, breach of fiduciary duty, and negligence. On September 29, 1998, the NASD held Mr. Kim liable and ordered him to pay the claimant \$32,541.⁷³⁵

⁷²⁶ NASD CRD for Henry D. Fahman at 4–5 (Feb. Hr'g Ex. 70).

⁷²⁷ NASD Regulation, Inc. Arbitration Judgment, Case #98–03309, Aug. 11, 1999, at 3 (“Le Judgment”) (Feb. Hr'g Ex. 71).

⁷²⁸ Telephone Interview of William Shepherd, Jan. 14, 2000, at 1 (“Shepherd Int.”).

⁷²⁹ Second Amended Statement of Claim, Case No: 98–02900, at 4–5 (“Richardson Complaint”).

⁷³⁰ Shepherd Int. at 1.

⁷³¹ Moon Int. at 2.

⁷³² Ex. 71, at 3.

⁷³³ Id.

⁷³⁴ Shepherd Int. at 1.

⁷³⁵ NASDR CRD for Kwang Ho Kim (Feb. Hr'g Ex. 72). Kwang Ho Kim is also known as Keith Kim.

B. Providential's Risk Disclosure Policies

Today, Providential maintains new customer account documentation that gives very strong warnings about the potential risks associated with day trading.⁷³⁶ Providential's "Customer Acknowledgment of Risk" warns potential customers that the risk of loss in day trading can be substantial and encourages the customer to determine whether he or she is suitable for day trading.⁷³⁷ The document also warns potential day trading customers that they could lose more than their initial investment, that customers will be charged interest for margin loans, and that commission charges can be significant because of the high volume of trading.⁷³⁸

The Subcommittee's investigation found evidence, however, that this risk disclosure form has not always been used by Providential and that the form has not been consistently utilized by the firm's various branch offices. For instance, when Amy Le opened a day trading account at Providential's Los Angeles office, neither Mr. Moon nor Mr. Cao gave her this risk disclosure form. Instead, Mr. Cao asked Ms. Le to sign a form entitled "Acknowledgment of Liability," which did not mention day trading, much less its risks.⁷³⁹ The form also made no reference to excessive commission charges or the risks of margin trading.⁷⁴⁰

The Subcommittee reviewed new account forms provided by Providential and determined that Providential has generally required new customers to review and sign the risk disclosure forms. For example, virtually all of the 43 new day trading customers who opened accounts at the Oregon branch office signed the risk disclosure statements. In addition, the Subcommittee reviewed the new account forms provided for Providential's California offices, which also show a substantial number of customers signed the risk disclosure forms. The Subcommittee could not verify, however, that all of Providential's day trading customers reviewed written risk disclosure forms.

C. Providential's Misleading Advertising

Even though the evidence suggests that Providential provided most of its customers written risk disclaimers, the evidence shows that Providential officials may have undermined these good risk disclosure documents with misleading advertising and oral statements that contradicted the disclaimers. The Subcommittee's investigation uncovered several questionable statements by Providential in newspaper advertisements and on its website. Former Providential customers also claimed to Subcommittee staff that Providential officials made statements regarding the high profitability of day trading without adequate disclosure of the attendant risks. Such deceptive and misleading practices can often encourage individuals with limited investment experience and financial resources to enter the high-risk, day trading lifestyle.

(1) *Deceptive Newspaper Advertisement.* In his Subcommittee deposition, Mr. Fahman testified that he was responsible for re-

⁷³⁶ "Customer Acknowledgment of Risk," Providential Securities, Inc. (Feb. Hr'g Ex. 73).

⁷³⁷ *Id.* at 1.

⁷³⁸ *Id.* at 1-2.

⁷³⁹ "Acknowledgment of Liability," Hahna Global Securities, June 6, 1998 (Feb. Hr'g Ex. 74).

⁷⁴⁰ *Id.*

viewing and approving all firm advertising.⁷⁴¹ He said that Providential has never advertised on television for day trading customers.⁷⁴² Mr. Fahman explained that Providential had occasionally advertised on the radio but that the bulk of its day trading advertising was in newspapers.⁷⁴³

In 1998, Providential ran an advertisement in the Orange County Register and in Oregon newspapers that significantly distorted the risks and difficulties of profitable day trading.⁷⁴⁴ The Providential advertisement states that day trading is “a very simple” and “is not complex.”⁷⁴⁵ It then adds the unremarkable proposition that day trading requires traders to “Buy Low, * * * Sell High!!!”⁷⁴⁶ In addition, the Providential advertisement encourages prospective day traders in the following manner: “Take the appropriate gain Put the advantage in your column with the best of the best in the stock market today!!!!”⁷⁴⁷ The advertisement omits any mention of, or disclosure about, the risks of day trading.⁷⁴⁸

Under questioning at his deposition, Mr. Fahman conceded that day trading is not a “simple game.”⁷⁴⁹ In fact, Mr. Fahman testified that day trading is “rather complex” and “[i]t’s not that simple.”⁷⁵⁰ Further, at the Subcommittee’s hearing on February 25, 2000, he described day trading as, “very complex.”⁷⁵¹ He indicated that Providential later discontinued the advertisement because it did not accurately reflect the difficulties and risks associated with day trading.⁷⁵² Mr. Fahman acknowledged under questioning from Subcommittee staff that the advertisement “only reflected the positive, exciting aspects of day trading.”⁷⁵³ In addition, he remarked at the Subcommittee’s hearing that the ad was, “* * * not wholesome in all context.”⁷⁵⁴

(2) *Deceptive Website Text.* Prior to January 2000, Providential’s Internet website contained potentially misleading information about Providential’s day trading operation. Specifically, Providential’s website states that the firm and its current clearing agent, Penson, have the technical capacity to quickly execute clients’ trades, which is essential for day traders to profit from small

⁷⁴¹ Fahman Dep. at 243.

⁷⁴² Id. at 242.

⁷⁴³ Id.

⁷⁴⁴ Two former Providential day trading customers have filed a complaint with the NASD seeking \$425,000 in damages from Providential, resulting from trading losses and commissions. Claimants First Amended Statement of claim, Case No.: 99-01874, at 1. Among other allegations, the plaintiffs allege that they saw this newspaper advertisement and opened day trading accounts at Providential on the basis of the misleading representations made about the profit potential of day trading. Id. at 3–4. The claimants also allege that the “Premier Day Trading Course” cited in the advertisement lasted less than two hours and consisted of a few “simplistic charts.” Providential and the other respondents have denied the allegations in the lawsuit and claim that the plaintiffs were sophisticated investors. Id. at 2.

⁷⁴⁵ Providential advertisement (Feb. Hr’g Ex. 75).

⁷⁴⁶ Id.

⁷⁴⁷ Id.

⁷⁴⁸ Id.

⁷⁴⁹ Fahman Dep. at 247.

⁷⁵⁰ Id.

⁷⁵¹ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

⁷⁵² Fahman Dep. at 246.

⁷⁵³ Id.

⁷⁵⁴ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

changes in stock prices.⁷⁵⁵ The website states that “Providential Securities, Inc. can process trades quickly and efficiently to secure optimum prices for our clients.”⁷⁵⁶

The Subcommittee’s investigation has raised questions, however, about whether Providential’s software and other technology actually provides efficient execution services to day trading clients as the website proclaims. For example, Mr. Moon told Subcommittee staff that one reason he decided to close Providential’s Los Angeles branch office was that his customers were constantly experiencing computer-related problems.⁷⁵⁷ Mr. Moon said that customers frequently complained about the computer system and that computer difficulties prompted some customers to take their business to other firms.⁷⁵⁸ Mr. Moon further stated that neither Go Trading nor Providential ever provided adequate computer support.⁷⁵⁹ In addition, two former Providential clients, who day traded from Providential’s Oregon branch office, told Subcommittee staff that the firm’s order execution system frequently malfunctioned and caused them to lose money.⁷⁶⁰

Providential’s website also contains misleading information about customer account protection provided by the Securities Investor Protection Corporation (“SIPC”). SIPC is a non-profit corporation chartered by Congress that provides limited customer account compensation to the clients of registered brokerage firms that fail or are liquidated.⁷⁶¹ Providential’s website includes the following statement regarding the firm’s SIPC coverage:

PROTECTION FOR ALL INVESTOR ACCOUNTS

*Providential Securities, Inc. is a Member of the Securities Investor Protection Corporation (SIPC). Each client account is insured for \$25,000,000; the first \$500,000 of protection is provided by SIPC and the balance by an excess SIPC coverage insurance policy through a major domestic insurer.*⁷⁶²

To unsophisticated investors, Providential’s statement regarding SIPC coverage could easily leave the misimpression that SIPC would cover their day trading losses when, in fact, SIPC protection only applies when the entire brokerage firm fails. The Subcommittee referred Providential’s website to SIPC officials for review and comment. SIPC’s General Counsel later informed the Subcommittee that SIPC objected to Providential’s use of the word “insured” in its disclosure about SIPC protection.⁷⁶³ He explained that the word “insured” is “inappropriate in this context. A reference to ‘insurance’ can lead investors to believe that they can never lose money which they invested with a brokerage firm that

⁷⁵⁵ “Welcome to Providential Securities,” www.providential.net/english/main.html, Dec. 14, 1999, at 1.

⁷⁵⁶ *Id.*

⁷⁵⁷ Moon Int. at 4.

⁷⁵⁸ *Id.*

⁷⁵⁹ *Id.*

⁷⁶⁰ Telephone Interview of Holly Clark, Nov. 22, 1999, at 3 (“First Clark Int.”); Telephone Interview of Matt Lehr, Nov. 29, 1999, at 4 (“Lehr Int.”).

⁷⁶¹ “Who We Are,” www.sipc.org, Feb. 10, 2000.

⁷⁶² “Welcome to Providential Securities,” www.providential.net/english/main.html, Dec. 14, 1999, at 1.

⁷⁶³ Letter from Stephen P. Harbeck, SIPC General Counsel, to Wesley M. Phillips, Investigator for the Subcommittee, Nov. 30, 1999, at 1 (Feb. Hr’g Ex. 76).

is a member of SIPC.”⁷⁶⁴ He also informed Subcommittee staff that he would refer the Providential advertisement to the NASDR and ask Providential to conform with SIPC’s advertising regulations.⁷⁶⁵

(3) *Deceptive Statements by Providential Officials.* The investigation uncovered several former day trading customers of Providential who alleged that the firm’s employees or agents made misleading and deceptive statements about the risks of day trading. For instance, Amy Le, a former customer of Providential’s Los Angeles office, told Subcommittee staff that Huan Van Cao, a day trader at the office, persuaded her to open an account with deceptive statements about the risks of day trading.⁷⁶⁶ She said Mr. Cao told her that he “could guarantee a twenty percent annual return.”⁷⁶⁷ Mr. Cao, according to Ms. Le, chided her for being overly cautious with her funds when she declined initially to open a day trading account at Providential’s Los Angeles office.⁷⁶⁸ Ms. Le added that on the day she decided to open the account with Ms. Cao he asked her to sign a form called a “Sophisticated Investor Acknowledgment” but did not explain the purpose of the form.⁷⁶⁹ In addition, Ms. Le said Mr. Cao told her nothing about the risks of day trading, even after she told him that her investment objective was “income,” an objective at odds with a speculative day trading strategy.⁷⁷⁰ Mr. Cao denied most of Ms. Le’s allegations under oath at his Subcommittee deposition, though he conceded that he never gave Ms. Le any risk disclosure pertaining to day trading.⁷⁷¹

Subcommittee staff also interviewed a former day trader at Providential’s Oregon office named Holly Clark, who stated that Providential officials Tony and Alex Nguyen frequently made misleading statements about the profit potential of day trading without adequately disclosing the risks involved. For example, Ms. Clark stated that Tony Nguyen would frequently walk the day trading floor and state that the clients would become “millionaires” if they day traded for one year.⁷⁷² Ms. Clark also said that Alex Nguyen, who taught Providential’s training course, stated that day traders should follow certain technical strategies that would virtually guarantee that they would “make a lot of money.”⁷⁷³ Ms. Clark alleged, however, that Alex Nguyen told her that she should not tell anyone about this technical strategy to get rich day trading.⁷⁷⁴ Subcommittee staff interviewed Tony Nguyen and he adamantly denied making any statements that would mislead Providential customers about the profit potential of day trading and the risks involved.⁷⁷⁵

⁷⁶⁴ Id.

⁷⁶⁵ Id.

⁷⁶⁶ Interview with Amy Le, Oct. 21, 1999, at 4 (“Le Int.”).

⁷⁶⁷ Id. at 2.

⁷⁶⁸ Id. at 3.

⁷⁶⁹ Id. at 4.

⁷⁷⁰ Id.

⁷⁷¹ Deposition of Huan Van Cao, Dec. 28, 1999, at 158, 161–68 (“Cao Dep.”).

⁷⁷² Holly Clark Written Complaint to Oregon’s Division of Finance and Corporate Securities, Nov. 12, 1999 at 4 (“Clark Complaint”) (Feb. Hr’g Ex. 77).

⁷⁷³ Id.

⁷⁷⁴ Id.

⁷⁷⁵ Nguyen Int. at 3.

D. Providential's Suitability Standards for New Day Trading Accounts

In addition to requiring risk disclaimers, Providential has established suitability standards to ensure that the financial resources and investment objectives of its customers are appropriate for a high-risk, day trading strategy. Mr. Fahman told Subcommittee staff that he was responsible for reviewing and approving Providential's General Securities Supervisory Procedures and Compliance Manual ("Compliance Manual") as part of his previous responsibilities as Chief Compliance Officer.⁷⁷⁶ Mr. Fahman said that the Compliance Manual has been in effect in several versions since the firm's founding.⁷⁷⁷ The Compliance Manual sets forth Providential's procedures for complying with securities laws and regulations as well as the firm's day trading account opening and documentation procedures.⁷⁷⁸

The most recent version of Providential's Compliance Manual, dated October 1998, contains a section entitled "Know Your Client."⁷⁷⁹ This section states in pertinent part:

Living in such a litigious society, [brokers] need to take special care in gathering complete and accurate financial information about [your] customers. You must take the time with your clients to assess their situation on a regular basis, and make [sic] recommendations based on your fact finding mission. *Suitability is the key to client recommendation.*⁷⁸⁰

According to Mr. Fahman, the Know Your Customer procedures require Providential's brokers to collect significant financial information about a prospective client before opening a new day trading account, including the client's occupation, income, net worth, investment objectives, and tax status.⁷⁸¹ Mr. Fahman testified that Providential requires the firm's representatives to collect this information from prospective customers so the firm can determine whether the customer is suitable for day trading.⁷⁸²

Providential's Compliance Manual also makes clear that firm representatives should consider rejecting customers that do not provide the necessary information. Specifically, the Compliance Manual states the following: "Suggestion—If a client refuses to disclose certain information, you need to document it and have the client initial the appropriate section. One last thought, perhaps the client who will not disclose adequate information is not the client you want to be spending your valuable time with."⁷⁸³ The Compliance Manual advises its brokers that "the more you know about the customer and the more of that information that is recorded on account cards and associated documents * * * the more you are

⁷⁷⁶ Fahman Dep. at 136–37.

⁷⁷⁷ Id. at 137.

⁷⁷⁸ Providential Securities, Inc., General Supervisory Procedures and Compliance Manual, (Oct. 1998) (Feb. Hr'g Ex. 78).

⁷⁷⁹ Ex. 78, "Branch Office Supervisory Procedures," at 7.

⁷⁸⁰ Id. (emphasis in original).

⁷⁸¹ Fahman Dep. at 161. Mr. Fahman confirmed that Providential representatives must collect this information for both retail and day trading accounts. Id. at 162.

⁷⁸² Id. at 161, 169.

⁷⁸³ Feb Hr'g Ex. 78, "Branch Office Supervisory Procedures," at 7.

qualified to serve as his agent.”⁷⁸⁴ In addition, Mr. Fahman stated that all Providential representatives are required to know their customers and are required to “strongly encourage the potential day trader to provide complete financial information. If they don’t do that, it gives us reason to doubt their ability or suitability of becoming a day trader.”⁷⁸⁵

Despite the Compliance Manual’s requirement to obtain financial information from prospective customers before opening new day trading accounts, Subcommittee staff found that—in practice—Providential often ignored its Compliance Manual and failed to obtain the financial information from prospective clients that would allow the firm to determine whether the customer was suitable for day trading. The Subcommittee reviewed 234 day trading account forms and found that 61, or 26 percent, of the new account forms lacked the basic financial information, such as income and net worth, that Providential stipulated was necessary to open new day trading accounts.

At Providential’s Los Angeles office, the failure to obtain basic financial information about new day traders was striking. The Subcommittee analyzed 31 day trading account forms from the Los Angeles branch office and found that 23, or 74 percent, lacked either income or net worth data, or both. Providential’s Oregon branch office demonstrated the best performance where only 14 percent of the new account forms failed to include the required financial information. During his Subcommittee deposition, Mr. Fahman was shown several of these new account forms that lacked the necessary customer financial information. Mr. Fahman conceded that it was an “oversight” for Providential to have approved the opening of these day trading accounts without the requisite financial information about the customers.⁷⁸⁶

PROVIDENTIAL DAY TRADING CUSTOMER ACCOUNT FORMS THAT FAILED TO INCLUDE REQUIRED FINANCIAL INFORMATION ON INCOME AND/OR NET WORTH

Branch	Number of forms re-viewed	Number of forms without required information	Percentage of forms without required information
California branches ¹	160	32	20
Los Angeles branch	31	23	74
Oregon branch	43	6	14
Total	234	61	26

¹ Providential’s Fountain Valley, Alhambra, Encino, Glendale, and Lake Forest offices.
Source: Providential day trading customer account forms.

(1) *Providential’s Minimum Financial Requirements for New Day Trading Accounts.* At the outset of this investigation, the Subcommittee asked Providential to disclose any established minimum financial standards for accepting new day trading accounts. In a written response dated December 3, 1999, Providential indicated that it required new day trading customers to have a minimum income of \$50,000 and a minimum net worth of \$200,000.⁷⁸⁷ Provi-

⁷⁸⁴ Id. at 8.

⁷⁸⁵ Fahman Dep. at 161, 163.

⁷⁸⁶ Id. at 216.

⁷⁸⁷ Feb. Hr’g Ex. 69, at 2. In Mr. Fahman’s deposition, he retreated from the letter by referring to the standards as “targets” rather than fixed requirements. Fahman Dep. at 193–94.

dential also stated that it formerly required a minimum deposit of \$50,000 to open a day trading account.⁷⁸⁸ Providential indicated, however, that it subsequently lowered this initial deposit requirement to \$10,000 in response to competitive pressure from other day trading firms.⁷⁸⁹ In a letter to the Subcommittee, Mr. Moon contradicted Mr. Fahman by stating that Providential's Los Angeles branch office had no minimum financial requirements for day trading accounts.⁷⁹⁰

During his deposition, Mr. Fahman was asked about the competitive pressures that prompted the decision to lower the minimum capital requirement for new day trading accounts:

Q: Are you saying that while that [\$50,000] was your minimum requirement when you started for risk capital, you ended up having to lower it to \$10,000 because the day trading firms with which Providential was competing were accepting people with much less risk capital than \$50,000, is that fair?

A: Right. Right.

Q: And in order to compete for those customers and that business, Providential felt it was necessary to lower their standards to \$10,000, is that accurate?

A: Yes.⁷⁹¹

Mr. Fahman conceded that the amount of risk capital available to a day trader is directly related to the day trader's chances of profitability.⁷⁹² At his Subcommittee deposition, Mr. Fahman agreed that a trader "starting with \$150,000 has a better chance of success than one with \$50,000."⁷⁹³ He was then asked as follows:

Q: And that would be the same—the same equation would exist between \$50,000 and \$30,000, and \$30,000 and \$10,000?

A: Right.

Q: It's a sliding scale?

A: Right.⁷⁹⁴

Thus, by lowering its risk capital standards, Providential is now routinely accepting prospective day trading customers that it previously considered unsuitable for this speculative strategy. As Mr. Fahman's testimony shows, Providential is now accepting day trading customers whose chances of success are less than what Providential formerly considered appropriate for opening a new account. Moreover, Providential is now pursuing the day trading business of these unsuitable customers because of competitive pressures from firms whose standards were once lower than those of Providential.

(2) *Henry and Theodore Fahman Reviewed and Approved All New Day Trading Accounts.* Mr. Fahman testified that he and his brother, Theodore, are ultimately responsible for reviewing and approving all of Providential's new day trading account forms to ensure compliance with the firm's minimum financial require-

⁷⁸⁸ Feb. Hr'g Ex. 69, at 2.

⁷⁸⁹ Id.

⁷⁹⁰ Feb. Hr'g Ex. 18, at 13.

⁷⁹¹ Fahman Dep. at 195.

⁷⁹² Id. at 134.

⁷⁹³ Id.

⁷⁹⁴ Id.

ments.⁷⁹⁵ For example, if a prospective customer sought to open a day trading account at Providential's Oregon office, the applicant would complete the required documentation, including the new account form, and Tony Nguyen would sign the paperwork. Mr. Nguyen would then send the documentation to Providential's Fountain Valley headquarters.⁷⁹⁶ According to Mr. Fahman, officials in Providential's Operations Department would then review the documentation prior to forwarding it on to either Mr. Fahman or his brother.⁷⁹⁷ Once the Fahmans had approved the account paperwork, Providential's home office would assign an account number to the customer so that he or she could begin day trading.⁷⁹⁸

(3) *Providential Frequently Fails to Comply With Its Stated Day Trading Suitability Standards.* Despite Providential's stated minimum financial requirements for new day trading accounts, the Subcommittee found that the firm frequently failed to comply with its own suitability standards. The Subcommittee's analysis of the 234 new account forms produced by Providential showed that the firm often frequently opened day trading accounts in which the customers' stated financial condition was below the firm's then-existing minimum financial requirements of \$50,000 in income and \$200,000 of net worth. Overall, the Subcommittee found that 123, or 52.5 percent, of the 234 new account forms failed to satisfy the income or net worth targets or both.⁷⁹⁹ For example, one new customer account form from a Providential branch office in California listed the client as having an income of \$25,000 and a net worth of \$50,000.⁸⁰⁰

The Subcommittee's analysis also found that Providential representatives frequently failed to report the day trading customer's initial deposit amount, which Mr. Fahman testified was needed to open a new account.⁸⁰¹ The Subcommittee found that the vast majority of the 234 customer account forms do not provide any information relating to the "Initial Deposit." Moreover, based upon the information disclosed by many of its customers, Providential permitted day traders to open new accounts with less money than its already lenient standard of \$10,000. For example, Providential allowed one customer to open an account with just \$3,000.⁸⁰² Another Providential customer opened a day trading account with only \$2,359.42.⁸⁰³ This customer also listed a net income of \$20,000 and net worth of \$20,000.⁸⁰⁴

During his Subcommittee deposition, Subcommittee staff asked Mr. Fahman about the opening of a day trading account for a bus

⁷⁹⁵ Id. at 142–44.

⁷⁹⁶ Id. at 143.

⁷⁹⁷ Id.

⁷⁹⁸ Id. at 143–44.

⁷⁹⁹ This figure includes the 61 new account forms that did not contain the basic financial information needed to perform the rudimentary suitability analysis required by Providential's Compliance Manual. The Subcommittee included these poorly documented forms in the overall total of 123 because, without the required financial information, Providential officials had no way of determining whether the new account forms were in compliance with the firm's financial targets. If the 61 new account forms without the required financial information are not included in the calculation, then 62, or 26 percent, of the 234 new account forms failed to meet Providential's minimum financial requirements in place at the time.

⁸⁰⁰ New Account Approval-B for Kiem Van Dao, July 26, 1999 (Feb. Hr'g Ex. 79).

⁸⁰¹ Fahman Dep. at 194–95.

⁸⁰² New Account Approval-B for Hon V. Bui and Huong H. Ly, Apr. 6, 1999 (Feb. Hr'g Ex. 80).

⁸⁰³ New Account Approval-B for Bedar Samee, Feb. 1, 1999 (Feb. Hr'g Ex. 81).

⁸⁰⁴ Id.

driver who disclosed an annual income of \$50,000 and a net worth of \$95,000.⁸⁰⁵ The applicant's new account form does not indicate, however, how much risk capital the bus driver had available to open her day trading account.⁸⁰⁶ When asked whether the customer was suitable for day trading, Mr. Fahman testified that: "By purely looking at this [new account document], it would be hard to tell whether or not [the customer] would be suitable, and most likely they would not."⁸⁰⁷ Mr. Fahman's concession that it was impossible to evaluate the suitability of customers whose forms were incomplete evidences that Providential failed routinely to obtain the basic information about its customers that its Compliance Manual identified as critical to evaluating their suitability for day trading.

Subcommittee staff showed Mr. Fahman several other new account forms that clearly did not meet Providential's requirements for opening new day trading accounts. For example, in one case, the new account form did not provide any information about the client's income or net worth and the client listed their investment objectives as "short-term growth with high risk" and "long-term growth with greater risk."⁸⁰⁸ In this case, Mr. Fahman acknowledged that Providential lacked the required information to determine and that checking "long term growth with greater risk" is inconsistent with opening a day trading account.⁸⁰⁹ These examples illustrate that Providential representatives not only failed to gather the information necessary to perform the suitability analysis required in the firm's Compliance Manual, but also frequently opened day trading accounts even when the customer provided financial information below the minimum requirements of the firm.

(4) *Providential Officials Estimate That a Significant Number of Day Traders Lose Money.* Providential was unable to provide empirical data to the Subcommittee regarding the profitability of its day traders.⁸¹⁰ Mr. Fahman estimated, however, that only about 20 to 30 percent of Providential's day traders actually make money.⁸¹¹ Although there is no concrete data to support or contradict this estimate, other Providential representatives gave evidence indicating that Mr. Fahman's estimate of profitability is, if anything, high. For instance, Mr. Moon indicated that none of the individuals who opened day trading accounts at the Los Angeles branch office ever made money.⁸¹² In fact, Mr. Moon estimated that the average day trading customer remained at the Los Angeles branch for only about one month and that the average customer lost approximately \$50,000.⁸¹³ Mr. Fahman testified that he had no reason to disagree with Mr. Moon's profitability estimates at Providential's Los Angeles branch office.⁸¹⁴ In addition, Mr. Fahman said that only "a couple" of clients at the firm's Oregon office were profitable.⁸¹⁵ At his deposition, Mr. Fahman was asked as follows:

⁸⁰⁵ New Account Approval-B for Clara B. and Daryl Larry Grabowski, Apr. 13, 1999 (Feb. Hr'g Ex. 82).

⁸⁰⁶ *Id.*

⁸⁰⁷ Fahman Dep. at 224.

⁸⁰⁸ New Account Approval-B for Shao-Shin Liu, undated (Feb. Hr'g Ex. 83).

⁸⁰⁹ Fahman Dep. at 215-16.

⁸¹⁰ *Id.* at 253.

⁸¹¹ *Id.*

⁸¹² Feb. Hr'g Ex. 18, at 4.

⁸¹³ Moon Int. at 5.

⁸¹⁴ Fahman Dep. at 256.

⁸¹⁵ *Id.*

Q: * * * do you think, throughout the entire day trading operation at Providential, that the substantial majority of your day trading accounts are not profitable but that there may be a handful of accounts that are profitable? Would that be a fair, probably, estimate?

A: Overall, I would say it's a fair estimate.⁸¹⁶

E. A Providential Day Trader Mislead the Firm's Clients for Whom He Traded, and Generated Significant Losses

The Subcommittee's investigation determined that Mr. Cao, who traded for customers of Providential's Los Angeles office, made misleading and deceptive statements to those customers regarding the profitability and risks of day trading. Moreover, the evidence shows that Mr. Cao was a de facto representative of Providential's Los Angeles branch office when he enticed several unsophisticated investors into opening day trading accounts at Providential over which he possessed discretionary trading authority. While in possession of the customers' trading authorizations, Mr. Cao pursued a highly risky day trading strategy that resulted in enormous trading losses and excessive commission charges. The evidence gathered by the Subcommittee indicates that, when he day traded the accounts of these Providential customers, Mr. Cao may have been in violation of Texas and California securities laws, requiring the registration as an investment adviser of anyone who trades the account of another for compensation.

On August 11, 1999, an NASD arbitration panel awarded one of Mr. Cao's clients, Amy Le, a judgment of nearly \$38,000 against Mr. Cao, Mr. Moon, and Providential's Los Angeles office. Mr. Cao defaulted on the judgment and has sought bankruptcy protection.

(1) *Huan Van Cao's Initial Association With Providential's Los Angeles Branch Office.* In his deposition, Mr. Cao told Subcommittee staff that he was born on April 7, 1953 in the former South Vietnam and that he emigrated to the United States in 1975.⁸¹⁷ Mr. Cao said that he currently lives in an apartment in Fountain Valley, California and that he maintains a home in Houston, Texas where his family resides.⁸¹⁸ Mr. Cao told Subcommittee staff that, upon arriving in the United States, he took pre-law and finance courses at the University of Houston but never obtained his undergraduate degree.⁸¹⁹ Mr. Cao said that, since 1993, he has been a full-time day trader who trades for himself and clients for compensation.⁸²⁰ Mr. Cao confirmed that he does not hold any licenses in the securities industry.⁸²¹ By the spring of 1998, Mr. Cao was day trading his own account and the accounts of other customers at a day trading firm in Houston called Gro.⁸²²

Mr. Moon, the branch manager of Providential's Los Angeles office, told Subcommittee staff that he first heard about Mr. Cao from a friend who lived in Houston.⁸²³ Mr. Moon said that, in March 1998, he offered Mr. Cao the position of Senior Vice Presi-

⁸¹⁶ Id. at 256-57.

⁸¹⁷ Cao Dep. at 15.

⁸¹⁸ Id. at 6-7.

⁸¹⁹ Id. at 27, 29-30, 48.

⁸²⁰ Id. at 5, 51-52.

⁸²¹ Id. at 50-51.

⁸²² Id. at 87.

⁸²³ Moon Int. at 5.

dent for a consulting firm that Mr. Moon was starting called Hahna Global Capital Management (“HGCM”).⁸²⁴ Mr. Moon told Subcommittee staff that HGCM was a distinct corporate entity from Hahna Global Securities, which was the trade name for Providential’s Los Angeles branch office.⁸²⁵ Mr. Moon indicated that he established HGCM as a consulting firm to cultivate investments by Korean businesses in Vietnam.⁸²⁶ Mr. Moon told Subcommittee staff that he hired Mr. Cao to assist HGCM’s consulting business, since he believed that Mr. Cao had many contacts in Vietnam.⁸²⁷

Mr. Cao testified that, in the spring of 1998, Mr. Moon called him from California and asked him to become a day trader at Providential’s Los Angeles office.⁸²⁸ Mr. Cao said that Mr. Moon initially offered him compensation of \$5,000 per month.⁸²⁹ Mr. Cao said that Mr. Moon subsequently offered him the position with HGCM and discussed potential consulting work in Vietnam.⁸³⁰ In March 1998, Mr. Cao left Houston for California to begin day trading at Providential’s Los Angeles office.⁸³¹ When Mr. Cao left for Los Angeles, he took a few of his Houston accounts with him, but Mr. Cao testified that most of the 21 or 22 Providential customers for whom he day traded were prospects that he developed from the Vietnamese community in California.⁸³²

(2) *Mr. Cao Was a De Facto Representative of Providential.* Although Mr. Moon claims that he hired Mr. Cao to work for HGCM and not Providential’s Los Angeles office, the evidence demonstrates that Mr. Cao was a de facto representative of the branch office and that Mr. Moon brought him to Los Angeles expressly to increase the day trading business. Mr. Moon told Subcommittee staff that he understood that Mr. Cao was a successful day trader in Houston and that Mr. Cao’s trading would benefit Providential’s Los Angeles office by generating as many as 300 “tickets” per day and attracting other high volume day traders.⁸³³ Moreover, the Subcommittee obtained a copy of an “Independent Contractor Agreement,” between Mr. Moon and Mr. Cao that required Mr. Cao to generate “around 300 tickets per day” at a charge of \$25.00 per ticket.⁸³⁴ The contract, which was unsigned, was prepared on HGCM letterhead and stated that it was based on a “conversation” between Mr. Moon and Mr. Cao.⁸³⁵ In consideration for the 300 daily tickets generated by Mr. Cao at the Los Angeles office, the

⁸²⁴ Id.

⁸²⁵ Id. at 3.

⁸²⁶ Id.

⁸²⁷ Id. at 5.

⁸²⁸ Cao Dep. at 89–90.

⁸²⁹ Id. at 90.

⁸³⁰ Id. at 57, 90–91, 93.

⁸³¹ Id.

⁸³² Id. at 126, 134–37.

⁸³³ Moon Int. at 5.

⁸³⁴ Independent Contractor Agreement Between Hahna Global Capital Management and Huan Van Cao, May 1998 (Feb. Hr’g Ex. 84).

⁸³⁵ Id. Mr. Moon and Mr. Cao gave conflicting stories to Subcommittee staff about the unsigned contract. Mr. Moon told Subcommittee staff that Mr. Cao proposed the contract and that he promised to generate 300 trades per day and that his friends would generate another 1,000. According to Mr. Moon, this was one of several proposals Mr. Cao advanced to obtain compensation for his day trading activities. Mr. Moon said that he never signed the contract and that he became disillusioned by Mr. Cao and his clients because they never generated close to 300 day trading tickets per day. Moon Int. at 5–6. By contrast, Mr. Cao told Subcommittee staff that Mr. Moon proposed the contract but that Mr. Cao rejected the proposal. Cao Dep. at 99–100. Mr. Cao said that it was unreasonable for Mr. Moon to expect him to generate 300 trades per day. Id. at 93–94.

contract stated that Mr. Cao's expenses would be paid from the net commissions.⁸³⁶ For example, the contract stated that Mr. Cao's expenses would include his apartment, car, and personal secretary.⁸³⁷ In addition, under the contract, Mr. Cao would be entitled to 50 percent of the net profit from his day trading activity.⁸³⁸

Despite Mr. Moon's contention that Mr. Cao was never an employee of the Los Angeles office, the contract on HGCM letterhead strongly suggests that Mr. Moon was responsible for, and/or complicit in, the contract's preparation. Furthermore, the terms of the contract are similar to other contracts that Mr. Fahman testified are routinely used by Providential to establish independent contractor relationships with branch office personnel.⁸³⁹ For example, the independent contractor agreements between Providential and its branch office representatives allow the branch officers to retain a significant percentage of the commissions charged to customers to pay operating expenses.⁸⁴⁰ Indeed, Mr. Fahman testified that he had a verbal independent contractor agreement with Mr. Moon to operate Providential's Los Angeles branch office whereby Mr. Moon retained 90 percent of his commissions to cover the office's expenses.⁸⁴¹ Similarly, the proposed contract between Mr. Moon and Mr. Cao would have permitted Mr. Cao to pay his expenses from the gross commissions that he generated. The fact that Mr. Moon was familiar with such Providential contracts as a branch manager strongly suggests that he was responsible for drafting the contract between himself and Mr. Cao and that it reflected Mr. Moon's understanding of their mutual agreement.⁸⁴²

The Subcommittee discovered other evidence suggesting that Mr. Cao was a de facto representative of Providential's Los Angeles branch office and that his mission was to increase its day trading commission revenue. For example, Mr. Moon told Subcommittee staff that HGCM and the Providential branch office shared the same office space in Los Angeles and that Mr. Cao had his own office and shared a secretary with Mr. Moon.⁸⁴³ Also, according to a document Mr. Moon provided to Subcommittee staff, Mr. Moon paid Mr. Cao nine separate payments totaling \$13,500 between April 1, 1998 and September 25, 1998.⁸⁴⁴ Mr. Cao testified that Mr. Moon paid him this money to cover his expenses as a day trader at Providential's Los Angeles branch office.⁸⁴⁵ Mr. Moon told Subcommittee staff that Mr. Cao later repaid about \$12,000 of these expense payments.⁸⁴⁶

As documented in more detail below in the Brenda Richardson and Amy Le case summaries, Mr. Cao held himself out as an officer of Hahna by using the "Hahna Global" name to recruit and maintain day trading clients. For example, HGCM's letterhead list-

⁸³⁶ Feb. Hr'g Ex. 84.

⁸³⁷ *Id.*

⁸³⁸ *Id.*

⁸³⁹ Fahman Dep. at 50-56.

⁸⁴⁰ *Id.* at 50-52.

⁸⁴¹ *Id.* at 55-56.

⁸⁴² Mr. Fahman testified that he was originally the President and Chief Executive Officer of HGCM but that he resigned shortly after its incorporation. *Id.* at 104.

⁸⁴³ Moon Int. at 6.

⁸⁴⁴ Letter from Susan H. Tregub, Attorney for Tae Goo Moon, to Eugene Horwitz, Special Investigator for NASDR, Sept. 29, 1999, at 5 (Feb. Hr'g Ex. 85).

⁸⁴⁵ Cao Dep. at 221.

⁸⁴⁶ Feb. Hr'g Ex. 85, at 5. Mr. Cao testified that he borrowed only \$10,000, which he repaid in full. Cao Dep. at 220-21.

ed Mr. Cao as an officer of the firm, and Mr. Cao sent that letterhead to prospective clients, including Ms. Richardson.⁸⁴⁷ Mr. Cao even used his office at Providential's Los Angeles branch to meet with prospective day trading clients, such as Ms. Le.⁸⁴⁸ Further, Mr. Moon said that he authorized Mr. Cao to perform basic administrative functions, suggesting that Mr. Cao acted as a Providential employee whose role was to recruit prospective day traders and generate commission revenue for the firm. For example, Mr. Moon said that Mr. Cao had the authority to fill out information on new account forms for prospective day trading clients, which he did in the Amy Le case. Mr. Moon also told Subcommittee staff that Mr. Cao was authorized to arrange loans from other Providential customers to his clients so that the clients could satisfy margin calls.⁸⁴⁹ Mr. Cao was even listed as the "account executive" on Ms. Richardson's trading records.⁸⁵⁰

Based on this evidence, the Subcommittee determined that Mr. Cao acted as an agent of Mr. Moon and Providential's Los Angeles branch office from the spring of 1998 until Mr. Moon asked him to leave later that fall. The evidence shows that, in his capacity as an agent for the Los Angeles office, Mr. Cao solicited new day trading accounts for the firm and the firm obtained the benefit of commission revenue that was generated from those new accounts.

(3) *Summary of Brenda Richardson and Amy Le Cases.* The Subcommittee found that, in his role as an agent of Providential's Los Angeles office, Mr. Cao made false and misleading statements about the risks and profitability of day trading to at least two clients, Ms. Richardson and Ms. Le. Ms. Richardson recently compromised her NASD complaint against Providential, Penson Securities, and others and received a substantial sum of money in settlement. Ms. Le won a judgment of nearly \$38,000 against Mr. Cao, Mr. Moon and Providential's Los Angeles office in August 1999. Neither Ms. Richardson nor Ms. Le have received any compensation from Mr. Cao because he has defaulted on the judgment and filed for bankruptcy protection.⁸⁵¹

(a) *Brenda Richardson.* Ms. Richardson was born in 1951 and is a pharmacist living in Houston.⁸⁵² In the summer of 1997, Ms. Richardson began day trading on-site at a Houston firm called Gro Corporation.⁸⁵³ Ms. Richardson said that she had no experience investing prior to her association with the day trading industry.⁸⁵⁴ Ms. Richardson said that she was completely unprepared to day trade successfully and lost about \$30,000 to \$40,000 within a few weeks.⁸⁵⁵ While at Gro, Ms. Richardson met Mr. Cao who she understood was a successful day trader.⁸⁵⁶ Ms. Richardson said that Mr. Cao offered to help her resolve several billing disputes that she

⁸⁴⁷ Letter from Huan Van Cao, Senior Vice President of Hahna Global Capital Management, to Brenda Richardson, Mar. 20, 1998 (Feb. H'g Ex. 86).

⁸⁴⁸ Le Int. at 3.

⁸⁴⁹ Moon Int. at 7. In fact, Mr. Moon told Subcommittee staff that most of these loans were made by his partner, Chung Lee, rather than other Providential customers. Id.

⁸⁵⁰ Trading records provided to the Subcommittee by Brenda Richardson.

⁸⁵¹ Cao Dep. at 216, 220.

⁸⁵² Interviews of Brenda Richardson, No. 18, 1999 and Dec. 17, 1999, at 1 ("First Richardson Int.").

⁸⁵³ Id. at 3.

⁸⁵⁴ Id. at 1.

⁸⁵⁵ Id. at 3. Ms. Richardson cited a lack of training by Gro as one reason that she was ill-prepared to day trade. Id.

⁸⁵⁶ Id. at 4.

had with Gro.⁸⁵⁷ For example, Ms. Richardson said that Mr. Cao offered to help her resolve disputed margin calls that Gro required her to pay.⁸⁵⁸ Ms. Richardson alleges that, during this period, Mr. Cao told her that he was an attorney and retired policeman.⁸⁵⁹

Ms. Richardson told the Subcommittee that she permitted Mr. Cao to day trade her account at Gro and an account that she shared with her daughter from about January 1998 until March 1998.⁸⁶⁰ Ms. Richardson said that she opened one account with about \$30,000 that she borrowed from her credit card.⁸⁶¹ According to Ms. Richardson, she had a verbal arrangement with Mr. Cao by which she received 60 percent of the net profits that Mr. Cao generated day trading her account.⁸⁶²

Mr. Cao acknowledged in a Subcommittee deposition that he had an oral arrangement with Ms. Richardson whereby she paid him ten to fifteen percent of the net trading profits he generated in her Gro account.⁸⁶³ Mr. Cao testified that, pursuant to this agreement, Ms. Richardson paid him about \$2,500 during the time he traded her account at Gro.⁸⁶⁴

When Mr. Cao arrived in California in March 1998, he sent Ms. Richardson a letter advising her that he was in California and that he would be in touch.⁸⁶⁵ Mr. Cao's letter was on HGCM letterhead, but he sent the letter via the facsimile machine in Providential's Los Angeles office.⁸⁶⁶ Ms. Richardson alleges that Mr. Cao convinced her to transfer the \$56,000 which remained in her two accounts at Gro to Providential's Los Angeles branch office.⁸⁶⁷ Ms. Richardson told Subcommittee staff that, at that time, Mr. Cao told her that "Hahna" offered many benefits over Gro. For instance, she said that Mr. Cao told her that he had been given \$500,000 from the firm to cover customer losses and that the firm did not have margin calls.⁸⁶⁸ Ms. Richardson said that, to be safe, she contacted the NASD to determine if a firm called "Hahna" actually existed.⁸⁶⁹ After the NASD confirmed to her that Hahna was a branch office of Providential, Ms. Richardson called the Los Angeles office to verify that Mr. Cao was employed with the firm.⁸⁷⁰ After receiving assurances that Mr. Cao was indeed affiliated with the Los Angeles office, Ms. Richardson decided to transfer her accounts from Gro to Providential.⁸⁷¹

In his deposition, Mr. Cao denied that he ever told Ms. Richardson that she should transfer her accounts from Gro to Providential's Los Angeles branch office.⁸⁷² Mr. Cao claimed that Ms. Richardson decided on her own to transfer the accounts to Providential.⁸⁷³

⁸⁵⁷ Id. at 5.

⁸⁵⁸ Id.

⁸⁵⁹ Id. at 4.

⁸⁶⁰ Id. at 6.

⁸⁶¹ Id. at 5.

⁸⁶² Id. at 6.

⁸⁶³ Cao Dep. at 78-79.

⁸⁶⁴ Id. at 83.

⁸⁶⁵ Ex. 86.

⁸⁶⁶ Cao Dep. at 85.

⁸⁶⁷ First Richardson Int. at 6-7.

⁸⁶⁸ Id. at 6.

⁸⁶⁹ Id. at 6.

⁸⁷⁰ Id.

⁸⁷¹ Id.

⁸⁷² Cao Dep. at 112.

⁸⁷³ Id. at 110, 112.

Ms. Richardson told Subcommittee staff that it was her understanding that Mr. Cao would embark on what she perceived as a relatively conservative day trading strategy whereby he would attempt to earn profits of \$250 to \$500 per day.⁸⁷⁴ The evidence shows, however, that Mr. Cao pursued an aggressive day trading strategy that resulted in substantial losses to Ms. Richardson. Specifically, Mr. Cao made 1,397 trades in Ms. Richardson's account in just ten weeks.⁸⁷⁵ Ms. Richardson alleged that the trades generated commissions of about \$38,000 and total trading losses of \$30,000.⁸⁷⁶ Ms. Richardson also alleged that Mr. Cao and the other respondents arranged for about \$550,000 to be loaned from other Providential customers into Ms. Richardson's account to satisfy the margin calls generated by Mr. Cao's trading.⁸⁷⁷ Ms. Richardson told Subcommittee staff that she did not understand the purpose of these loans. In fact, Ms. Richardson said that Mr. Cao told her that the loans were necessary to utilize the \$500,000 that the firm had provided to him for the purpose of managing her accounts.⁸⁷⁸ Ms. Richardson stated that Mr. Cao assured her that the loans were not being used to meet margin calls.⁸⁷⁹

Mr. Cao testified that, even though he day traded Ms. Richardson's account, he never knew how much she earned for a living and that he did not know her net worth.⁸⁸⁰ He also denied ever knowing that Ms. Richardson borrowed money from her credit cards to fund his day trading activities in her account.⁸⁸¹ Mr. Cao acknowledged that Ms. Richardson paid him approximately \$4,000 to \$5,000 for trading her account at Providential's Los Angeles office.⁸⁸²

On January 13, 2000, Ms. Richardson settled her NASD claim arising from Mr. Cao's activities.⁸⁸³ As part of the settlement, Ms. Richardson received a payment from Providential's clearing firm, Penson Securities.⁸⁸⁴ Henry Fahman, Providential's President, wrote Ms. Richardson a check in satisfaction of her claims against Providential and Mr. Moon, as the head of Providential's Los Angeles branch office.⁸⁸⁵ As explained above, Mr. Cao has sought bankruptcy protection and has refused to compensate Ms. Richardson for her losses.⁸⁸⁶

(b) *Amy Le*. Ms. Le is a homemaker who lives in Garden Grove, California.⁸⁸⁷ In April of 1998, Mr. Cao approached Ms. Le while she was working as a part-time sales clerk at a music store that caters to the Vietnamese community located in the "Little Saigon" area of Westminster, California.⁸⁸⁸ At his Subcommittee deposition, Mr. Cao confirmed that he first discussed day trading with Ms. Le

⁸⁷⁴ First Richardson Int. at 7.

⁸⁷⁵ Analysis of Richardson Account by William Sheperd & Associates, at 1 ("Claimant's Exhibit 2A").

⁸⁷⁶ Id. at 2.

⁸⁷⁷ Id. at 3.

⁸⁷⁸ First Richardson Int. at 7.

⁸⁷⁹ Id.

⁸⁸⁰ Cao Dep. at 114.

⁸⁸¹ Id. at 113.

⁸⁸² Id. at 132.

⁸⁸³ Shepherd Int. at 1.

⁸⁸⁴ Id.

⁸⁸⁵ Id.

⁸⁸⁶ Cao Dep. at 216.

⁸⁸⁷ ILe Int. at 1.

⁸⁸⁸ Id. at 2.

in the music store in Little Saigon.⁸⁸⁹ Mr. Cao testified that he frequently prospected for clients among the members of the Vietnamese community in Southern California.⁸⁹⁰ He explained his prospecting efforts as follows:

Q: Okay. And so you built a reputation in the Vietnamese community working with these friends of yours, and then they might pass your name on to other people?

A: Well, I build my good reputation with my friend, and it up to them to pass the word to somebody else.

* * * * *

Q: —on the West Coast? How many total do you think you traded on their behalf?

A: In and out?

Q: Yeah.

A: Maybe 21, 22.

* * * * *

Q: So you might have a friend who wouldn't open an account, but their brother might or their uncle—

A: No. They opened it—

Q: Oh, they would—

A: —and then after I make the good money, they—I *build up the trust, and then they refer to their children or their in-laws.*⁸⁹¹

Ms. Le said that, through a variety of misleading statements, she came to trust Mr. Cao and he convinced her to make her limited family savings available to him for day trading at Providential's Los Angeles branch office. For example, Ms. Le said that Mr. Cao told her that he could guarantee a twenty percent investment return for his clients.⁸⁹² Ms. Le also said that Mr. Cao told her that he was a registered broker and attorney.⁸⁹³ The Subcommittee has determined that Mr. Cao was never an attorney or broker.⁸⁹⁴ According to Ms. Le, she believes that Mr. Cao made these statements to impress her, explaining that such positions are highly respected within the Vietnamese community.⁸⁹⁵ At the Subcommittee's hearing in February though, Mr. Cao maintained that Ms. Le was the one who inquired as to his occupation and he responded, "selling stock."⁸⁹⁶

Ms. Le also said that Mr. Cao repeatedly contacted her by telephone over a period of several weeks in an effort to convince her to invest with him and Providential's Los Angeles branch office.⁸⁹⁷ Ms. Le stated that she traveled to Los Angeles from her home in Orange County to visit Mr. Cao in his office.⁸⁹⁸ During this meet-

⁸⁸⁹ Cao Dep. at 145–46.

⁸⁹⁰ Id. at 136.

⁸⁹¹ Id. at 136–37 (emphasis added).

⁸⁹² Le Int. at 2.

⁸⁹³ Id.

⁸⁹⁴ The NASDR, Texas, and California securities regulators have no listing of Mr. Cao as a registered broker or dealer. As stated previously, Mr. Cao also told Subcommittee staff that he is not a licensed broker or registered representative in the securities industry. Cao Dep. at 51. Mr. Cao also confirmed that he was never an attorney or auditor. Id. at 27.

⁸⁹⁵ Le Int. at 2.

⁸⁹⁶ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

⁸⁹⁷ Le Int. at 3.

⁸⁹⁸ Id.

ing, Ms. Le said that Mr. Cao took several telephone calls from other customers and then claimed that he had just made substantial profits for them.⁸⁹⁹

Mr. Cao also told her that he had a real-time quote machine that “blinked” when it was time to buy and “blinked” again when it was time to sell.⁹⁰⁰ Mr. Cao made similarly dubious statements to the Subcommittee in his deposition. At his Subcommittee deposition, Mr. Cao conceded that he told Ms. Le that he had a “money-making machine” because the computer he used for day trading was “a machine to make money.”⁹⁰¹ He explained that his computer monitor provided a blue signal when it was time to buy a stock and a red signal when it was time to sell a stock.⁹⁰² Mr. Cao testified that the blinking lights not only helped him “avoid” losses, but would actually “prevent” losses.⁹⁰³ Mr. Cao described his simplistic approach to day trading in this colloquy:

Q: Is that kind of your strategy? You wait for the light to start blinking?

A: Yes.

Q: And then when you see the light blinking that tells you—if it’s a blue light, that tells you that you want to buy. And if you see a red light, that tells you that you want to sell. Is that kind of the basics of your strategy?

A: Yes, for day trading.⁹⁰⁴

In the course of her dealings with Mr. Cao, Ms. Le also learned that Hahna was a branch office of Providential.⁹⁰⁵ Ms. Le said that Mr. Cao’s association with Providential was comforting to her because Providential was highly regarded within the Vietnamese community.⁹⁰⁶ Ms. Le said that, in June 1998, she decided to invest with Mr. Cao because her car was old and frequently broke down.⁹⁰⁷ She hoped Mr. Cao would earn enough on her money from day trading so that she could buy a new car.⁹⁰⁸

Mr. Cao drove from Los Angeles to Orange County, where Ms. Le resides, and they sat in her old car to complete the paperwork necessary to start Mr. Cao trading on her behalf.⁹⁰⁹ Ms. Le said that, during their conversation, Mr. Cao told her to look for a new car because he would earn a substantial return on her investment.⁹¹⁰ Ms. Le’s new account form stated that her investment objective was “income” rather than “short term growth with high risk.”⁹¹¹ This new account form strongly supports Ms. Le’s contention that she did not understand that Mr. Cao planned to use her funds for a high risk trading strategy. The new account form also omitted Ms. Le’s net worth, which was required by Providential’s Compliance Manual, and indicated that the account was being opened with only \$10,000, well below the \$50,000 minimum risk

⁸⁹⁹ Id.

⁹⁰⁰ Id.

⁹⁰¹ Cao Dep. at 167.

⁹⁰² Id. at 168–70.

⁹⁰³ Id. at 168.

⁹⁰⁴ Id. at 169–70.

⁹⁰⁵ Le Int. at 4.

⁹⁰⁶ Id.

⁹⁰⁷ Id.

⁹⁰⁸ Id.

⁹⁰⁹ Id.

⁹¹⁰ Id.

⁹¹¹ New Account Approval-B for Amy Le, undated (Feb. Hr’g Ex. 87).

capital requirement in effect at the time.⁹¹² Mr. Moon acknowledged to Subcommittee staff that he was “in error” for approving Ms. Le’s new account form given her stated investment objectives.⁹¹³ Mr. Fahman agreed in his Subcommittee deposition that, “[b]ased on the information provided on the new account form, it would not be appropriate” to open Ms. Le’s account in 1998.⁹¹⁴

Ms. Le said that, while in Mr. Cao’s car, she signed a check for \$10,000 and gave it to Mr. Cao.⁹¹⁵ Ms. Le told Subcommittee staff that “her hands were shaking as she signed the check” and gave it to Mr. Cao.⁹¹⁶ Ms. Le deposited another \$38,000 in her day trading account at Providential over the next two months for a total deposit of \$48,000.⁹¹⁷ Ms. Le said that the final deposit of \$12,000 in July 1998, was money that Ms. Le borrowed from her elderly mother.⁹¹⁸ According to Ms. Le, her mother planned to use this money to repair ancestral graveyards in Vietnam.⁹¹⁹ Ms. Le said that she informed Mr. Cao of the source of these funds and the importance of the money to her family.⁹²⁰ She told Subcommittee staff that Mr. Cao promised to invest the funds safely.⁹²¹ Instead, Mr. Cao embarked on an aggressive day trading campaign that, by September 1998, resulted in losses to Ms. Le of about \$35,000 out of her total deposit of \$48,000.⁹²²

Ms. Le also alleged that Mr. Cao provided misleading information to her during this period about the performance of her account.⁹²³ In addition, Ms. Le said that Mr. Cao and Mr. Moon arranged for a \$20,000 loan from Mr. Moon’s partner into Ms. Le’s account to meet margin calls.⁹²⁴ Ms. Le said that Mr. Cao telephoned her in July of 1998 and convinced her to sign a loan authorization form.⁹²⁵ Even though the loan authorization form states that the journalling of funds is “to cover the outstanding margin call in the account,” Ms. Le alleges that Mr. Cao told her that the purpose of the loan was not to meet a margin call but, rather to increase her “buying power.”⁹²⁶

Mr. Cao testified that he “never” called Ms. Le on the telephone to convince her to day trade her funds and he denied that he ever told Ms. Le that he was an attorney or stock broker.⁹²⁷ The Subcommittee did obtain some corroborative evidence to support Ms. Le’s claims from two other former day trading clients of Mr. Cao, who substantiated her claim that Mr. Cao presented himself as an attorney, registered representative.⁹²⁸ One of these individuals,

⁹¹² *Id.*

⁹¹³ Moon Int. at 5.

⁹¹⁴ Fahman Dep. at 239.

⁹¹⁵ Le Int. at 4.

⁹¹⁶ *Id.*

⁹¹⁷ *Id.* at 4–5.

⁹¹⁸ *Id.* at 5.

⁹¹⁹ *Id.*

⁹²⁰ *Id.*

⁹²¹ *Id.*

⁹²² *Id.* at 6.

⁹²³ *Id.* at 5.

⁹²⁴ *Id.*

⁹²⁵ Amy Le’s Loan Authorization to Lori Assunto, Margin Department of Penson Financial Services, July 6, 1998 (Feb. Hr’g Ex. 88). Le Int. at 5.

⁹²⁶ Le Int. at 5.

⁹²⁷ Cao Dep. at 149, 167.

⁹²⁸ Telephone Interview of Dung Tran, Nov. 2, 1999, at 1–2 (“Dung Tran Int.”); Interview of Minn Tran, Nov. 2, 1999, at 1–2 (“Minn Tran Int.”).

Dung Tran, has since filed an NASD arbitration claim against Mr. Cao and Providential, which is discussed in more detail below.⁹²⁹

In his deposition, Mr. Cao made several key admissions that corroborate much of Ms. Le's account. For instance, when asked about any risk disclosure that might have been given to Ms. Le, he claimed that Ms. Le was a sophisticated investor who said she knew everything she needed to know to open a day trading account.⁹³⁰ He was then asked directly about risk disclosure:

Q: Did you tell her it was high risk?

A: No, I did not tell her. I tell her that if you want to know, Mr. Moon, he qualified to tell her.

Q: So you never sat down and told her this is a very high risk, gambling type of strategy or anything like that?

A: It not my job.⁹³¹

Mr. Cao also admitted that Ms. Le told him she was "very poor" in the course of his discussions with her about opening an account at the Los Angeles office.⁹³² Mr. Cao told Subcommittee staff that, when he met Ms. Le in Orange County in June 1998, Ms. Le showed him her old car and stated that she would like to buy a new car from the proceeds of Mr. Cao's trading activities.⁹³³ Thus, Mr. Cao essentially acknowledged that he knew Ms. Le was not a suitable candidate for day trading given her limited financial resources and unrealistic investment objectives.

As explained above, Ms. Le filed an NASD arbitration claim against Mr. Cao, Mr. Moon, Hahna, Providential and others. She eventually received a judgment for \$37,791.11 on August 11, 1999.⁹³⁴ The NASD arbitrators found Mr. Cao liable for \$22,600, Hahna liable for \$12,500 and Providential and its officers liable for \$450.⁹³⁵ As stated previously, Mr. Fahman testified that Providential paid the \$12,500 judgment on behalf of Mr. Moon as the branch manager of its Los Angeles office.⁹³⁶ On October 22, 1999, Mr. Cao filed for bankruptcy in the United States District Court in Houston.⁹³⁷ Ms. Le has not been able to collect the \$22,600 that Mr. Cao owes her as a result of the judgment. Providential refused to pay Ms. Le the portion of the judgment attributable to Mr. Cao because Mr. Fahman claimed it was not his responsibility.⁹³⁸ Ms. Le told Subcommittee staff that she has only collected about \$8,000 of the judgment after subtracting legal fees and court costs.⁹³⁹

(4) *Huan Van Cao Continues to Day Trade for Clients at Providential*. Mr. Cao testified that Mr. Moon terminated his day trading privileges at Providential's Los Angeles branch office in Sep-

⁹²⁹ NASD Regulation, Inc., Statement of Claim (No Case #), at 1 ("Tran Complaint").

⁹³⁰ Cao Dep. at 162.

⁹³¹ Id. at 158.

⁹³² Id. at 151. Mr. Cao said that he understood Ms. Le to be a housewife and part-time sales clerk at a music store. Id. at 155. He also claimed, however, that Ms. Le's poverty was a ruse and that she had access to a certificate of deposit in the amount of \$280,000. Id. at 171. Mr. Cao offered no evidence to support the allegation, however.

⁹³³ Id. at 151.

⁹³⁴ Ex. 71.

⁹³⁵ Id.

⁹³⁶ Fahman Dep. at 182-83.

⁹³⁷ Huan Van Cao bankruptcy filing in the United States Bankruptcy Court, Oct. 22, 1999, Case number: 99-40177 (Feb. Hr'g Ex. 89).

⁹³⁸ Fahman Dep. at 183.

⁹³⁹ Le Int. at 6.

tember 1998.⁹⁴⁰ Mr. Moon told Subcommittee staff that he terminated Mr. Cao in August 1998, after Ms. Le complained about his trading activities.⁹⁴¹

The evidence shows that Mr. Cao obtained permission from Mr. Fahman to begin day trading at Providential's Fountain Valley office in September 1998, even though Mr. Fahman knew of Ms. Le's complaints about Mr. Cao by the late summer of 1998.⁹⁴² According to records provided to the Subcommittee by Providential, Mr. Cao continued to day trade at Providential's headquarters throughout 1999. The records indicate that Mr. Cao day traded for himself, his wife, his daughter, and four other clients.⁹⁴³ Mr. Cao testified that one of these clients had paid him about \$40,000 for his day trading services.⁹⁴⁴ Mr. Cao said that this client's account subsequently lost approximately \$114,000, due largely to problems with Providential's computer system.⁹⁴⁵

That Mr. Cao continued to day trade for himself and other clients at Providential throughout 1999 demonstrates the firm's irresponsible business practices. By the time Mr. Cao began trading at Providential's Fountain Valley office, Mr. Fahman and Providential were fully aware that Ms. Le had alleged serious misconduct against Mr. Cao and that he had been expelled from the Los Angeles office by Mr. Moon. In addition, other former customers of Mr. Cao, including Ms. Richardson, had lodged similar allegations against him by this time.

Furthermore, in the fall of 1999, Mr. Cao filed for bankruptcy. Indeed, Mr. Cao testified that he has no income and insufficient assets to pay off his creditors, including Ms. Le. Yet, Providential considers Mr. Cao suitable for day trading. When asked at the Subcommittee's February hearing why Mr. Cao was allowed to continue trading despite his bankruptcy status, Mr. Fahman could only offer, "I do not know if there is any law that prohibits a person from trading if he has filed bankruptcy."⁹⁴⁶ The Subcommittee believes that, based upon his past performance and misconduct, Mr. Cao's continued day trading activities on behalf of Providential's clients places these clients at great risk of financial loss.

(5) *Mr. Cao's Bankruptcy Claim.* As explained above, Mr. Cao filed a Chapter 7 bankruptcy petition in the United States Bankruptcy Court in Houston on October 22, 1999.⁹⁴⁷ In that petition, Mr. Cao sought to discharge the claims of his unsecured creditors, including Ms. Le's judgment in the amount of \$37,791.11 and a fine of \$5,000 by the NASDR for his misconduct relating to Ms. Le.⁹⁴⁸ Mr. Cao's petition, however, also claims approximately \$100,000 of real and personal property as exempt from the bankruptcy proceeding, including \$50,000 for his Houston home and \$25,000 in

⁹⁴⁰ Cao Dep. at 189.

⁹⁴¹ Moon Int. at 6.

⁹⁴² Cao Dep. at 181, 192.

⁹⁴³ Letter from Henry D. Fahman, President of Providential Securities, to Wesley M. Phillips, Investigator for the Subcommittee, undated (Feb. Hr'g Ex. 90).

⁹⁴⁴ Cao Dep. at 185.

⁹⁴⁵ Id. at 210.

⁹⁴⁶ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 25, 2000) (hearing transcript).

⁹⁴⁷ Feb. Hr'g Ex. 89.

⁹⁴⁸ Id. at Schedule F.

the retirement account held in his wife's name.⁹⁴⁹ Mr. Cao testified at his Subcommittee deposition that he day trades at Providential's Fountain Valley office in the account of his daughter and several other customers.⁹⁵⁰ He claimed that, even though he traded at the Fountain Valley office from the fall of 1998 to the present, he has never been compensated by those traders.⁹⁵¹

Despite Mr. Cao's bankruptcy petition and protestations of poverty, there is some evidence that Mr. Cao may be concealing income or assets from his creditors, including Ms. Le and the NASDR. Based on the trading records produced to the Subcommittee, Mr. Cao traded his own account and the accounts of other Providential customers for almost a full year before filing for bankruptcy. It seems highly implausible that he would have done so without compensation or any other visible means of financial support. In addition, Mr. Cao testified that, when he opened his own day trading account with Providential's Fountain Valley office in 1998, he deposited about \$400,000 of equity in the account.⁹⁵² Mr. Cao said that his equity increased to almost \$1,000,000 in the spring of 1999, just six months before he filed for bankruptcy.⁹⁵³ Mr. Cao then claimed that, because of malfunctions in Providential's software, he lost all but \$2,000 in August 1999, the very same month that the NASD arbitration panel found Mr. Cao liable to Ms. Le and just two months before he sought bankruptcy protection.⁹⁵⁴

Mr. Cao's abrupt loss of his entire equity in the same month that an NASD arbitration panel entered a judgment against him and only two months before he sought bankruptcy protection is an extremely suspicious sequence of events. At his deposition, Mr. Cao testified under oath that he did not transfer any funds out of his Providential day trading account prior to his bankruptcy filing.⁹⁵⁵ However, when asked about the nature of the property he is seeking to exempt from the bankruptcy proceeding, Mr. Cao refused to answer the question, asserting his Fifth Amendment right against self-incrimination.⁹⁵⁶ Moreover, when Mr. Cao was asked about paying Ms. Le's judgment, he refused to answer as follows:

Q: Okay. Now with respect to that matter, is it your testimony that you do not have funds at your disposal to satisfy the judgment and the fine from the NASD and Amy Le?

A: I take the Fifth Amendment on that.⁹⁵⁷

The Subcommittee recommends that the bankruptcy court be given copies of Mr. Cao's deposition and supporting documents so that the court may inquire about any fraudulent transfer of assets that Mr. Cao may have executed prior to filing for bankruptcy protection. The court may deem such transfers fraudulent and subject to recovery by the bankruptcy trustee for distribution to creditors, like Ms. Le who received no compensation from Mr. Cao.

⁹⁴⁹ Id. at Schedule C.

⁹⁵⁰ Cao Dep. at 209-10.

⁹⁵¹ Id. at 209.

⁹⁵² Cao Dep. at 189.

⁹⁵³ Id. at 190.

⁹⁵⁴ Id. at 190-91.

⁹⁵⁵ Id. at 191-92.

⁹⁵⁶ Id. at 214.

⁹⁵⁷ Id. at 216.

(6) *Mr. Cao May Have Violated State Investment Adviser Registration Laws.* The evidence gathered by the Subcommittee indicates that Mr. Cao may have violated state laws in Texas and California requiring investment advisers to register with the state's securities commissions. Under these state laws, persons who buy or sell securities on behalf of another for compensation must register as investment advisers. Although some states have de minimus exemptions that allow persons with no place of business in the state to trade for a small number of people for compensation without registration, Mr. Cao would likely not qualify for such an exemption. Mr. Cao had places of business in both California and Texas where he traded the accounts of others for compensation. As discussed previously, Mr. Cao had an arrangement with Ms. Richardson in Texas to receive compensation for day trading on her behalf. In addition, Mr. Cao had an arrangement with Ms. Richardson and, at least one other client, to day trade for compensation in their accounts at Providential's Los Angeles branch office.

The Subcommittee reviewed registration records in Texas and California and found no evidence that Mr. Cao ever registered as an investment adviser in either state. Moreover, Mr. Cao admitted in his Subcommittee deposition that he never registered with the State of Texas or the State of California as an investment adviser.⁹⁵⁸ Mr. Cao claimed initially that it was not necessary for him to register as an investment adviser because he was told by the NASD that day traders were exempt.⁹⁵⁹ Mr. Cao could offer no evidence to support this dubious claim. He then argued the counterintuitive proposition that he did not need to register as an investment adviser because day traders are qualified to buy and sell stocks for clients but not qualified to give financial advice.⁹⁶⁰ The following exchange captures Mr. Cao's curious justification for not registering as an investment adviser:

Q: Let me just make sure we got that right. You're qualified to buy and sell the stock on their behalf; correct?

A: Correct.

Q: But you are not qualified to give them advice about the buying and selling of stock on their behalf; correct?

A: That right.

* * * * *

Q: Right, and in your mind, that's what distinguishes you from an investment adviser?

A: That one of it.⁹⁶¹

Mr. Cao's unusual logic aside, California and Texas law requires day traders or anyone else who buys or sells securities for another in return for compensation to register as an investment adviser. Mr. Cao's own testimony suggests that, by failing to register in Texas and California, he may have violated the law.

(7) *A Providential Official Who Had Been Accused of Securities Violations Day Traded A Client's Account.* While at Providential's Los Angeles office, Mr. Cao briefly day traded the account of an-

⁹⁵⁸ Cao Dep. at 114, 116.

⁹⁵⁹ Id. at 116.

⁹⁶⁰ Id. at 125.

⁹⁶¹ Id.

other Vietnamese client by the name of Tom Dzung Tran.⁹⁶² Mr. Moon told Subcommittee staff that Mr. Cao initially was responsible for the customer's account but that Mr. Tran decided to transfer his trading authorization from Mr. Cao to Keith Kim, a registered broker in the Los Angeles office.⁹⁶³ Almost six months before he began trading Mr. Tran's account, Mr. Kim became the subject of an NASD arbitration claim in January 1998 and faced allegations of failure to supervise, breach of fiduciary duty, and negligence. On September 29, 1998, an NASD arbitration panel found Mr. Kim liable and ordered him to pay the claimant \$32,541.⁹⁶⁴

Mr. Tran and his wife also have filed an NASD arbitration claim against Mr. Cao, Mr. Moon, Mr. Kim, Mr. Fahman, Providential and others.⁹⁶⁵ In the complaint, Mr. Tran alleges that he transferred his wife's accounts from a large securities firm to Providential's Los Angeles office because Mr. Cao told him that he was a registered broker and expert trader.⁹⁶⁶ Mr. Tran also alleges that Mr. Moon recommended that he transfer account authority to Mr. Kim who then proceeded to grossly mismanage his account through excessive day trading.⁹⁶⁷ For example, Mr. Tran alleges that Mr. Kim purchased approximately \$200 million in securities in his account between September and November 1998, generating about \$90,000 in commissions over three months.⁹⁶⁸ He also claims that Mr. Kim purchased and sold all of these securities with only about \$120,000 in equity in his account.⁹⁶⁹ He further alleges that Providential arranged for \$500,000 in loans from other customers so that he could meet margin calls and Mr. Kim could continue trading the account and generating commissions.⁹⁷⁰ The customer is seeking damages of about \$275,000.⁹⁷¹

Messrs. Moon and Cao denied Mr. Tran's charges. Both Mr. Kim and Mr. Moon claim that the customer was a risk-oriented trader who was responsible for managing his own accounts.⁹⁷² In addition, Mr. Cao testified that the customer frequently traded his own account over the Internet.⁹⁷³ The Subcommittee has uncovered no independent information to verify or discredit Mr. Tran's claim against the respondents.

F. A Providential Official "Recommends" That Day Traders Purchase Particular Stocks

The Subcommittee's investigation found persuasive evidence that the senior official in Providential's Oregon branch office, Tony Nguyen, made stock recommendations to day traders in the office. These day traders told Subcommittee staff that they lost significant sums of money following Mr. Nguyen's recommendations. As dis-

⁹⁶² Id. at 217.

⁹⁶³ Moon Int. at 7.

⁹⁶⁴ Feb. Hr'g Ex. 72.

⁹⁶⁵ Tran Complaint at 1.

⁹⁶⁶ Id. at 4. As discussed previously, Mr. Cao also allegedly told Ms. Le that he was a registered broker. Another former client of Mr. Cao, Minn Tran, told Subcommittee staff that Mr. Cao said he was a registered broker, a lawyer, and a former auditor of securities firms. Telephone Interview with Minn Tran, Nov. 3, 1999, at 3 ("Tran Int.").

⁹⁶⁷ Tran Complaint at 5-6.

⁹⁶⁸ Id. at 5, 6, 8.

⁹⁶⁹ Id. at 13.

⁹⁷⁰ Id. at 6.

⁹⁷¹ Id. at 9.

⁹⁷² Moon Int. at 6.

⁹⁷³ Cao Dep. at 217, 219.

cussed previously in this report, the day trading industry has strongly contested the notion that it is subject to existing NASD suitability rules, which require a registered representative to recommend the purchase or sale of a security that is suitable for the customer given the customer's stated investment objective and financial condition.⁹⁷⁴ Many in the day trading industry argue that this rule is not applicable to day trading since the trader is executing the orders rather than sending them through a broker-dealer and because the trader is making the decision to buy and sell the stock without the benefit of a broker's guidance. With respect to Providential's Oregon office, however, several former day traders told Subcommittee staff that Mr. Nguyen did give instructions to customers as to what stocks to buy or sell, when to purchase or sell, and at what price. Mr. Nguyen denies making recommendations to clients but does acknowledge suggesting that they "follow" certain stocks.

(1) *Providential Client Holly Clark Was Unsuitable for Day Trading.* During its investigation, Subcommittee staff interviewed a former Providential client by the name of Holly Clark who day traded at the Oregon branch office. The Subcommittee found that Providential opened a day trading account for Ms. Clark even though she did not satisfy the firm's minimum financial requirements. Ms. Clark told Subcommittee staff that she was a single mother who moved from California to Oregon in 1998.⁹⁷⁵ Ms. Clark said that, prior to leaving California, she had worked at an entry level job with a major computer manufacturer earning about \$30,000 per year.⁹⁷⁶ In addition, Ms. Clark said that, when she moved to California, her entire net worth was \$100,000, which included \$50,000 in net proceeds from the sale of her house, the value of her automobile, and the value of personal property.⁹⁷⁷ Ms. Clark said that she moved into a friend's apartment with her youngest daughter upon arriving in Oregon.⁹⁷⁸

Even though she had no prior investment experience, Ms. Clark told Subcommittee staff that she decided to pursue day trading in Oregon as a means to make a living since it offered a potentially lucrative income as well as a flexible schedule.⁹⁷⁹ Ms. Clark hoped to earn at least \$3,000 per month day trading on-site during the first year while she learned the business and improved her skills.⁹⁸⁰ After the first year, Ms. Clark expected to have progressed sufficiently that she could become a remote day trader from her home.⁹⁸¹ Ms. Clark said that she intended to fund her day trading account with the proceeds from the sale of her California home.⁹⁸² She planned to use \$25,000 to open her account and keep the remaining \$25,000 to pay living expenses.⁹⁸³

Ms. Clark told Subcommittee staff that, in January and February 1999, she started day trading at a firm called Wein Securi-

⁹⁷⁴ See NASD Rule 2310.

⁹⁷⁵ Telephone Interview with Holly Clark, Dec. 28, 1999, at 1 ("Second Clark Int.").

⁹⁷⁶ *Id.*

⁹⁷⁷ *Id.*

⁹⁷⁸ *Id.*

⁹⁷⁹ *Id.* at 2.

⁹⁸⁰ *Id.*

⁹⁸¹ *Id.*

⁹⁸² *Id.* at 1.

⁹⁸³ *Id.*

ties Corporation (“Wein”) in Beaverton, Oregon.⁹⁸⁴ However, Ms. Clark said she only spent about six weeks at Wein, including three weeks of training and three weeks of trading.⁹⁸⁵ Ms. Clark told Subcommittee staff that she did not think Wein’s training program was adequate and the firm’s computer system failed repeatedly.⁹⁸⁶ Ms. Clark indicated that she lost about \$700 of her \$25,000 account equity during her initial three weeks of day trading at Wein.⁹⁸⁷

In April 1999, Ms. Clark decided to leave Wein and open a day trading account at Providential’s Oregon branch office.⁹⁸⁸ Ms. Clark said that she visited Providential on the recommendation of an acquaintance and discussed opening a day trading account with Tony Nguyen.⁹⁸⁹ Ms. Clark’s new account form indicates that she disclosed to Providential an income of \$30,000 and a net worth of \$100,000, both of which were below Providential’s income and net worth financial requirements in existence at the time.⁹⁹⁰ The form also states the mutually contradictory investment objectives of “income” and “short-term growth with high risk.”⁹⁹¹ In Mr. Fahman’s Subcommittee deposition, he conceded that Providential did not follow appropriate procedures in approving the Holly Clark day trading account.⁹⁹²

Ms. Clark did sign the risk disclosure form given to her by Mr. Nguyen, which warns potential day traders about the high risks of financial loss associated with day trading.⁹⁹³ During an interview with Subcommittee staff, Ms. Clark acknowledged that she had been told of the risks of day trading but she indicated that Mr. Nguyen put her at ease by discussing day trading’s profit potential.⁹⁹⁴ In fact, Ms. Clark said that she told Mr. Nguyen that she was an “inexperienced” trader, and he replied that he would give her counsel and advice to help her become successful.⁹⁹⁵ Ms. Clark told Subcommittee staff that she felt like Mr. Nguyen had a day trading system that she could follow that would limit risk and increase profitability.⁹⁹⁶ Indeed, Ms. Clark said that she felt that Tony Nguyen acted “hypocritically” after she signed the risk disclaimer because he made frequent pronouncements about the high profit potential of day trading.⁹⁹⁷ As discussed previously, Ms. Clark said that Mr. Nguyen told her and others that they could become “millionaires” by day trading.⁹⁹⁸

(2) *Holly Clark Allegedly Lost Money Day Trading on the Recommendation of Tony Nguyen.* Ms. Clark told Subcommittee staff that she took Providential’s two week training course taught by

⁹⁸⁴ Id. at 2.

⁹⁸⁵ Id.

⁹⁸⁶ Id. at 3.

⁹⁸⁷ Id. at 2–3.

⁹⁸⁸ Id. at 3.

⁹⁸⁹ Id.

⁹⁹⁰ New Account Approval-B for Holly C. Clark, Apr. 26, 1999 (Feb. Hr’g Ex. 91).

⁹⁹¹ Id.

⁹⁹² Fahman Dep. at 232–34.

⁹⁹³ Providential Securities, Inc.’s Customer Acknowledgment of Risk for Holly C. Clark, Apr. 13, 1999, at 4 (attached hereto at Ex. 92).

⁹⁹⁴ Second Clark Int. at 4.

⁹⁹⁵ Id. at 3.

⁹⁹⁶ Id.

⁹⁹⁷ Id. at 4. Another day trader in Providential’s Oregon office confirmed that Mr. Nguyen acted “hypocritically” by warning about the risks when the trader opened his account but then recommended particular stocks for their high profit potential. Lehr Int. at 3.

⁹⁹⁸ Clark Complaint at 4.

Tony Nguyen's brother Alex.⁹⁹⁹ Ms. Clark said that the training course was inadequate and that, as a new day trader, she expected Tony and Alex Nguyen to assist her.¹⁰⁰⁰ Ms. Clark said that she felt Tony Nguyen could assist her because he was known to be a successful day trader and told her "we want you to make money" and "we will help you."¹⁰⁰¹

Ms. Clark told Subcommittee staff that Tony Nguyen offered assistance by frequently coming out of his back office onto the trading floor and recommending that customers purchase particular stocks.¹⁰⁰² Ms. Clark said that Mr. Nguyen traded in the back room for his own accounts and would enthusiastically recommend that Providential clients buy the same stocks that he purchased.¹⁰⁰³ For example, Ms. Clark alleges that Mr. Nguyen often shouted that a particular stock was about to "pop."¹⁰⁰⁴ In fact, Ms. Clark further alleges that, on her second day of trading at Providential in late April 1999, Tony Nguyen recommended that she purchase a particular stock that he said would do well.¹⁰⁰⁵ According to Ms. Clark, Mr. Nguyen said that he had already purchased 10,000 shares of the stock for his own account.¹⁰⁰⁶ Ms. Clark further alleges that Mr. Nguyen even clicked her computer mouse without her consent to purchase 5,000 shares of the stock.¹⁰⁰⁷

Ms. Clark said, however, that the stock recommended by Mr. Nguyen quickly declined in value and that she lost a substantial amount of the \$25,000 that she used to open her day trading account.¹⁰⁰⁸ Ms. Clark stated that the losses in her account were so great that she could no longer day trade at Providential other than to "paper trade" on a computer simulator.¹⁰⁰⁹ Because Ms. Clark still desperately wanted to learn how to day trade successfully, she traded on the simulator for several months in the hope that the stock in her account would rebound and she would have sufficient capital to resume live trading.¹⁰¹⁰ Ms. Clark eventually stopped paper trading after the stock price did not recover.

Subcommittee staff contacted three other day traders from Providential's Oregon office and they all corroborated Ms. Clark's contention that Tony Nguyen frequently recommended or suggested that traders purchase particular stocks.¹⁰¹¹ For example, one of the former traders stated that Mr. Nguyen would frequently walk the trading floor and shout at traders "BUY NOW!"¹⁰¹² The day trader said that other customers would go into a stock buying "frenzy" on the basis of Mr. Nguyen's recommendations.¹⁰¹³ The day trader said that, as recommended by Tony Nguyen, he purchased 2,500

⁹⁹⁹ Second Clark Int. at 4.

¹⁰⁰⁰ Id. at 4-5.

¹⁰⁰¹ Id. at 4.

¹⁰⁰² First Clark Int. at 3.

¹⁰⁰³ Id. at 4.

¹⁰⁰⁴ Clark Complaint at 4.

¹⁰⁰⁵ Id. at 4-5.

¹⁰⁰⁶ Id. at 5.

¹⁰⁰⁷ Id. at 4.

¹⁰⁰⁸ Id. A Subcommittee analysis of Providential account statements provided by Ms. Clark show that her account balance declined from \$25,000 in April 1999 to about \$4,770 on July 30, 1999, which was several weeks before Ms. Clark quit day trading and left Providential. Ms. Clark told Subcommittee staff that she repeatedly had to sell shares of her stock to meet margin calls since she had no more funds to deposit into the account. Second Clark Int. at 6.

¹⁰⁰⁹ Second Clark Int. at 6.

¹⁰¹⁰ Id. at 3.

¹⁰¹¹ Bogardis Int. at 2; Lehr Int. at 2; Scherner Int. at 2.

¹⁰¹² Lehr Int. at 2.

¹⁰¹³ Id.

shares of the same stock that Ms. Clark purchased on Mr. Nguyen's recommendation.¹⁰¹⁴ The trader said that he also lost substantial sums of money on this particular stock.¹⁰¹⁵ Another Providential customer confirmed to Subcommittee staff that he purchased the same stock on Mr. Nguyen's recommendation and then lost substantial sums of money.¹⁰¹⁶ This trader said that he stopped listening to Mr. Nguyen's recommendations thereafter and jokingly said to other traders that the best strategy was to do the opposite of what Mr. Nguyen recommended.¹⁰¹⁷

Mr. Nguyen told Subcommittee staff that he trades for a client and for his wife and that all of the day traders in the Oregon office are aware of this trading.¹⁰¹⁸ Mr. Nguyen also said that the value of his client's account was about \$400,000 as of December 1999 and the value in his wife's account was about \$500,000.¹⁰¹⁹ Mr. Nguyen asserted that he does not receive any compensation for the trading that he performs for the client.¹⁰²⁰ The Subcommittee reviewed Mr. Nguyen's trading records and confirmed that he does trade stocks that former Providential traders allege he recommends to customers. For example, Mr. Nguyen made a purchase of 10,000 shares in his wife's account of the same stock that Holly Clark alleged that Mr. Nguyen recommended she purchase. In fact, Mr. Nguyen purchased the 10,000 shares on the same day that Ms. Clark alleges that he clicked her mouse to buy 5,000 shares of the stock.

However, Mr. Nguyen denied to Subcommittee staff that he "recommends" that day traders purchase particular stocks and he denied that he ever screams at traders to buy a particular stock.¹⁰²¹ Further, Mr. Nguyen denied that he ever clicked Holly Clark's computer mouse thereby causing the purchase of the stock mentioned earlier.¹⁰²² Mr. Nguyen said, however, that he does suggest that customers "watch" a particular stock that may do well.¹⁰²³ Mr. Nguyen said that he generally gives these suggestions to new day traders or those who are not succeeding.¹⁰²⁴

Mr. Fahman told Subcommittee staff that, if a Providential official advises a client to buy a particular stock at a particular time, he would consider such a statement to be a "recommendation" as defined by NASD rules.¹⁰²⁵ Despite Mr. Nguyen's denials, the evidence given by Ms. Clark and several other day traders who were formerly customers of Providential's Oregon office suggests that Mr. Nguyen may have advised Providential's customers to buy or sell a particular security at a specified time and price. If so, as Mr. Fahman indicated, Mr. Nguyen's activities may implicate existing NASD suitability rules.

¹⁰¹⁴ Id.

¹⁰¹⁵ Id.

¹⁰¹⁶ Scherner Int.at 2.

¹⁰¹⁷ Id.

¹⁰¹⁸ Nguyen Int. at 2-3.

¹⁰¹⁹ Id.

¹⁰²⁰ Id. at 3.

¹⁰²¹ Id.

¹⁰²² Id.

¹⁰²³ Id.

¹⁰²⁴ Id.

¹⁰²⁵ Fahman Dep. at 267.

G. Providential Failed to Supervise Mr. Nguyen, Mr. Moon and Mr. Cao

The Subcommittee uncovered disturbing evidence about the management and compliance structure at Providential. The investigation shows that Mr. Fahman, while acting as the firm's President and Chief Compliance Officer, failed to exercise diligent oversight of his branch office personnel, particularly those in the Oregon and Los Angeles branch offices. Specifically, Mr. Fahman neglected to supervise Mr. Moon's handling of the day trading business at the Los Angeles office and Mr. Nguyen's management of the Oregon office. This lax supervision contributed to many of the problems discovered by the Subcommittee.

One of the most glaring deficiencies in Providential's compliance program related to the setting of company policies and the communication of those policies to branch office personnel. For instance, even though Providential claimed that it required new day trading customers to have a minimum of \$50,000 of risk capital to open an account, Providential apparently did not communicate this standard to its Los Angeles office. Mr. Moon, the branch manager, indicated in a written response to Subcommittee interrogatories that new accounts were considered "on a case by case basis and did not have specific minimum financial standards."¹⁰²⁶ In addition, at his Subcommittee deposition, Mr. Cao testified that Providential's Los Angeles office required new day traders to have a minimum of \$10,000 in 1998,¹⁰²⁷ even though Mr. Fahman testified that the standard in place at that time was \$50,000.¹⁰²⁸ The disparity in this testimony highlights how poorly Providential communicated firm policies to the branch offices.¹⁰²⁹

The failure to set and communicate firm policies was not the only deficiency in Providential's compliance program. Providential also neglected to implement the internal supervisory controls necessary to ensure that branch office personnel complied with not only firm standards but also state and federal securities laws. For instance, Mr. Fahman testified that, as the Chief Compliance Officer, he frequently audited the branch offices, including the Los Angeles office.¹⁰³⁰ Yet, when asked to produce copies of all documents reflecting audits or examinations, neither Providential nor Mr. Moon produced any responsive documents.¹⁰³¹ In fact, Mr. Moon contradicted Mr. Fahman's testimony when he told Subcommittee staff that Providential never audited the Los Angeles branch office.¹⁰³² As with the failure to set and communicate firm policies, Providential made no serious effort to monitor the compliance of its branch office personnel. Given that Mr. Fahman was not only the President of Providential but also its Chief Compliance Officer, he must bear the primary responsibility for the firm's failure to detect and prevent misconduct by registered personnel.

¹⁰²⁶ Feb. Hr'g Ex. 18, at 12.

¹⁰²⁷ Cao Dep. at 156-57.

¹⁰²⁸ Fahman Dep. at 194-95.

¹⁰²⁹ In fact, Mr. Cao testified that Mr. Moon never gave him a branch manual or compliance manual during the entire six months that he day traded for Providential customers at the Los Angeles office. Cao Dep. at 137-38.

¹⁰³⁰ Fahman Dep. at 172.

¹⁰³¹ Feb. Hr'g Ex. 69, at 1-2; Feb. Hr'g Ex. 18, at 6-7.

¹⁰³² Moon Int. at 3.

During Mr. Fahman's deposition, he tried to disassociate himself from Mr. Moon's day trading operations prior to July 1998, when the Los Angeles office cleared day trading transactions through Go Trading.¹⁰³³ Mr. Fahman testified that he did not approve day trading accounts from the Los Angeles office prior to July 1998.¹⁰³⁴ Even accepting Mr. Fahman's questionable argument that he was not responsible for supervising the Los Angeles day trading operation prior to July 1998,¹⁰³⁵ his argument is moot with respect to the Subcommittee's analysis of Providential's compliance with its own suitability standards. The Subcommittee found that 26, or 84 percent, of the 31 new account forms provided for the Los Angeles branch office were completed after July 1998, when Providential assumed responsibility for overseeing the office's day trading operations.¹⁰³⁶ Moreover, Mr. Fahman conceded that, when Providential began offering day trading services to its Los Angeles customers all of Mr. Moon's existing day trading customers had to be approved by Providential before they were assigned an account number.¹⁰³⁷

Finally, the Subcommittee notes that Messrs. Fahman and Moon had an opportunity to present their defense to the charges filed by Amy Le with the NASD. The NASD arbitrators heard and rejected that defense, and held Messrs. Moon and Cao and the Los Angeles office liable for a total judgement of \$37,791.11.¹⁰³⁸ Mr. Fahman conceded at his Subcommittee deposition that he was responsible for supervising Mr. Moon and the Los Angeles office.¹⁰³⁹ Mr. Fahman testified that Providential actually paid Mr. Moon's \$12,500 judgement.¹⁰⁴⁰ As noted above, Mr. Fahman said that Providential has recently retained two experienced compliance officers to improve the firm's compliance program, particularly relating to its day trading business. While this is a positive development, it is disconcerting that Providential waited to hire those individuals until approximately two weeks before Mr. Fahman's Subcommittee deposition.¹⁰⁴¹

V. CASE STUDY: MOMENTUM SECURITIES, INC.

A. *Founding and Structure*

The genesis of Momentum Securities, Inc. ("Momentum") dates to 1995, when James H. Lee and Jack "Jay" Earnest, Jr. coupled Lee's investment banking experience and Earnest's knowledge of systems design to form a securities firm dedicated to servicing professional day traders.¹⁰⁴² Mr. Lee currently maintains securities licenses with the registered broker-dealer Momentum, including a

¹⁰³³ Fahman Dep. at 144.

¹⁰³⁴ Id.

¹⁰³⁵ As noted above, senior SEC officials told Subcommittee staff that, while a branch office may be registered with two different broker-dealers, a registered representative with supervisory authority cannot contract away legal responsibility for a particular line of business. Thus, the SEC officials said that Mr. Fahman could not disassociate himself from supervising the Los Angeles office's day trading operations prior to July 1998. Subcommittee interview with senior SEC officials, Dec. 17, 1999.

¹⁰³⁶ One form was completed in July 1998 and Subcommittee staff could not determine the dates for four other forms.

¹⁰³⁷ Fahman Dep. at 146-47.

¹⁰³⁸ Feb. Hr'g Ex. 71, at 3.

¹⁰³⁹ Fahman Dep. at 57.

¹⁰⁴⁰ Id. at 181.

¹⁰⁴¹ Id. at 107.

¹⁰⁴² "Momentum Securities, Inc.," www.soes.com, Jan. 14, 2000 ("www.soes.com").

Series 7, Series 24, Series 55, and Series 63.¹⁰⁴³ Mr. Earnest originally became involved with Momentum after starting a software development and technology company called Computer Stop, Inc. (“CSI.net”) in early 1990.¹⁰⁴⁴ CSI.net provided software development, network design, and maintenance.¹⁰⁴⁵ Mr. Earnest was working with CSI.net when he and Mr. Lee began Momentum in 1995.¹⁰⁴⁶

Currently, Momentum is a licensed broker dealer with the SEC and the NASD.¹⁰⁴⁷ In addition to its home office in Houston, Texas, Momentum has branch offices located in several other Texas cities, including North Houston, Austin, Dallas, Tyler, and Plano.¹⁰⁴⁸ Momentum has also opened several branch offices outside of Texas, including Irvine, California; Chicago, Illinois; Atlanta, Georgia and Milwaukee, Wisconsin.¹⁰⁴⁹

Between January 1, 1998 and October 1, 1999, Momentum opened 1,757 day trading accounts, including branch offices and remote locations.¹⁰⁵⁰ The firm claims that, since its inception, Momentum customers have executed more than 6 million securities transactions, totaling 5 billion shares and having a market value in excess of \$150 billion.¹⁰⁵¹

At the outset, Momentum’s original shareholders were Mr. Earnest, who held 50 percent of the stock, Mr. Lee, who held 30 percent, and Mr. Lee’s brother, who held the remaining 20 percent ownership interest.¹⁰⁵² On June 30, 1999, Momentum and Tradescape.com agreed to a stock swap by which Momentum’s shareholders, principally Messrs. Lee and Earnest, received shares of Tradescape.com and became officers of the new company.¹⁰⁵³ Just before the stock swap with Tradescape.com, Messrs. Lee and Earnest effectively owned 50% of the equity interests in (i) Momentum Securities, Inc., a Texas corporation, (ii) Momentum Securities Partners, L.P., a Texas limited partnership, (iii) Momentum Securities Management Company, a Texas corporation, and (iv) CSI.net, Inc., a Texas corporation.¹⁰⁵⁴ Following the agreement with Tradescape.com, there were no changes in Momentum’s essential business structure and operations.¹⁰⁵⁵ Mr. Lee testified that one employee from Tradescape.com did join Momentum’s Houston office

¹⁰⁴³ Lee Dep. at 18–20. Mr. Lee also holds these securities licenses with a registered broker-dealer called Sunbelt Securities, and a third broker-dealer that he created, James H. Lee & Associates. Id.

¹⁰⁴⁴ Id. at 19.

¹⁰⁴⁵ Id. at 27–28.

¹⁰⁴⁶ Id. at 19. Sometime prior to the summer of 1997, Mr. Lee bought fifty percent of CSI.net for \$250,000, which was secured by a promissory note to Mr. Earnest that he ultimately paid off. Id. at 30. In July, 1999, Messrs. Lee and Earnest sold CSI.net for cash to Tradescape.com as a part of a stock swap between Momentum and Tradescape.com. Id. at 26.

¹⁰⁴⁷ www.soes.com. The firm holds licenses in the following states: Arizona, California, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Kentucky, Louisiana, Maryland, Nebraska, Nevada, New Jersey, New York, North Carolina, Oklahoma, Oregon, Tennessee, Texas, Utah, Virginia, Washington, Wisconsin, and Wyoming. Id.

¹⁰⁴⁸ Id.

¹⁰⁴⁹ Id.

¹⁰⁵⁰ Letter from Robert Bennett, Counsel for Momentum Securities, Inc., to K. Lee Blalack, Chief Counsel & Staff Director for the Subcommittee, Jan. 20, 2000, at 2 (Feb. Hr’g Ex. 93).

¹⁰⁵¹ www.soes.com

¹⁰⁵² Lee Dep. at 23.

¹⁰⁵³ Id. at 58–59.

¹⁰⁵⁴ Momentum’s Organization Chart and Structure, undated (Feb. Hr’g Ex. 94).

¹⁰⁵⁵ Letter from James H. Lee, Principal for Momentum Securities, Inc., to Robert Garza, NASD Regulations, Inc., Dist. 6, June 21, 1999, at 1 (Feb. Hr’g Ex. 95).

but the firm continued to operate under the Momentum name.¹⁰⁵⁶ In fact, in a letter to NASD Regulation, Mr. Lee confirmed that

[Momentum] will not need to obtain additional licenses or registrations as a result of the proposed transaction [with Tradescape]. [Momentum] will maintain its existing business relationships with banks, auditors, and clearing entities. The financial controls, compliance policies, supervisory procedures, operational controls, training needs and record keeping systems presently in place will be maintained by [Momentum] following the ownership change.¹⁰⁵⁷

One of the central features of Momentum's organization and management structure is its reliance on management companies to direct the day-to-day operations of its branch offices. The Subcommittee's investigation found that Momentum contracts with numerous management companies to provide general management services for the branch offices.¹⁰⁵⁸ These services range from locating and leasing office space, setting up and maintaining trader work stations, paying the salaries of branch office employees and, in some cases, providing training for new Momentum customers.¹⁰⁵⁹ All of Momentum's branch offices currently rely on a management company to direct its non-broker-related functions.¹⁰⁶⁰

For example, in an interview with Subcommittee staff, David Dial, the branch manager for Momentum's office in Tyler, Texas, explained that L&D Trading ("L&D"), a management company run by Harry Leatherwood and Kevin Dickinson, directs all management functions for the Tyler office.¹⁰⁶¹ In consideration for these services, L&D receives a management fee from Momentum, which Mr. Dial characterized as an income based commission.¹⁰⁶² Mr. Dial told Subcommittee staff that he receives a salary from both L&D and Momentum.¹⁰⁶³ He indicated that all Tyler branch personnel are L&D employees.¹⁰⁶⁴ Mr. Dial's function as a branch manager is to oversee the on-sight offices in Tyler and his direct supervisors for compliance matters are Momentum's Elizabeth Cummins and Chief Compliance Officer Bill Cathriner.¹⁰⁶⁵

This management structure is also present at the other Momentum branch offices. Momentum Securities Partners, a management company owned by Messrs. Lee and Earnest, directs the Houston, Dallas, and Austin offices.¹⁰⁶⁶ Mr. Dial and several associates from the Tyler office manage Momentum's branch office in Atlanta through a management company that they started called Professional Traders Group.¹⁰⁶⁷ In his Subcommittee deposition, Mr. Lee confirmed that Momentum's other offices were also run by manage-

¹⁰⁵⁶ Lee Dep. at 104.

¹⁰⁵⁷ Feb. Hr'g Ex. 95, at 1.

¹⁰⁵⁸ Lee Dep. at 37.

¹⁰⁵⁹ Id. at 34-48.

¹⁰⁶⁰ Id. at 40-48.

¹⁰⁶¹ Interview of David Dial, Dec. 21, 1999, at 1 ("Dial Int.").

¹⁰⁶² Id.

¹⁰⁶³ Id.

¹⁰⁶⁴ Id.

¹⁰⁶⁵ Id.

¹⁰⁶⁶ Lee Dep. at 36. Mr. Lee testified that neither he nor Mr. Earnest possess an ownership interest in any of the other management companies that direct Momentum's branch offices. Id. at 36-48.

¹⁰⁶⁷ Dial Int. at 1.

ment companies, but he could not identify them all by name.¹⁰⁶⁸ Mr. Lee stated as follows:

Q: Do you know what the name of the management company is for the office located in Irvine, California?

A: I believe it's Newport. I don't know the full structure.

* * * * *

Q: With respect to Plano, is there a management company for Plano?

A: I believe there is, but I couldn't tell you the name.

* * * * *

Q: Okay. What about the office in north Houston?

A: I believe there is a management company there, sir. I believe there is a management company.

Q: Do you know what the name of that management company is?

A: No, sir.

Q: And the office in south Houston, do you know if they use a management company?

A: I believe they do, yes, sir.

Q: And do you know the name of that management company?

A: No, I do not offhand.¹⁰⁶⁹

Two other Momentum branch offices, those located in Milwaukee and Chicago, have a "piggy-back" relationship with La Salle Street Trading ("La Salle"), a broker-dealer located in Chicago.¹⁰⁷⁰ According to Mr. Lee, in such arrangements, the functions of the brokerage firm are divided among three entities—two order entry firms and a clearing firm.¹⁰⁷¹ La Salle is responsible for controlling the trading activity of the customers, and Momentum is responsible for account opening procedures, trade processing and execution.¹⁰⁷² Mr. Lee said that Southwest Securities, a clearing firm, acts as the custodian.¹⁰⁷³

B. Jim Lee Was the Catalyst for the Creation of the Electronic Traders Association

In addition to starting Momentum, Mr. Lee took a lead role in the creation of the Electronic Traders Association ("ETA"), a Washington-based trade group that purports to represent day trading firms.¹⁰⁷⁴ In fact, Mr. Lee was the driving force behind ETA, which he organized in 1996 to improve the day trading industry's influence with respect to regulatory changes that were being considered by the SEC.¹⁰⁷⁵ At his Subcommittee deposition, Mr. Lee said that, when the SEC proposed new order-handling rules in 1996, it prompted him to contact the heads of several competing day trading firms to discuss the impact of the proposed rules on their businesses.¹⁰⁷⁶ Mr. Lee said that he successfully organized an industry

¹⁰⁶⁸ Lee Dep. at 40–42.

¹⁰⁶⁹ Id.

¹⁰⁷⁰ Id. at 48.

¹⁰⁷¹ Id. at 54.

¹⁰⁷² Id. at 50.

¹⁰⁷³ Id.

¹⁰⁷⁴ Id. at 86–89.

¹⁰⁷⁵ Id. at 87–88.

¹⁰⁷⁶ Id.

group to make its case to the SEC and that ETA evolved from there.¹⁰⁷⁷ Mr. Lee also stated that he believes that through responsible leadership, ETA may be used to encourage other day trading firms to strive for best policies and practices to improve the industry as a whole.

Mr. Lee stated that, at times, ETA has represented as many as 30 or 40 different firms.¹⁰⁷⁸ Today, according to Mr. Lee, ETA only consists of the day trading firms that have a representative sitting on ETA's Board of Directors "and maybe a handful of others."¹⁰⁷⁹ In 1999, ETA's board members included representatives of Momentum, Andover Brokerage, LLC, Mount Pleasant Brokerage Services, LP, On-Line Investment Services, Inc., and Tradescape.com, Inc.¹⁰⁸⁰ Mr. Lee indicated that, while ETA represents a small number of day trading firms, ETA members are responsible for about 60% of the trading volume attributable to the industry.¹⁰⁸¹

C. Suitability: a Case Study—Scott Webb, David Dial, Justin Hoehn, and the Atlanta Office

On July 29, 1999, a deranged day trader named Mark Barton walked into the Atlanta offices of Momentum and All-Tech, mumbled a few ominous words about the falling market and then began firing gunshots at random.¹⁰⁸² After killing four people at Momentum, Barton proceeded across the street to All-Tech where he opened fire on the trading floor, killing five people there.¹⁰⁸³ In all, Barton shot and killed nine people at the two day trading firms. One of his victims was Scott Webb, a young man of 30 who was attempting to day trade for a living at Momentum's Atlanta office. Mr. Webb opened his day trading account with the Atlanta office of Momentum in July, 1998, approximately one year prior to his tragic and senseless death. While the Subcommittee questions Mr. Webb's suitability for day trading, no inference should be drawn that the Subcommittee believes Momentum is responsible for his death. Rather, how Scott Webb became a day trader at Momentum is a telling case study about the importance of determining the suitability of customers for this highly risky practice.

(1) *The Opening of Momentum's Atlanta Office.* Justin Hoehn, the branch manager of Momentum's Atlanta office, first became interested in day trading in early 1998, after reading an article on the subject while he was studying to become a retail stock broker at Dean Witter in St. Louis.¹⁰⁸⁴ At the time, Mr. Hoehn was 22 years old and was preparing for his Series 7 and Series 63 exams.¹⁰⁸⁵ Mr. Hoehn had joined Dean Witter in September 1997, after working at A.G. Edwards for two years in its computer department.¹⁰⁸⁶ Though Mr. Hoehn passed his Series 3, 7, 63 and 65 exams, he never became a producing broker.¹⁰⁸⁷

¹⁰⁷⁷ Id. at 88–89.

¹⁰⁷⁸ Id. at 88.

¹⁰⁷⁹ Id. at 90.

¹⁰⁸⁰ Cohen statement at 204.

¹⁰⁸¹ Lee Dep. at 91.

¹⁰⁸² Adam Cohen, "A Portrait of a Killer," Time, Aug. 9, 1999, at 22.

¹⁰⁸³ Id.

¹⁰⁸⁴ Interview of Justin Hoehn, Dec. 21, 1999, at 1–2 ("Hoehn Int.").

¹⁰⁸⁵ Id. at 2.

¹⁰⁸⁶ Id. at 1.

¹⁰⁸⁷ Id. at 2.

Mr. Hoehn left Dean Witter early in 1998 and began day trading at Block Trading's office in St. Louis, which later changed its name to Insight Trading.¹⁰⁸⁸ As part of his compensation agreement with Insight Trading, Mr. Hoehn received a percentage of all commissions generated by day traders that he brought to the firm.¹⁰⁸⁹ Mr. Hoehn told Subcommittee staff that he recruited three to six new customers to Insight Trading and that one of those customers was Scott Webb, a colleague of his from Dean Witter.¹⁰⁹⁰ At the time, Mr. Webb was 29 years old and a graduate of Loyola Marymount University.¹⁰⁹¹ Mr. Webb's sister and mother told Subcommittee staff that Scott Webb decided to join Mr. Hoehn at Insight Trading after he failed to meet production quotas at Dean Witter.¹⁰⁹²

In order to begin their day trading careers, Messrs. Webb and Hoehn needed capital and neither had it. Mr. Hoehn told Subcommittee staff that he borrowed between \$10,000 and \$15,000 from a friend to finance his jump into day trading.¹⁰⁹³ Mr. Hoehn also said that Mr. Webb borrowed about \$10,000 to fund his day trading.¹⁰⁹⁴ According to Mr. Hoehn, he and Mr. Webb lost virtually all of those funds day trading at Insight over the course of a few months.¹⁰⁹⁵ Mr. Hoehn said that none of the traders at Insight were profitable.¹⁰⁹⁶ He told Subcommittee staff that Insight Trading dissolved in March or April of 1998.¹⁰⁹⁷

Shortly after Insight Trading closed its doors, Mr. Hoehn met David Dial, the branch manager of Momentum's Tyler, Texas office.¹⁰⁹⁸ The meeting occurred while Mr. Dial was visiting Insight Trading to determine whether to purchase the firm's computer systems for use by Momentum at a new branch office in either St. Louis or Atlanta.¹⁰⁹⁹ Mr. Dial told Subcommittee staff that Mr. Hoehn was his point of contact.¹¹⁰⁰ Mr. Dial said that he was impressed with Mr. Hoehn, describing him as "eager and demonstrating confidence."¹¹⁰¹ During the meeting, Mr. Dial mentioned that he was considering opening a Momentum branch office in Atlanta.¹¹⁰² Mr. Hoehn told Subcommittee staff that he expressed an interest in becoming involved with this new Atlanta office.¹¹⁰³ During the spring of 1998, Messrs. Hoehn and Dial continued their discussions about Mr. Hoehn associating with Momentum

¹⁰⁸⁸ Id.

¹⁰⁸⁹ Id.

¹⁰⁹⁰ Id.

¹⁰⁹¹ Id.

¹⁰⁹² Resume of Scott A. Webb, undated (Feb. Hr'g Ex. 96).

¹⁰⁹³ Interview of Elizabeth Cheetham-Webb, Dec. 9, 1999, at 1 ("Cheetham-Webb Int."); Interview of Alyce Wenzel, Dec. 7, 1999, at 1 ("Wenzel Int.").

¹⁰⁹⁴ Hoehn Int. at 2.

¹⁰⁹⁵ Id.

¹⁰⁹⁶ Id.

¹⁰⁹⁷ Id.

¹⁰⁹⁸ Id. Mr. Dial is a 30-year-old resident of Tyler, Texas. Mr. Dial attended Austin Community College and the University of Houston in 1990 and 1991 but did not earn his degree. Dial Int. at 1. He then joined Texas Mortgage Investors for nine months in the loan servicing department. Id. In 1993, Mr. Dial passed his Series 7 exam and later went to work for Chris Block of Block Trading. Id. In October of 1995, Mr. Dial moved to Tyler to help set up the first Block Trading branch office. Id. On September 19, 1997, Momentum acquired Block Trading's Tyler office, and Mr. Dial became its branch manager. Id.

¹⁰⁹⁹ Dial Int. at 1.

¹¹⁰⁰ Id.

¹¹⁰¹ Id.

¹¹⁰² Hoehn Int. at 2.

¹¹⁰³ Id.

and, in the summer of that year, Mr. Hoehn traveled to Tyler for two weeks of training at Momentum's branch office.¹¹⁰⁴

Mr. Hoehn told Subcommittee staff that he informed Mr. Dial of his losses at Insight Trading and he assumed that Mr. Dial was aware of Mr. Webb's losses as well.¹¹⁰⁵ Mr. Dial, however, denied knowing of Mr. Hoehn's losses at Insight Trading.¹¹⁰⁶ He nonetheless indicated that it "would not have affected his decision to make him a branch manager."¹¹⁰⁷ Indeed, Mr. Dial told Subcommittee staff that he did not believe it was necessary for someone to demonstrate the ability to day trade profitably before hiring them as a branch manager.¹¹⁰⁸ He analogized the hiring of an unprofitable day trader as a branch manager to hiring a coach who was never a successful player.¹¹⁰⁹ Mr. Dial even told Subcommittee staff that it was not necessary for a trainer of new customers to show that they had day traded successfully in the past.¹¹¹⁰ Mr. Dial stated that what was important to him was that Mr. Hoehn had three months of day trading experience, which was "a lot in this business."¹¹¹¹

Elizabeth Cheetham-Webb, Scott Webb's sister, told Subcommittee staff that her brother traveled to Tyler for training during the summer of 1998 in anticipation of moving to Atlanta after Momentum's new branch office opened.¹¹¹² She claimed that Momentum put the two young men in apartments and that Momentum "wined and dined" them.¹¹¹³ Mr. Webb trained in Tyler for two weeks.¹¹¹⁴ During this training period, Mr. Webb told his sister that he was excited about his new day trading career, stating, "I think I have finally found my niche."¹¹¹⁵ In correspondence with his mother, Alyce Wenzel, Mr. Webb expressed great optimism about his new career, writing, "It is so exciting being your own boss and I love what I am doing, I finally feel like I have control of my future."¹¹¹⁶

After completing their training in Tyler, Messrs. Hoehn and Webb moved to Atlanta along with David Dial's older brother, Kevin, to open the Atlanta office.¹¹¹⁷ The elder Dial directed the "recruiting" of new day traders while Mr. Hoehn was responsible for the daily operations of the office.¹¹¹⁸ Mr. Webb was only a day trader when he first arrived in Atlanta but he was later retained by Momentum and Professional Traders Group, the management company that runs the Atlanta office, to train new customers.¹¹¹⁹

(2) *Scott Webb's Unsuitability for Day Trading and His Resulting Losses.* Upon arriving in Atlanta, Messrs. Hoehn and Webb moved

¹¹⁰⁴ Dial Int. at 1.

¹¹⁰⁵ Hoehn Int. at 2.

¹¹⁰⁶ Dial Int. at 1.

¹¹⁰⁷ Id.

¹¹⁰⁸ Id.

¹¹⁰⁹ Id.

¹¹¹⁰ Id.

¹¹¹¹ Id.

¹¹¹² Cheetham-Webb Int. at 1.

¹¹¹³ Id.

¹¹¹⁴ Id.

¹¹¹⁵ Id.

¹¹¹⁶ Letter from Scott Webb to Alyce Wenzel, Apr. 1998, at 1 (Feb. Hr'g Ex. 97).

¹¹¹⁷ Dial Int. at 1-2. Kevin Dial was tragically killed by Momentum day trader Mark Barton on July 29, 1999. Id.

¹¹¹⁸ Id. at 2.

¹¹¹⁹ Id. at 1-2.

into an apartment together.¹¹²⁰ In addition to having very little cash, Ms. Wenzel said that her son had a very poor credit record and that his father even had to co-sign his car loan.¹¹²¹ Nevertheless, on July 29, 1998, Momentum opened two day trading accounts for Mr. Webb. The first account was in the name of Mr. Webb, and the second account was for Spyderstorm Capital, LLC, a corporation created by Mr. Webb to cross-guarantee trading in his personal account.¹¹²² Prior to opening his account, it appears that Mr. Webb reviewed and signed a document entitled “House Systems and Trading Rules Acknowledgment.”¹¹²³ The document advises the customer of the execution risks associated with day trading using Momentum’s software system.¹¹²⁴ Specifically, the document informed Mr. Webb of the possibility that the software system might crash and that execution might be difficult on the highly volatile NASDAQ market.¹¹²⁵ The disclosure made no attempt to advise Mr. Webb about the risks of day trading. In fact, the disclosure document does not even mention the term “day trading.” Rather, the entire focus is on “systems risks.” It does not address margin trading, excessive commission charges from high volume trading or any of the other important subjects that Momentum routinely discloses in its current risk disclaimers.

Even though Mr. Webb had not been gainfully employed for almost six months and had lost about \$10,000 day trading with Mr. Hoehn at Insight Trading, he disclosed an annual income of \$50,000.¹¹²⁶ In the space requesting his net worth, Mr. Webb wrote “N/A.”¹¹²⁷ Mr. Webb also left blank the space on the new account form denoting the customer’s initial deposit.¹¹²⁸

The Subcommittee’s investigation discovered that Mr. Webb opened his day trading accounts entirely with borrowed funds.¹¹²⁹ Mr. Hoehn told Subcommittee staff that Mr. Webb borrowed \$30,000 from his father and another \$30,000 from Gerald Simpson, a Momentum customer at the Tyler office and a friend of Mr. Dial.¹¹³⁰ Roy Webb, Scott Webb’s father, confirmed to Subcommittee staff that he loaned \$30,000 to his son in order to fund his day trading career.¹¹³¹ He said that Scott assured him that the funds would be used for a conservative trading strategy.¹¹³² In

¹¹²⁰ Hoehn Int. at 3.

¹¹²¹ Wenzel Int. at 1.

¹¹²² New Account Approval-B for Scott Allyn Webb, July 28, 1998 (Feb. Hr’g Ex. 98); New Account Approval-B for Spyderstorm Capital, LLC, July 29, 1998 (Feb. Hr’g Ex. 99); Cross-Guarantee Agreement between Scott Allyn Webb and Spyderstorm Capital, LLC, July 29, 1998 (Feb. Hr’g Ex. 100) (“Webb New Account Forms”).

¹¹²³ Momentum Securities, Inc., “House Systems and Trading Rules Acknowledgment,” July 27, 1998 (Feb. Hr’g Ex. 136). The Subcommittee requested that Momentum produce any risk disclosure documents that Mr. Webb had reviewed and signed. Momentum produced this document as part of Mr. Webb’s new account materials early in the investigation. In addition, Momentum produced three additional documents that were purportedly risk disclosure statements signed by Mr. Webb in December 1998 and January 1999, almost six months after Mr. Webb opened his account. These additional documents provide very good risk disclosure regarding the key issues pertaining to day trading. However, the Subcommittee has been unable to verify that these documents were signed by Mr. Webb.

¹¹²⁴ Feb. Hr’g Ex. 136.

¹¹²⁵ Id.

¹¹²⁶ Feb. Hr’g Ex. 98; Feb. Hr’g Ex. 99.

¹¹²⁷ Id.

¹¹²⁸ Id.

¹¹²⁹ Hoehn Int. at 2. There is currently no law that requires any brokerage firm to determine the source of a customer’s funds.

¹¹³⁰ Id.; Dial Int. at 2.

¹¹³¹ Telephone Interview of Roy A. Webb, Dec. 9, 1999, at 1 (“Webb Int.”).

¹¹³² Id.

order to obtain the additional \$30,000 of trading capital from Mr. Simpson, Mr. Webb provided Mr. Simpson a promissory note in which Mr. Webb agreed to pay 18 percent interest during the term of the loan.¹¹³³ According to Mr. Hoehn, David Dial arranged the loan between Mr. Webb and Mr. Simpson.¹¹³⁴

Ms. Wenzel told Subcommittee staff that, “from the moment he started trading,” her son lost money.¹¹³⁵ At the Subcommittee’s hearing on February 24, 2000, Ms. Wenzel testified, “* * * he thought he was going to be rich, he was going to have this lavish lifestyle, and two weeks after he was in Atlanta, when I talked to him, he was a different person.”¹¹³⁶ Ronda McPherson, Mr. Webb’s girlfriend, indicated that, with the exception of a brief period at the outset, Mr. Webb lost money day trading and was often depressed about his lack of success.¹¹³⁷ In fact, Mr. Webb told Ms. McPherson that he was glad “he had lasted as long as he had.”¹¹³⁸ An audit of Mr. Webb’s account shows that, of the \$60,000 he borrowed to begin day trading at Momentum, only about \$19,000 remained at the time of his death in July 1999.

Mr. Hoehn described Mr. Webb as a high volume trader, usually averaging over 60,000 shares and 100 tickets per day.¹¹³⁹ Mr. Hoehn told Subcommittee staff that Mr. Webb was a “sophisticated trader,” a person “attracted by the opportunities [of day trading],” and one who “loved day trading.”¹¹⁴⁰ Ms. Cheetham-Webb said that her brother often told her about his losses.¹¹⁴¹ She said that Mr. Webb frequently indicated that he received margin calls, which he could not cover, and was prohibited from trading.¹¹⁴² As Mr. Webb’s financial condition worsened, Ms. Wenzel described her son as “absolutely broke,” “scared” about his looming debts, and under “so much stress.”¹¹⁴³ She described her son further at the Subcommittee’s hearing, “* * * he was in so deep, he felt he probably could not get out. He had to keep going and he was stressed. The first time I saw him after he came home from Atlanta, I could see in his eyes, Scott had lost some weight and was very, very stressed.”¹¹⁴⁴

(3) *Despite Heavy Trading Losses, Mr. Webb Was Hired to Train New Momentum Customers.* Even though Mr. Webb accumulated mounting losses from day trading, he did develop a source of income at Momentum in 1999, when Professional Traders Group hired him to train new customers at the Atlanta branch office. In fact, David Dial told Subcommittee staff that Mr. Webb was in charge of creating the training curriculum and teaching the courses

¹¹³³ Promissory Note between Gerald Simpson and Scott Webb, July 29, 1998 (Feb. Hr’g Ex. 101).

¹¹³⁴ Hoehn Int. at 2.

¹¹³⁵ Wenzel Int. at 1.

¹¹³⁶ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

¹¹³⁷ Telephone Interview of Ronda McPherson, Dec. 12, 1999, at 1 (“McPherson Int.”).

¹¹³⁸ Id.

¹¹³⁹ Hoehn Int. at 2.

¹¹⁴⁰ Id. at 3.

¹¹⁴¹ Cheetham-Webb Int. at 1.

¹¹⁴² Id.

¹¹⁴³ Wenzel Int. at 1.

¹¹⁴⁴ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

at the Momentum office.¹¹⁴⁵ Professional Traders Group paid Mr. Webb approximately 75 percent of the tuition fee of \$1,500 to \$2,000 per customer.¹¹⁴⁶

According to Mr. Dial, Mr. Webb's training program focused on Momentum's execution software rather than trading strategies.¹¹⁴⁷ Mr. Dial said that it would have been inappropriate for Mr. Webb to teach new customers trading strategies.¹¹⁴⁸ The Subcommittee obtained a copy of Mr. Webb's training syllabus which indicates that, contrary to Mr. Dial's belief, Mr. Webb did teach prospective Momentum customers trading strategies.¹¹⁴⁹ For instance, Mr. Webb instructed potential customers about key trading indicators, such as crossed and locked markets as well as trading philosophies.¹¹⁵⁰ Mr. Webb's syllabus lists several different trading techniques, such as "scalping" and "position trading" and "gambling."¹¹⁵¹ Mr. Hoehn told Subcommittee staff that he referred all new customers to Mr. Webb for training.¹¹⁵² He estimated that Mr. Webb trained approximately 15 to 20 customers over a three or four month period, ending with his death in July 1999.¹¹⁵³ Although he was training Momentum's customers, Mr. Webb was not an actual employee of Momentum and was never licensed with the state or the SEC.¹¹⁵⁴

Mr. Webb was working at Momentum in his capacity as a trainer on the day Mark Barton walked into Momentum's Atlanta office and began his homicidal rampage. Mr. Webb was training a new customer when Barton emerged and began shooting. His mother, Ms. Wenzel, has filed a wrongful death action against the estate of Mark Barton, Momentum and others as a result of the shooting.¹¹⁵⁵ When Roy Webb attempted to collect the remaining equity in his son's account, he was notified by Mr. Hoehn that Gerald Simpson held a \$30,000 promissory note from his son and, therefore, Mr. Simpson had a superceding claim on the funds.¹¹⁵⁶

(4) *Momentum Failed to Properly Supervise the Atlanta Office.* The tragic story of Scott Webb raises serious questions about Momentum's internal policies pertaining to risk disclosure and the suitability of new day trading customers. It also reveals several glaring deficiencies in Momentum's management and supervision of its branch offices.

First and foremost, it is very troubling that Momentum failed to provide Mr. Webb a comprehensive written risk disclosure. The risk disclosure that Mr. Webb signed made no mention of the risks of day trading strategies, the importance of risk capital, the high

¹¹⁴⁵ Dial Int. at 2.

¹¹⁴⁶ Id.; Hoehn Int. at 3. Mr. Hoehn said that, on occasion, Mr. Webb was paid directly by the customer he was training. Hoehn Int. at 3.

¹¹⁴⁷ Dial Int. at 2.

¹¹⁴⁸ Id.

¹¹⁴⁹ Syllabus for Professional Traders Group Training Seminar, Jan. 4, 1999 to Jan. 29, 1999, at 1-2 (Feb. Hr'g Ex. 102).

¹¹⁵⁰ Id.

¹¹⁵¹ Id. at 2. Mr. Hoehn told Subcommittee staff that he believed Mr. Webb's inclusion of "gambling" as a trading "technique" was probably Mr. Webb's effort to distinguish day trading from gambling. Hoehn Int. at 3. Mr. Hoehn cited no documentary evidence to support this conclusion but simply indicated that he knew Mr. Webb did not consider trading equivalent to gambling. Id.

¹¹⁵² Hoehn Int. at 3.

¹¹⁵³ Id.

¹¹⁵⁴ Id.

¹¹⁵⁵ Wenzel Int. at 1.

¹¹⁵⁶ Webb Int. at 1.

commissions attendant to heavy trading, or the risk of loss associated with margin trading. It addressed only the systems and execution risks of day trading. While important, these risks are only a few of the perils of day trading. As discussed in detail below, Momentum's current risk disclosure forms are quite comprehensive and thorough and advise customers of risks that extend beyond those disclosed to Mr. Webb. Given Mr. Webb's enthusiasm for his new career, it is impossible to know whether better risk disclosures would have been effective in informing Mr. Webb of the significant risks of day trading. Because this simple precaution was never taken, however, it is very possible that, at the outset, Mr. Webb did not fully appreciate the financial risks of his new career.

The evidence is also overwhelming that Mr. Webb was not suitable for day trading and that Mr. Hoehn and Mr. Dial knew it at the time Mr. Webb opened his Momentum account. Mr. Hoehn admitted to Subcommittee staff that he knew that Mr. Webb had not been successful as a producing broker for Dean Witter and had not been gainfully employed for almost six months when he opened his day trading account in July 1998.¹¹⁵⁷ Mr. Hoehn also knew that Mr. Webb had borrowed \$10,000 to day trade at Insight Trading in St. Louis and, within several months, had lost most if not all of it.¹¹⁵⁸ Further, Mr. Hoehn knew that, when Mr. Webb sought to open his Momentum account, he funded the account entirely with borrowed funds.¹¹⁵⁹ In fact, Messrs. Hoehn and Dial facilitated this borrowing by putting Mr. Webb in touch with Gerald Simpson, a day trader at Momentum's Tyler office, who loaned Mr. Webb \$30,000 to day trade.¹¹⁶⁰

Given what Messrs. Hoehn and Dial knew about Mr. Webb's past trading performance and poor financial condition, it was irresponsible for them to help him open an account at Momentum. When interviewed by Subcommittee staff, Mr. Hoehn was asked why he signed and accepted Mr. Webb's new account form when it indicated that Mr. Webb had an annual income of \$50,000 and no available net worth. Mr. Hoehn said that he thought Mr. Webb had a "trust fund" and some "income from real estate" investments.¹¹⁶¹ Mr. Webb's mother and father told Subcommittee staff, however, that their son had no trust fund or investments that generated income.¹¹⁶² At the Subcommittee's hearing on February 24, 2000, Mr. Hoehn attempted to justify the opening of Mr. Webb's account when he stated, "At the time of Scott Webb's initial account opening, we did not have guidelines as we have today. So [the opening of the account] was on the circumstantial situation."¹¹⁶³

Subcommittee staff also confronted Mr. Dial about why Mr. Webb had been allowed to open his day trading account with \$60,000 of borrowed funds. Mr. Dial initially said that it did not bother him that Mr. Webb opened his day trading account with

¹¹⁵⁷ Hoehn Int. at 2.

¹¹⁵⁸ Id.

¹¹⁵⁹ Id. at 3.

¹¹⁶⁰ Dial Int. at 2.

¹¹⁶¹ Hoehn Int. at 3.

¹¹⁶² Wenzel Int. at 1; Webb Int. at 1.

¹¹⁶³ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

borrowed funds.¹¹⁶⁴ Mr. Dial then agreed with Subcommittee staff that Momentum's internal policies require day traders to use only "risk capital," which he said were "funds one can afford to lose."¹¹⁶⁵ Under questioning, Mr. Dial conceded that borrowed funds do not qualify as risk capital.¹¹⁶⁶

While it is disturbing that Messrs. Hoehn and Dial knowingly encouraged Mr. Webb to open a day trading account when he clearly did not possess adequate risk capital, the most troubling finding of the investigation is that Momentum's compliance personnel in Houston apparently knew for a full ten months before Mr. Webb's death that he was unsuitable for day trading. In mid-September 1998, Valynda Ewton, a former NASD examiner who did consulting work for Momentum, conducted an examination of the Atlanta office.¹¹⁶⁷ In her examination, Ms. Ewton specifically flagged Mr. Webb's account, along with several others, as only "marginally suitable."¹¹⁶⁸ Ms. Ewton stated her concern about these accounts in no uncertain terms:

[S]ome written memorandum may be needed to document why these persons were allowed to day trade. Perhaps limits on dollar amounts of losses, additional credit checks or written attestations from the customer. Or, special attention needs to be provided by Kirk or another trainer. I believe that NASD will start taking a hard look at the knowledge and suitability of customers.¹¹⁶⁹

Ms. Ewton's warning about Mr. Webb's unsuitability for day trading apparently went unheeded. Mr. Webb continued to incur losses day trading for almost a full year before he was killed by Mark Barton. When asked if any action was taken in regard to limiting Mr. Webb's trading as the result of Ms. Ewton's audit, Mr. Hoehn responded, "As a result of this audit, no, but Scott and I would frequently, on a daily basis, discuss his trading. So we were monitoring the trading closely."¹¹⁷⁰

That Momentum opened a day trading account for Mr. Webb is itself troubling, given what the firm knew about his financial condition and poor trading performance. Perhaps most startling, however, is that Mr. Webb was then hired to train Momentum's new customers at the Atlanta office. In light of Mr. Webb's mounting trading losses at Insight and later Momentum, it is shocking that Momentum relied on a young man who had never traded successfully to teach new customers how to become profitable day traders. Mr. Dial's analogy of Mr. Webb's role as a trainer to a good coach who was never a great player is flawed. Mr. Webb was a very poor day trader, and it is unthinkable that an athlete of comparable skill could ever rise to be a successful coach. Scott Webb clearly did not possess the skills or temperament to be a successful day trader,

¹¹⁶⁴ Dial Int. at 2.

¹¹⁶⁵ Id.

¹¹⁶⁶ Id.

¹¹⁶⁷ Momentum Securities, Inc. Branch Examination, Atlanta, Georgia, Sept. 14, 1998 to Sept. 17, 1998 (Feb. Hr'g Ex. 103).

¹¹⁶⁸ Id. at 3.

¹¹⁶⁹ Id.

¹¹⁷⁰ Day Trading: Everyone Gambles But the House, Hearings Before the Permanent Subcommittee On Investigations, Committee on Governmental Affairs, 106th Cong., 2nd Sess. (Feb. 24, 2000) (hearing transcript).

and the decision to have him instruct new customers reflects poorly on Momentum's supervision of the Atlanta office.

The opening and handling of Mr. Webb's account typifies the poor management and supervision that existed at Momentum's Atlanta office from the summer of 1998 until the spring of 1999, when Momentum began to improve its compliance effort. It is unclear why it took six months to clean up the Atlanta office since Momentum's management in Houston had notice of a serious problem as early as mid-September 1998. In Ms. Ewton's examination findings on Momentum's Atlanta office, she noted that Mr. Hoehn "basically did not know what to do as far as what records to review for what."¹¹⁷¹ Ms. Ewton found that, of 26 day trading customers at the time, there were 8 accounts with incomplete or inaccurate information on the new account forms and 5 accounts with no paperwork at all.¹¹⁷²

In her conclusion, Ms. Ewton was harshly critical of the management and supervision of the Atlanta office.

Neither Justin [Hoehn] nor Kevin [Dial] have a clue as to how to supervise. Despite supplying copies of the Written Supervisory Procedure's to each of them, neither one has read them. They received little if any guidance from the Tyler office. Reports were printed in Tyler for a period of time, but were not forwarded to Atlanta until the SEC walked in. It only takes one hiccup from a branch office to undermine an entire broker/dealer organization. Tyler and Atlanta are branch offices of Momentum—Houston. If there is a regulatory problem, then it can and likely will go against [Momentum]—Houston and its principals. David [Dial] said he was reviewing all the reports in Tyler. However, he needs to spend more time with Justin [Hoehn] advising him how to read them and what to look for. He must provide guidance to Atlanta.¹¹⁷³

Ms. Ewton suggested that, "[t]o help head off any future problems," Momentum should "draft a branch office manual" which should be "reviewed and circulated amongst all branch managers in the near future."¹¹⁷⁴ She also suggested that Momentum adopt "a branch managers monthly compliance report" that would be submitted to the home office in Houston at the close of each month.¹¹⁷⁵ Ms. Ewton concluded with a stern warning to Momentum management about the Atlanta office and urged immediate action to avoid future problems:

Before another branch office is opened, [Momentum] must make sure there are controls in place to monitor the newly hired S24 and provide supervisory training if required. I am hopeful that the SEC exam in Atlanta was only a training exercise for a new examiner. This could be a disastrous experience if a well seasoned regulatory team

¹¹⁷¹ Momentum Securities, Inc. Branch Examination, Atlanta, Georgia, Sept. 14, 1998 to Sept. 17, 1998 at 4 (Feb. Hr'g Ex. 103).

¹¹⁷² Id. at 2, 3, 5.

¹¹⁷³ Id. at 6.

¹¹⁷⁴ Id.

¹¹⁷⁵ Id. at 7.

would come in considering the shape of the Atlanta office.¹¹⁷⁶

To its credit, the Atlanta office did eventually improve. Momentum conducted a second audit six months after Ms. Ewton made her evaluations. Although the report did not address any specific improvements by Messrs. Hoehn and Dial, it did note that files were maintained with greater accuracy, customer financial status was more thoroughly transmitted, and the environment was much more conducive to customer service.¹¹⁷⁷ Nevertheless, the examination still reported that many new account forms were not filled out completely.¹¹⁷⁸

Ms. Ewton's examination findings probably should not be surprising given that Mr. Hoehn had virtually no experience or qualifications to serve as a branch manager of a securities firm. Mr. Hoehn was only 22 years old when he became the branch manager of the Atlanta office. His only experience to serve as a branch manager was that he had been a broker-trainee for several months at Dean Witter before losing \$10,000 to \$15,000 of borrowed funds in several months at Insight Trading.¹¹⁷⁹ Mr. Hoehn had never before acted as a registered representative for a brokerage firm when he became the branch manager of the Atlanta office much less supervised other licensed personnel. Mr. Dial justified hiring Mr. Hoehn as the branch manager because he was "eager and demonstrat[ed] confidence," and also had three months of trading experience, which was "a lot in this business."¹¹⁸⁰ Mr. Dial's justification for hiring Mr. Hoehn as the branch manager is hardly persuasive since, Mr. Hoehn's confidence aside, he had virtually no management experience as a young man of only 22. Moreover, three months of unsuccessful day trading experience should not inspire confidence.

Ms. Ewton's stinging critique of the management and supervision of Momentum's Atlanta office was also directed at Mr. Dial's failure to provide guidance to Mr. Hoehn. Subcommittee staff found Momentum's reliance on Professional Traders Group troubling since it appears that the Houston compliance operation relied on Mr. Dial and his associates in the Tyler branch office to provide direct supervision and management. Indeed, it appears that Mr. Dial and the Tyler office provided the entire impetus for the opening of the branch office in Atlanta, suggesting that Momentum's reliance on management companies has diluted the internal controls necessary to ensure that branch office personnel comply with not only securities laws, but also firm policies. The case of Scott Webb and the Atlanta office suggests that Momentum failed to adequately supervise its branch offices.

D. Momentum Operates a Lending Program That Allows Day Traders to Evade the Purpose of the Margin Rules

One of the most troubling discoveries of the Subcommittee's investigation of Momentum related to inter-customer lending to sat-

¹¹⁷⁶ Id.

¹¹⁷⁷ Momentum Securities, Inc. Branch Examination, Atlanta, Georgia, Mar. 5, 1999, at 1 (Feb. Hr'g Ex. 104).

¹¹⁷⁸ Id. at 2.

¹¹⁷⁹ Hoehn Int. at 2.

¹¹⁸⁰ Dial Int. at 1-2.

isify margin calls. In response to Subcommittee interrogatories, Momentum stated that as of October 1, 1999, 103 of the firm's 2,128 customers had loaned money to another customer to meet margin calls.¹¹⁸¹ Momentum indicated that these loans occur between customers in the same office and those who are located in different branch offices.¹¹⁸² Momentum also stated that the firm plays an essentially passive role in the lending process.¹¹⁸³ Specifically, the firm stated that "Momentum *may incidentally inform customers* as to the availability of private party loans from persons who may themselves be existing customers, and identify such existing customers. Terms of the loans are agreed upon between the customers."¹¹⁸⁴

The Subcommittee discovered, however, that Momentum performs more than an "incidental" role in the lending process. In fact, the evidence shows that Momentum actively promotes and encourages loans between its customers to satisfy intra-day margin calls. For example, the branch manager for Momentum's Atlanta office, Mr. Hoehn, told Subcommittee staff that Momentum's clearing firm initiates the lending process by notifying the margin department in Houston of those customers that have margin calls.¹¹⁸⁵ Houston then notifies the branch managers, who are responsible for informing the customers of the margin calls and their options for satisfying the calls.¹¹⁸⁶ Mr. Hoehn indicated that he informs customers that they can cover the margin calls with their own funds or obtain a short-term loan from other Momentum customers.¹¹⁸⁷ If the customer wishes to take advantage of the loans, Mr. Hoehn informs the home office in Houston, which apparently maintains a list of customers who have agreed to make their accounts available for short-term margin loans.¹¹⁸⁸ After the initial authorization process is completed, Momentum will automatically cover future margin calls with funds from the lending customer unless the borrowing customer indicates that he or she wishes to cover the calls themselves.¹¹⁸⁹

Not only does Momentum affirmatively connect the borrowing and lending customers, it also appears to set the terms of the loans in direct contradiction of Momentum's written response to the Subcommittee's interrogatories. Mr. Dial, the branch manager of the Tyler office, confirmed that the borrowing customers usually do not know or communicate with the lending customers.¹¹⁹⁰ In addition, Mr. Hoehn did not believe that his borrowing customers in Atlanta

¹¹⁸¹ Letter from Saul S. Cohen, Counsel for Momentum, to Glynn C. Parde, Senior Counsel for the Subcommittee, Nov. 17, 1999, at 1, 2 (Feb. Hr'g Ex. 105). There are three types of margin calls that may have applied to customers at Momentum: Regulation T initial margin calls; maintenance margin calls; and special maintenance margin calls for day trading ("day trading calls"). Subcommittee staff does not know for certain, and neither does Momentum, whether the lending practices implicated each of these kinds of calls. Momentum produced no written firm policy or documentation to support the assertion that these inter-customer loans were limited to day trading calls.

¹¹⁸² *Id.* at 2.

¹¹⁸³ *Id.*

¹¹⁸⁴ *Id.* (emphasis added).

¹¹⁸⁵ Hoehn Int. at 3.

¹¹⁸⁶ *Id.*

¹¹⁸⁷ *Id.*

¹¹⁸⁸ *Id.*

¹¹⁸⁹ Dial Int. at 2.

¹¹⁹⁰ *Id.*

ever communicated directly with the lending customers, who were usually located in other branch offices and particularly Tyler.¹¹⁹¹

During their Subcommittee interviews, both Messrs. Hoehn and Dial authenticated journal authorization forms between Scott Webb and Gerald Simpson, a day trader in the Tyler office, in which the names of the borrowing and lending customers were simply written into blank spaces on pre-printed forms.¹¹⁹² Mr. Dial told Subcommittee staff that Mr. Simpson is a long-time client of the Tyler branch office who “makes his account available” to customers and provides them loans to meet margin calls.¹¹⁹³ Mr. Dial said that, while Mr. Simpson gives an initial authorization to make his account available to other customers who need loans to cover margin calls, he normally does not know or speak with the borrower and is not necessarily aware of all the loans that are made from his account.¹¹⁹⁴ In fact, Mr. Dial confirmed that Mr. Simpson’s signature on the Webb journal authorization forms was merely a signature stamp applied by Momentum personnel.¹¹⁹⁵

These blank journal authorization forms were apparently maintained by the various branch offices so that funds could be routinely moved between the accounts of borrowing and lending customers. For instance, Subcommittee’s analysis of several of Mr. Webb’s margin loans shows that Mr. Webb borrowed money from Mr. Simpson frequently and in large amounts.

Webb margin loans from Simpson

<i>Date</i>	<i>Amount</i>
October 5, 1998	\$27,000.00
October 14, 1998	61,000.00
November 20, 1998	800.00
November 24, 1998	82,000.00
December 17, 1998	51,000.00
January 27, 1999	136,000.00
February 4, 1999	120,000.00
February 23, 1999	134,000.00
March 3, 1999	32,000.00
May 12, 1999	54,000.00
June 1, 1999	76,000.00
June 9, 1999	77,000.00
June 17, 1999	117,000.00
June 28, 1999	86,000.00
July 7, 1999	90,000.00
July 21, 1999	89,000.00

Source: Journal Authorizations Between Accounts of Gerald Simpson and Spyderstorm Capital, LLC.

The Simpson account was not the only account that Momentum used to provide short-term margin loans to its day traders. The Subcommittee reviewed the lending activity in one account held by a customer named Claypool. According to an analysis by the Subcommittee, between June 30, 1999 and July 30, 1999, Momentum used the Claypool account to loan almost \$10,000,000 to 52 other Momentum customers.¹¹⁹⁶ The Claypool account provided loans in excess of \$100,000 on 21 occasions during the month of July.¹¹⁹⁷

¹¹⁹¹ Hoehn Int. at 3.

¹¹⁹² Dial Int. at 2; Hoehn Int. at 3. Mr. Simpson was also the customer that loaned Mr. Webb \$30,000 in July of 1998 to help fund his day trading activities at Momentum. Id.

¹¹⁹³ Dial Int. at 2.

¹¹⁹⁴ Id.

¹¹⁹⁵ Id.

¹¹⁹⁶ Momentum Journal Authorizations into the Claypool Account (Feb. Hr’g Ex. 106).

¹¹⁹⁷ Id.

Several of the borrowers were repeat customers. For instance, a day trader named Baylor borrowed money to cover margin calls on eight separate occasions during the month of July for a total of \$582,637.¹¹⁹⁸ Another customer named Thofner borrowed money from the Claypool account in seven different instances in July, totaling \$335,394.¹¹⁹⁹

During his interview with Subcommittee staff, Mr. Dial said that he did not know of a circumstance when these loans were not repaid by the borrowing day trader.¹²⁰⁰ While the Subcommittee has no indication that borrowing customers defaulted on these margin loans, there is evidence that Momentum's day traders did not always repay their loans in a timely fashion and, thus, continued to incur substantial interest charges. A review of the Claypool journal authorizations indicates that Momentum customers often failed to repay the margin loans on the anticipated date, prompting Momentum officials to cross out the amount due on the journal form and write in a new amount to reflect added interest.¹²⁰¹ For example, a customer named Schwinger failed to repay a loan of \$35,016 that was originally due on June 30, 1999.¹²⁰² The form contains marginalia stating, "6 days, went over".¹²⁰³ When the loan was repaid, the added interest resulted in Schwinger paying Claypool an additional \$114.¹²⁰⁴ There are several other journal authorizations in the Claypool records which suggest that the loans may not have been repaid. For instance, while most of the forms bear the notation "done" or "completed"—presumably indicating that the loan was repaid—some of the forms note "went over" or "not done yet".¹²⁰⁵

In summary, the evidence indicates that customers frequently borrowed funds from other customers to meet margin calls and that, as a matter of course, Momentum managed the entire lending process. Momentum connected the borrower and the lender who normally did not know each other or communicate with one another during the lending process. As such, it is simply wrong to suggest, as Momentum does, that the terms of these loans were in any way the process of a bargained exchange. While there is nothing inherently improper with customers lending money to one another to satisfy margin calls, it is problematic for day trading firms to encourage such lending when their revenue stream depends heavily on sustained customer trading. The obvious conflict of interest should be sufficient to dissuade Momentum from continuing this troubling practice in the future.

E. Momentum Has Not Engaged in a Deceptive or Misleading Advertising Campaign

In the area of advertising, the Subcommittee found that, in general, Momentum did not sponsor deceptive or misleading advertisements concerning the firm or the day trading industry overall. Indeed, Momentum should be commended for including risk dislo-

¹¹⁹⁸ Id.

¹¹⁹⁹ Id.

¹²⁰⁰ Dial Int. at 2.

¹²⁰¹ Feb. Hr'g Ex. 106.

¹²⁰² Id.

¹²⁰³ Id.

¹²⁰⁴ Id.

¹²⁰⁵ Id.

tures on television commercials that it sponsors on behalf of its branch offices. A review of these commercials by Subcommittee staff found no misleading statements or unbalanced presentations about the risks and profitability of day trading.

However, in August 1999, NASDR wrote a letter to Momentum citing several potential violations of NASD advertising rules that required corrective action.¹²⁰⁶ NASDR examiners reviewed a sample of Momentum's Internet website and print advertisements and found exaggerated claims or failure to disclose risks. For example, Momentum's website made the claims, "Cutting-Edge Technology and Thorough Customer Training = Superior Performance Results,"¹²⁰⁷ which NASDR said "appear[ed] to exaggerate the potential performance that a day trader can expect."¹²⁰⁸ NASDR also criticized the website's risk disclosure section because it did not warn potential day traders that market volatility and volume can delay system access and trade execution.¹²⁰⁹ NASDR examiners also criticized Momentum for a news release that they characterized as "exaggerated and unwarranted and in apparent violation of NASD Conduct Rules."¹²¹⁰ Further, NASDR stated that "the material appears to be incomplete and unbalanced in that it fails to reflect the risks inherent in day trading."¹²¹¹

In response to the NASDR, Momentum agreed to remedy these complaints by removing the statement from its news release, providing a more comprehensive risk disclosure on its website, and giving more accurate risk disclosure in seminar advertisements.¹²¹² With the exception of the advertising problems raised by the NASDR, the Subcommittee found no evidence that Momentum has engaged in deceptive and misleading advertising.

F. Increased Regulatory Scrutiny of Day Trading Prompted Momentum to Improve its Standards and Compliance Program

The Subcommittee's investigation determined that, after regulatory scrutiny of the day trading industry increased in early 1999, Momentum made a concerted effort to improve its standards and compliance program. Ms. Ewton's examination findings concerning the Atlanta office in September, 1998, suggest that Momentum's internal policies and compliance structure were lacking during the firm's early years, particularly as it related to branch office supervision. In fact, the Subcommittee's investigation found that, until April of 1999, Momentum either did not adopt minimum financial requirements for new day trading accounts or neglected to communicate those standards to branch office personnel. As the Scott Webb case illustrates, Momentum also failed to implement sound internal controls that would have allowed the firm's management to supervise more effectively its branch office personnel.

(1) *Momentum Has No Branch Office Manual.* From its founding to as late as September, 1998, Momentum did not have a branch office manual. Indeed, in her examination findings on the Atlanta

¹²⁰⁶ Letter from Scott H. Maestri, NASD Examiner, to William Cathriner, Vice President of Momentum, Aug. 10, 1999, at 1 (Feb. Hr'g Ex. 107).

¹²⁰⁷ *Id.* at 2.

¹²⁰⁸ *Id.*

¹²⁰⁹ *Id.*

¹²¹⁰ *Id.* at 3-4.

¹²¹¹ *Id.* at 4.

¹²¹² Letter from William Cathriner, Momentum Chief Compliance Officer, to Scott H. Maestri, NASDR Compliance Examiner, Aug. 23, 1999, at 1 (Feb. Hr'g Ex. 108).

office, Ms. Ewton specifically indicated that Momentum intended to prepare a branch office manual within two weeks.¹²¹³ She noted that the manual would be circulated to the branch offices as part of an effort to improve supervision by Momentum's Houston office.¹²¹⁴ Ms. Ewton also indicated that Momentum would create a new document known as a "Monthly Compliance Report" that each branch manager would have to complete and return to the compliance department in Houston by the tenth day of each month.¹²¹⁵ The evidence indicates, however, that Momentum did not circulate either of these documents as Ms. Ewton anticipated.

In response to Subcommittee interrogatories, Momentum produced two copies of a document entitled "Brokerage Operations Manual", which appears to be a branch office manual. One copy of the manual was marked "draft" and the second copy bore no such designation. Both copies are dated July 1999 and discuss new account opening procedures, including risk disclaimers and minimum financial standards for new accounts.¹²¹⁶ Because the new account standards and new account documents listed in the Brokerage Operations Manual are very similar to Momentum's currently stated policies, it appears that Momentum might have introduced the Brokerage Operations Manual by at least July 1999.¹²¹⁷ Mr. Lee testified, however, that the manual was never completed or circulated to Momentum personnel or the branch offices.¹²¹⁸ Mr. Lee stated that, while many of the directives set forth in the manual reflect Momentum's current policy, several items do not.¹²¹⁹ For instance, when asked about a document in the manual entitled "Branch Manager's Monthly Compliance Report," Mr. Lee testified that he did not believe that the form had ever been utilized by Momentum's branch offices.¹²²⁰

Thus, it does not appear that Momentum ever heeded Ms. Ewton's guidance. Almost fifteen months after Ms. Ewton indicated the importance of preparing both a branch office manual and a monthly compliance report, Momentum has still not circulated those documents to its branch office personnel. In April of 1999, however, Momentum introduced a series of new account opening documents and accompanying standards that were designed to respond to increased regulatory scrutiny of the day trading industry.¹²²¹ The evidence shows that, before the firm adopted these new standards, Momentum's internal policies pertaining to opening new accounts were poorly understood by branch office personnel and were frequently disregarded.

(2) *Momentum's Registered Personnel Failed to Gather Financial Information About Customers In Order to Determine Their Suitability for Day Trading.* Without a branch manual to communicate firm policies and standards to a growing number of satellite offices,

¹²¹³ Feb. Hr'g Ex. 103, at 6-7.

¹²¹⁴ Id.

¹²¹⁵ Id. at 7.

¹²¹⁶ Momentum Securities, Inc. "Brokerage Operations Manual" (July 1999) (Feb. Hr'g Ex. 109).

¹²¹⁷ Lee Dep. at 182.

¹²¹⁸ Id. at 112. Mr. Lee stated that the manual was in "a draft form" and that Momentum was "still working on it." Id.

¹²¹⁹ Id. at 170. Mr. Lee testified that, even though the Brokerage Operations Manual describes a detailed risk management program that requires Momentum personnel to monitor customer accounts and note percentage losses, no such program has been implemented. Id. at 170-77.

¹²²⁰ Id. at 148.

¹²²¹ Id. at 122.

Momentum has relied on written supervisory procedures to communicate the firm's expectations to its personnel.¹²²² The "Written Supervisory Procedures for Momentum Securities, Inc.," dated March 31, 1998, set forth the only written statement of Momentum's internal policies concerning the opening of new accounts that the Subcommittee has located for the period preceding April 1999.¹²²³ The Supervisory Procedures makes clear that Momentum expected its registered personnel to collect financial information about its prospective customers in order to evaluate their suitability for day trading.¹²²⁴ The Supervisory Procedures state as follows:

The Registered Representative must take steps to gather all of the new account information required including, but not limited to occupation, net worth, annual income, and tax status. This information must be taken into account when determining whether an investment is suitable for a customer.

* * * * *

*The representative must take care to insure that not only he (she) is satisfied that suitability has been met, but also that the investor fully understands the significance of the suitability requirement. * * **

The representative has the responsibility of insuring that written material to be completed by the customer establishing suitability has been completed by the customer and that the firm's records contain such material.¹²²⁵

Although the Supervisory Procedures did not specify minimum financial requirements, they do require Momentum personnel to obtain a complete picture of a customer's financial condition. At a bare minimum, the registered representative was to obtain the customer's occupation, net worth, annual income, and tax status.¹²²⁶ Despite the clear language of the Supervisory Procedures, the Subcommittee found that many of Momentum's new account forms did not contain this basic information about prospective day traders.

For example, the new account form for Benchmark Trading Fund, Ltd., which was opened on April 14, 1998, is virtually blank.¹²²⁷ Momentum opened this account without the account holder stating an investment objective, estimated annual income, or net worth.¹²²⁸ The new account form also omits any information about the initial deposit and tax status.¹²²⁹ In fact, the only information on the new account form is the name and address of the account holder.¹²³⁰ At his Subcommittee deposition, Mr. Lee was asked about the manner in which this new account documentation was completed:

¹²²² Ms. Ewton commented in her examination of the Atlanta office that, even though she had given copies of Momentum's Written Supervisory Procedures to Mr. Hoehn and Kevin Dial, neither gentleman had read them. Feb. Hr'g Ex. 103, at 6.

¹²²³ "Written Supervisory Procedures for Momentum Securities, Inc.," (Mar. 31, 1998) (Feb. Hr'g Ex. 110).

¹²²⁴ Id. at III-5.

¹²²⁵ Id. (emphasis added).

¹²²⁶ Id.

¹²²⁷ New Account Approval-B for Benchmark Trading Fund, Ltd., Apr. 14, 1998 (Feb. Hr'g Ex. 111).

¹²²⁸ Id.

¹²²⁹ Id.

¹²³⁰ Id.

Q: In your view, is this form filled out adequately for the purposes of making a determination about whether to open this account?

A: I would like to have seen it completed.¹²³¹

The Subcommittee found numerous other examples where Momentum opened a new day trading account for a customer without collecting the financial information that the firm's Supervisory Procedures identify as essential for determining the suitability of the client. For instance, on September 29, 1998, Momentum opened a day trading account for Henry Castro and an account for Amit Berstein.¹²³² Both new account forms failed to provide figures for estimated annual income, estimated net worth, or initial deposit amounts.¹²³³ Once again, Mr. Lee addressed these new account documents during his deposition:

Q: * * * Do you believe that this form was filled out appropriately for making—in terms of your business judgment, business practices as the president of the company for making the determination about whether or not the account should be opened?

A: All of this paperwork could have been done better. If the customer is a full-time day trader, I'd like to see a higher standard. And I think safeguards are in place today to improve upon this, what you're looking at.

Q: That wouldn't have been in place back at that time necessarily [in 1998]?

A: May not have been.¹²³⁴

The new account form for another day trading account, Lunker Investment Corporation, indicates that the customer declined to state their estimated annual income, net worth or tax status.¹²³⁵ Momentum's Supervisory Procedures make clear that, "[i]f the customer refuses to supply this information, then the Registered Representative should keep complete notes" of why the account was opened.¹²³⁶ The Subcommittee found no such notes in the new account materials produced by Momentum in connection with this account. The new account form simply bears marginalia stating, "refuse to disclose."¹²³⁷ In his deposition, Mr. Lee explained his understanding of how Momentum personnel are expected to respond to a customer's unwillingness to disclose financial information essential to the firm's suitability determination:

Q: Is that a common problem that Momentum registered representatives encounter when opening new accounts, that customers don't want to disclose this information?

A: It's been my experience that it's very common.

Q: Okay. How are your registered representatives instructed to respond when a customer tells them, I'm not going to tell you what my annual income or net worth is?

¹²³¹ Lee Dep. at 244.

¹²³² New Account Approval-B for Henry Castro, Sept. 29, 1998 (Feb. Hr'g Ex. 112); New Account Approval-B for Amit Berstein, Sept. 29, 1998 (Feb. Hr'g Ex. 113).

¹²³³ Id.

¹²³⁴ Lee Dep. at 245-46.

¹²³⁵ New Account Approval-B for Lunker Investments Corporation, Dec. 2, 1998 (Feb. Hr'g Ex. 114).

¹²³⁶ Feb. Hr'g Ex. 110, at III-5.

¹²³⁷ Feb.

A: Today, we won't approve the account, once we adopted that policy that we spoke about earlier, March or May—March or April of this year.

Q: Okay. Back prior to the adoption of these new procedures you were talking about, how was this sort of thing handled, do you know?

A: I think we generally respect the interest of the customer—desire of the customer.

Q: Okay. Would that likely lead to the opening of the account if they wanted the account to be opened even though they wouldn't provide the information requested?

A: It could happen, yes, sir.¹²³⁸

Momentum allowed another day trader, Flora Siman, to open an account on July 7, 1998, and her new account form omitted all information about her financial status.¹²³⁹ In fact, after noting her name and address, the abbreviation “N/A” is written in all of the remaining spaces on the new account form.¹²⁴⁰ Mr. Lee conceded at his deposition that he “expect[ed] the person on site to complete this information. I would have expected Houston [compliance] not to approve this until it was more complete at that time. That's certainly the policy today.”¹²⁴¹

These poorly documented new account forms indicate that Momentum's compliance personnel were not adequately enforcing the Supervisory Procedures, which state clearly that the firm's registered personnel were responsible for “insuring that written material to be completed by the customer establishing suitability has been completed by the customer and that the firm's records contain such material.”¹²⁴² These new account forms suggest that new day trading customers were often allowed to open an account without disclosing the financial information that Momentum identified as critical to the firm's ability to evaluate their suitability.

(3) *Prior to April 1999, Momentum Had No Minimum Financial Requirements for Opening Day Trading Accounts.* According to the Supervisory Procedures, Momentum personnel were to consider factors such as annual income and net worth to determine a prospective customer's suitability, but no minimum financial thresholds were identified.¹²⁴³ In response to written interrogatories from the Subcommittee, Momentum indicated that it now requires new day trading customers to possess a minimum deposit of \$50,000 and a net worth of \$100,000.¹²⁴⁴ Momentum explained that these figures are “guidelines” and that “other factors are used with this guideline to evaluate a prospective customer's capabilities to day trade.”¹²⁴⁵

Momentum also stated that, “[p]rior to April of 1999, Momentum used a benchmark or guideline criteria of a deposit of approximately \$25,000 on the opening of an account. This is a guideline, however, and other factors were used with this benchmark to

¹²³⁸ Lee Dep. at 248.

¹²³⁹ New Account Approval—B for Flora Siman, July 7, 1998 (Feb. Hr'g. Ex. 115).

¹²⁴⁰ Id.

¹²⁴¹ Lee Dep. at 254.

¹²⁴² Feb. Hr'g Ex.110, at III-5.

¹²⁴³ Id.

¹²⁴⁴ Letter from Lily Camet, Counsel for Momentum Securities, Inc., to Brian C. Jones, Investigator for the Subcommittee, Dec. 20, 1999, at 1 (Feb. Hr'g Ex. 116)

¹²⁴⁵ Id.

evaluate a prospective customer's capabilities to day trade."¹²⁴⁶ During his Subcommittee deposition, however, Mr. Lee gave a confusing description of Momentum's minimum financial standards. Mr. Lee initially stated that there were no minimum financial requirements in place before April 1999 but that customers were advised that they needed \$125,000 of risk capital to have the best opportunity for success.¹²⁴⁷ Mr. Lee was then shown Momentum's response to the Subcommittee's interrogatories indicating that, prior to April 1999, the firm utilized a standard of \$25,000. Mr. Lee stated that he was unfamiliar with that standard:

Q: So, do I understand you to be saying that this \$25,000 benchmark or guideline was not something you were familiar with?

A: I just don't recall that.

Q: Okay. Is it possible that there was such a guideline or benchmark being implemented by the branch managers' without your participation or knowledge?

A: That could have happened during the period that I wasn't functioning in that supervisory role. I just—I couldn't—I don't know.¹²⁴⁸

When asked to explain the discrepancy between his testimony and Momentum's written response to the Subcommittee's interrogatories, Mr. Lee again denied that the firm ever maintained a uniform minimum financial standard for opening new day trading accounts prior to April 1999, and expressed confusion about his attorneys' response to the Subcommittee:

Q: So, in your view, setting of something like a guideline for the opening of a new account would not have been a policy decision rising to the level that it was necessary to bring that to your attention as a principal?

A: I don't believe that there was a uniform level. And if there was, I wasn't aware of it in the system prior to April. So, it's hypothetical what we're talking about. *It is here in this letter [from Momentum's attorneys]. And I can't explain to you why our counsel dealing with Bill Cathriner and Elizabeth [Cummins] and whoever produced this happened to use \$25,000 because it's prefaced—it's prefaced with the term "benchmarking guidelines."*¹²⁴⁹

Mr. Lee was not the only Momentum employee unfamiliar with the firm's minimum financial standards prior to April 1999. For instance, David Dial, the branch manager for Momentum's office in Tyler could not recall any minimum financial standards employed by the firm prior to the adoption of the new standards.¹²⁵⁰

The Subcommittee will assume that the testimony of Mr. Lee and Mr. Dial accurately describes the firm's policy prior to April

¹²⁴⁶ Id. at 2.

¹²⁴⁷ Lee Dep. at 121–25.

¹²⁴⁸ Id. at 136.

¹²⁴⁹ Id. at 139–40 (emphasis added).

¹²⁵⁰ Dial Int. at 2. When asked what amount of risk capital he considered necessary for a potential day trading customer, Mr. Dial stated that an amount less than \$10,000 would significantly limit the trader's chances of success. Id. At the same time, however, Mr. Dial believed that a trader could be profitable with amounts between \$20,000 and \$40,000. Id. He further stated that the current \$50,000 standard is a good benchmark because it is enough capital for a day trader to survive the "learning curve", the first three to six months when a new trader is the most susceptible to financial losses. Id.

1999. However, the confusion about the firm's standards prior to April of 1999 is unsettling. In light of the uncertainty about what the firm's minimum standards were before April 1999, it is not surprising that the Subcommittee found many examples of new accounts that were opened with capital well below the \$125,000 figure that Mr. Lee cited originally in his testimony.

For example, Momentum opened a day trading account for Hung C. Chan on January 21, 1999, in which Mr. Chan made an initial deposit of \$30,000.¹²⁵¹ Also, Minder Singh opened a day trading account with Momentum on November 6, 1998, with an initial deposit of only \$25,000.¹²⁵² Similarly, Larry Hartman initially deposited only \$30,000 in his day trading account, which Momentum opened on October 19, 1998.¹²⁵³ As a final example, Michael St. John Dinsmore opened his day trading account at Momentum on March 13, 1997 with a deposit of \$30,000.¹²⁵⁴ During his deposition, Mr. Lee was shown each of these new account forms and asked whether, based upon the information disclosed by the customers, it was appropriate for Momentum to have opened these accounts. Despite his earlier testimony indicating that Momentum advised customers that they should have a minimum of \$125,000 of risk capital to day trade, Mr. Lee testified that it was proper for the firm to have opened these accounts based on the information disclosed by the customers.¹²⁵⁵

As noted above, in April 1999, Momentum instituted a number of changes in its internal policies and standards. For the first time, the firm set minimum financial standards for accepting new day trading customers.¹²⁵⁶ Momentum's Brokerage Operations Manual described the new standards as follows:

EQUITY

The minimum equity a client can deposit into a new day trading account is \$50,000.00. If your customer only deposits \$50,000.00, it is recommended that he/she trade in 100 share lots for at least the first month. This will prohibit the client from losing the majority of his equity during the learning curve.

NET WORTH

All customers *must* have a minimum net worth of \$100,000.00.

TRADING EXPERIENCE

*If a customer has at least 5 years trading experience, it is possible that an exception will be made to the above parameters. A branch manager must obtain permission from the CSO. He/she should complete the Account Parameters Exception form and fax to Houston for approval.*¹²⁵⁷

¹²⁵¹New Account Approval-B for Hung C. Chan, Jan. 21, 1999 (Feb. Hr'g. Ex. 117). Mr. Chan also disclosed an estimated annual income of \$28,000 and an estimated net worth of \$80,000. Id.

¹²⁵²New Account Approval-B for Minder Singh, Nov. 6, 1998 (Feb. Hr'g. Ex. 118). Mr. Singh also disclosed an estimated annual income of \$30,000 and a net worth of \$100,000. Id.

¹²⁵³New Account Approval-B for Larry L. Hartman, Oct. 19, 1998 (Feb. Hr'g. Ex. 119). Mr. Hartman disclosed an estimated annual income of \$30,000 and an estimated net worth of \$60,000. Id.

¹²⁵⁴New Account Approval-B for Michael St. John Dinsmore, Mar. 13, 1997 (Feb. Hr'g. Ex. 120).

¹²⁵⁵Lee Dep. at 269, 274, 281, 282.

¹²⁵⁶Id. at 121.

¹²⁵⁷Feb. Hr'g. Ex. 109, Risk Management, at 2 (emphasis added).

Mr. Lee testified to the importance of the \$50,000 minimum within the context of the “learning curve” for day trading.¹²⁵⁸ He explained that, because new day traders routinely experience losses during their first months of trading, it is critical that they possess sufficient risk capital to withstand that learning curve.¹²⁵⁹

As stated in the Brokerage Operations Manual, Momentum appears to have adopted a very stringent and exacting standard for opening new day trading accounts. It suggests that, absent the requisite risk capital and net worth, a prospective customer cannot open a day trading account. The branch manager can make an exception to this financial standard only if the customer has five years of trading experience and the branch manager obtains the approval of the home office in Houston.

During his Subcommittee deposition, however, Mr. Lee distanced Momentum from the language of its Brokerage Operations Manual. He indicated that the Brokerage Operations Manual was never finalized and does not reflect an accurate statement of firm policy regarding the opening of new day trading accounts.¹²⁶⁰ He explained that, under the policy adopted by Momentum in April 1999, a new day trading account can be opened if the prospective customer has a minimum starting equity of \$50,000 and a minimum net worth of \$100,000, or attests to five years of trading experience.¹²⁶¹ In addition, Mr. Lee testified that these standards are very flexible so that a customer who lacks the requisite capital or trading experience can still open an account after appealing to Houston’s compliance office.¹²⁶² Mr. Lee explained the policy as follows: “Today, what we try to do as a matter of policy, voluntarily, is to say, look, you need a \$50,000 minimum deposit and a minimum disclosed net worth of [\$100,000]. We have those two collective, or five years trading experience. If you don’t represent one of those two to us, then I believe the process is that you’re kicked out. It’s rejected. And then you have to go through an appeal. * * *”¹²⁶³

In a review of Momentum’s new account documentation, the Subcommittee found several examples of day trading accounts that were opened for customers after April 1999 that did not possess the \$50,000 minimum deposit or \$100,000 disclosed net worth. In each case, as Mr. Lee testified, the prospective customer attested on the new account paperwork that they possessed five years or more of trading experience. For instance, Momentum opened a new account for Manfred Pojar on July 2, 1999 with only \$18,000.¹²⁶⁴ Mr. Pojar indicated on the new account paperwork that he was “unemployed”, had annual income of approximately \$15,000 and a liquid net worth of \$35,000.¹²⁶⁵ Despite his very limited means, Momentum opened the account for Mr. Pojar because he represented that he had six years of trading experience.¹²⁶⁶

One new account form suggests that most customers that lack the requisite capital can easily open the account by claiming past

¹²⁵⁸ Lee Dep. at 161.

¹²⁵⁹ Id. at 161–62.

¹²⁶⁰ Id. at 153.

¹²⁶¹ Id. at 128–29.

¹²⁶² Id. at 153.

¹²⁶³ Id. at 128–29.

¹²⁶⁴ Momentum Securities, Inc., New Account Paperwork Check List for Manfred Pojar, July 1, 1999 (Feb. Hr’g Ex. 121).

¹²⁶⁵ Id. at 298.

¹²⁶⁶ Id.

trading experience, even when common sense might warrant skepticism of the claim. A 23 year old named Charles Lande opened a day trading account at Momentum with only \$15,000, a disclosed income of \$31,500 and \$50,000 in net worth—all well below the firm’s minimum standards.¹²⁶⁷ Momentum approved his account, however, because Mr. Lande listed trading experience of six years.¹²⁶⁸ If true, Mr. Lande was very precocious indeed, since he would have begun his trading career at the age of 17.

Mr. Lee also disputed that Momentum policy requires new day trading customers to indicate that their investment objective is “Short-Term Growth with High Risk.”¹²⁶⁹ Despite language to that effect in the Brokerage Operations Manual, Mr. Lee was unfamiliar with such a requirement:

Q: You would not open an account for the purposes of day trading for any customer unless they indicate for the opening of that account that their investment objective is short-term growth and high risk?

A: I would—I wouldn’t say never; but I would expect it to be that way, yes.

Q: What are the circumstances in which you conceive in which that would not be the case?

A: A person met the minimum thresholds, came in and desired to day trade yet said their objective was something different than that on, the paperwork.

Q: Such as?

A: Long-term growth with greater risk.

* * * * *

Q: If you’ll look down under account information [of the Brokerage Operations section of the manual], in big bold print on the last sentence it says: In regard to investment objectives, short-term growth with high risk must be checked on all day trading accounts.

* * * * *

A: Okay.

Q: Is that not to be interpreted as an inflexible rule but as a—just a guideline?

A: It’s not a rule. Again, this document is used as disclosure from a customer. If the customer is looking at this a different way, I would tell you that I would expect all day traders as we’ve defined them to classify their intention and their goals this way, yes.

Q: But if they didn’t, that wouldn’t in any way cause you to hold up the account approval process?

A: I would expect that it would probably get bumped, but I don’t know for sure, bump meaning sent back.¹²⁷⁰

As stated in the Brokerage Operations Manual, the firm’s minimum financial standard for new day trading accounts is a commendable policy that would be a best practice for the rest of the day trading industry. It would discourage branch office personnel

¹²⁶⁷ Momentum Securities, Inc., New Account Paperwork Check List for Charles R. Lande, Jr., July 19, 1999, at 3, 7 (Feb. Hr’g Ex. 122).

¹²⁶⁸ Id. at 5.

¹²⁶⁹ Feb. Hr’g Ex. 109, Risk Management, at 4.

¹²⁷⁰ Lee Dep. at 265–66.

from opening new accounts for prospective day traders that have very little chance of success because they lack the risk capital necessary to survive the learning curve or take advantage of the full range of trading strategies. As the policy is actually implemented, however, it provides much less protection to the firm or the unwitting customer because the prospective day trader can simply assert that he or she has five years trading experience or simply appeal the decision to Momentum's home office with no specified criteria to govern the appeal. Moreover, many of the best internal policies in the Brokerage Operations Manual have never been formally adopted or communicated to the branch offices.

(4) *Momentum Significantly Improved Its Written Risk Disclosures to Prospective Day Traders in Early 1999.* Prior to 1999, Momentum provided its new customers with a modest risk disclaimer that was included within the account opening paperwork.¹²⁷¹ As the Scott Webb case illustrates, however, this risk disclosure was not comprehensive and was apparently focused on the systems and execution risks of day trading. In late 1998 and early 1999, as regulatory scrutiny of the day trading industry increased, Momentum dramatically improved its risk disclosure program for new customers. Today, Momentum's written risk disclosure is one of the finest in the industry, if not the best.

Momentum's current risk disclosure documents are included as part of a detailed package of materials exceeding thirty pages that customers must review and acknowledge before the day trading account will be opened. Specifically, Momentum's new account paperwork contains several different disclosures of the risks inherent to day trading.¹²⁷² The first disclosure document advises customers of the risks associated with trading Internet stocks and requires the customer to sign the disclosure form acknowledging that they understand those risks.¹²⁷³ The form notes that some Internet stocks have experienced price movements of as much as 100 points in a single day and advises customers to consider their individual trading strategies in light of such volatility.¹²⁷⁴ The form reminds customers that day trading is very risky and "may not be suitable for everyone."¹²⁷⁵

The second risk disclosure document is called the "Risk Disclosure Statement" and states in bold face type that day trading is extremely risky and, as such, "this activity may result in the loss of more than 100% of an investment," and "leverage can lead to large losses as well as gains."¹²⁷⁶ The form also advises new customers that day trading "involves a high volume of trading activity—the number of transactions in an account may exceed 100 per day. Each trade generates a commission and the total daily commissions on such a high volume of trading can be in excess of any earnings."¹²⁷⁷ Momentum requires new customers to review these disclaimers and sign them.¹²⁷⁸

¹²⁷¹ Id. at 258–60.

¹²⁷² Feb. Hr'g Ex. 109, New Account Approval at 20, 29–30, 33–34.

¹²⁷³ Id. at 20.

¹²⁷⁴ Id.

¹²⁷⁵ Id.

¹²⁷⁶ Id. at 29–30.

¹²⁷⁷ Id. at 29.

¹²⁷⁸ Id. at 30.

Momentum also gives new customers a disclosure form reciting SEC Chairman Arthur Levitt's published statement regarding the risks of Internet investing and day trading.¹²⁷⁹ This form states that, "[f]or most individuals, the stock market should be used for investment, not trading. Strategies such as day trading can be highly risky, and retail investors engaging in such activities should do so with funds they can afford to lose."¹²⁸⁰ The form must be reviewed and signed by the new customer before Momentum will open the account.¹²⁸¹

Taken together, these new risk disclosure documents are an impressive addition to the information customers review when opening an account. The Subcommittee found that some day trading firms provided their customers with written risk disclosures that were undermined or contradicted by misleading advertising or deceptive statements about the profitability of day trading, but there was no such evidence relating to Momentum. Though Momentum did not upgrade its written risk disclosures until regulatory scrutiny increased in early 1999, it nonetheless acted responsibly when it significantly improved its risk management program.¹²⁸²

(5) *The Evolution of Momentum's Compliance Operation.* All of Momentum's efforts to increase internal standards and policies can be tied to the firm's effort to improve its compliance operation. When Messrs. Lee and Earnest started Momentum in 1995, Mr. Lee was responsible for all compliance matters.¹²⁸³ Mr. Lee said that, though he remained at the top of Momentum's supervisory structure, he relinquished his day-to-day responsibilities for compliance issues to Elizabeth Cummins in mid-1996.¹²⁸⁴ At that point in time, Ms. Cummins acquired the primary responsibility for supervising compliance matters at Momentum.¹²⁸⁵ Mr. Lee testified that, in mid-1998, he resumed an active role in compliance issues, particularly with respect to setting firm policies and standards.¹²⁸⁶ He added the caveat, however, that Ms. Cummins continued to direct the day-to-day compliance operation in Houston.¹²⁸⁷ In fact, Mr. Lee described his role as, "if anything, more policy. I have not since the first year had much day to day."¹²⁸⁸

Mr. Lee also said that, in addition to Ms. Cummins, Momentum retained Ms. Ewton as an outside compliance consultant.¹²⁸⁹ As explained above, Ms. Ewton is a former NASD examiner who conducted audits of Momentum's branch offices to determine whether they were in compliance with applicable securities laws and regulations as well as firm policies.¹²⁹⁰ Mr. Lee described Ms. Ewton's primary function as an auditor who "goes through the branch office

¹²⁷⁹ Id. at 33–34.

¹²⁸⁰ Id. at 33.

¹²⁸¹ Id. at 34.

¹²⁸² Mr. Lee testified that, after the new risk disclosure documents were prepared, Momentum required that they be completed by all new customers. Lee Dep. at 109. He also indicated that Momentum required existing day traders to review the forms and sign them, though he conceded that some existing customers may have been missed.

¹²⁸³ Id. at 110.

¹²⁸⁴ Id. at 111.

¹²⁸⁵ Id. at 112–13. Mr. Lee also indicated that, at some point after 1996, Scott Brooks assumed an active role in Momentum's compliance effort. Id. at 114. Mr. Brooks joined Momentum after Momentum acquired Access Trading in Dallas during 1996. Id. at 110, 114.

¹²⁸⁶ Id. at 114–15.

¹²⁸⁷ Id. at 115.

¹²⁸⁸ Id.

¹²⁸⁹ Id. at 117–18.

¹²⁹⁰ Id. at 118. Mr. Lee said that Ms. Ewton still works with Momentum today. Id.

exams.”¹²⁹¹ During his deposition, however, Mr. Lee indicated that he had very little knowledge about the audits performed by Ms. Ewton:

Q: How long prior to Mr. Cathriner’s joining Momentum did [Ms. Ewton] perform that audit function?

A: We either did them internally or she assisted with them since inception.

Q: Did it start out as annual and come to quarterly or how did that —

A: I don’t know.

Q: Okay. Do you know whether those audits that she performed, if we can use that term, generated any kind of written document for you or senior management’s internal review or did she report back in an oral fashion?

A: I don’t—she may have been oral.¹²⁹²

In response to Subcommittee document requests, Momentum produced numerous written examination findings memorializing Ms. Ewton’s audits of the firm’s branch offices. Indeed, her branch examination of the Atlanta office in September 1998 was included in this production. It is troubling that Mr. Lee did not know whether Ms. Ewton documented her branch examinations in writing. It would be a matter of great concern if Ms. Ewton’s warnings and suggestions for improvement pertaining to the Atlanta office went unanswered because Momentum’s principals were unaware of her concerns. At a minimum, Mr. Lee’s vague understanding of Ms. Ewton’s activities suggests that he was not very involved in this critical oversight function.

As explained above, early in 1999, Momentum moved to improve its compliance operation and one critical aspect of the firm’s effort was its decision to hire Bill Cathriner as the new Chief Compliance Officer.¹²⁹³ Mr. Cathriner directs the entire compliance effort at Momentum, and he reports directly to Mr. Lee.¹²⁹⁴ Mr. Lee testified that Momentum hired Mr. Cathriner “to raise the bar” for the firm’s supervision and implementation of internal controls.¹²⁹⁵ Despite the apparent admission that Momentum’s compliance operation was deficient before Mr. Cathriner was retained, Mr. Lee denied that his hiring of Mr. Cathriner was an acknowledgment of past problems. Mr. Lee testified, “I don’t think that there was ever a problem that we perceived and a need to heighten it.”¹²⁹⁶

Mr. Lee conceded, however, that Momentum’s drive to improve its firm standards and internal policies in early 1999 was expressly undertaken in response to increased regulatory scrutiny:

Q: And how do you distinguish a guideline from a threshold?

¹²⁹¹ Id.

¹²⁹² Id.

¹²⁹³ Id. at 107.

¹²⁹⁴ Id. at 106–107.

¹²⁹⁵ Id. at 116.

¹²⁹⁶ Id. at 117. Mr. Lee testified that Momentum hired Mr. Cathriner simply because, as the firm grew in size, it became more cost effective to conduct branch examinations internally rather than outsourcing those functions to Ms. Ewton. Id. Under questioning, however, Mr. Lee agreed that Ms. Ewton still performs outside consulting work for Momentum and that Mr. Cathriner, Ms. Ewton and Ms. Cummins are collectively responsible for compliance matters at Momentum. Id. at 103.

A: One is more of an advisory where a—how do I distinguish between a guideline and a threshold? My terms, I guess. One, it's worked its way into the structure in the supervisory as a matter of policy of the firm, how we may modify our business. I think it's been more in a response to a great deal of scrutiny whether—

Q: From who?

A: I think it was in response to the proposed NASD rules.

Q: On risk disclosure and suitability or appropriateness?

A: Yes. Voluntarily.

Q: You mean your voluntary response to that—

A: Yes sir.¹²⁹⁷

Despite Mr. Lee's assertion that Mr. Cathriner's hiring did not reflect an acknowledgment of problems in the compliance structure prior to 1999, the evidence strongly suggests that Momentum recognized that regulatory scrutiny of day trading was increasing.

There is also considerable evidence that the firm determined that it must have the policies and standards in place to govern its growing day trading business. Ms. Ewton's examination of the Atlanta office shows that Momentum's management should have known that the firm did not have in place the kinds of internal controls that would allow for appropriate supervision of branch office personnel. In addition, Mr. Cathriner brought experience in branch office supervision that neither Mr. Lee nor Ms. Cummins possessed. During his deposition, Mr. Lee seemed to concede that, until Mr. Cathriner came on board in early 1999, Momentum lacked both adequate compliance policies and the managerial experience to implement those policies. In explaining the firm's decision to hire Mr. Cathriner, Mr. Lee stated as follows: "Bill Cathriner brought us some real experience * * *. So, he brought in some experience of branch office supervision, compliance checklists. *And once we developed policies, he's pretty good at executing those policies* * * *. So, if that's—his job was to, you know, raise the bar. * * *"¹²⁹⁸ While the Subcommittee believes it would have been better if Momentum had improved its compliance program earlier, the firm has nonetheless made great strides in this area and should be commended. It seems highly unlikely that Scott Webb would be allowed to day trade at Momentum today.

G. Momentum's Profitability Survey

In response to Subcommittee interrogatories requesting information about the profitability of Momentum's customers, the firm produced documents purporting to catalog, among other things, the success rates of its Texas day traders at the end of 1998.¹²⁹⁹ Mr. Lee and Momentum refer to the documents as the "Texas Facts."¹³⁰⁰ Though the Texas Facts is essentially a profitability study, Momentum has stressed repeatedly that it is not a "study" but rather a "survey" that is unscientific and not intended for pub-

¹²⁹⁷ Id. at 122.

¹²⁹⁸ Id. at 116 (emphasis added).

¹²⁹⁹ Feb. Hr'g Ex. 105.

¹³⁰⁰ Lee Dep. at 319; Momentum Securities, Inc., "Preliminary Results," Feb. 1999 ("Texas Facts") (Feb. Hr'g Ex. 123).

lic distribution.¹³⁰¹ Indeed, the Texas Facts bears a large bold legend stating “Not For Public Distribution” and includes the following disclaimer: “The following data is based on an unscientific survey of Momentum’s Texas customers. The data is un-audited and is not intended to be utilized for marketing or advertising purposes.”¹³⁰²

In tabulating the Texas Facts, Momentum basically reviewed the net profit and loss of 107 Momentum customers in Texas as of February 1999.¹³⁰³ The analysis purports to evaluate trading activity between September 1998 and January 1999 for both inexperienced traders—those in their first three months of day trading—and experienced traders—those who have traded at least five months.¹³⁰⁴ Mr. Lee testified that, “[w]e took a snapshot and then divided it on what we consider to be a reasonable learning curve.”¹³⁰⁵ The survey specifically references this learning curve, noting that “[t]hree to five months of diligent effort are often required before a customer can reasonably expect to become profitable, if at all.”¹³⁰⁶

The Texas Facts listed the following findings regarding the profitability of Momentum’s Texas customers during the relevant five month period:

- 56 percent of Momentum’s customers lost money during their first three months of trading and 44 percent were profitable during their first three months of trading;
- 36 percent of Momentum’s customers who had day traded longer than five months lost money from September 1998 to January 1999, and 64 percent of those same customers were profitable for that period;
- 70 percent of Momentum’s customers, as of February 1999, had been day trading at the firm for six months or longer; and
- there is a “an extremely high correlation between high profitability and high volume trading.”¹³⁰⁷

These conclusions are in some ways consistent with other profitability data that the Subcommittee reviewed during this investigation. For instance, the Subcommittee found that inexperienced day traders are consistently less successful than more experienced traders and that, without exception, a significant majority of new traders lose money. The similarities end there, however.

The profitability rates for both experienced and inexperienced day traders reported in the Texas Facts are considerably higher than the success rates generally reported in other studies. Though the Subcommittee has not subjected the Texas Facts to detailed scrutiny, there are several reasons to be skeptical about whether these profitability rates are representative of day traders as a whole. First, the Texas Facts only analyze the profitability of one day trading firm. Second, the Texas Facts only examines the profitability of Momentum’s Texas customers. It thereby excludes from the analysis the customers who day trade at four of Momentum’s ten offices. Although Mr. Lee opined in his deposition that he ex-

¹³⁰¹ Feb. Hr’g Ex. 123, at 2.

¹³⁰² Id.

¹³⁰³ Lee Dep. at 340. In his deposition, Mr. Lee explained that Momentum prepared the Texas Facts in response to anticipated public criticism by Texas securities regulators. Id. at 341. For that reason, Mr. Lee said that no other branch offices outside of Texas were included. Id.

¹³⁰⁴ Feb. Hr’g Ex. 123, at 2.

¹³⁰⁵ Lee Dep. at 339.

¹³⁰⁶ Feb. Hr’g Ex. 123, at 5 (emphasis in original).

¹³⁰⁷ Id. at 4–7 (emphasis omitted).

pected the results of the Texas Facts to be representative of both the overall firm and the day trading industry, he offered no data to support that estimation.¹³⁰⁸ In order to draw any meaningful picture of the success rates of Momentum's customers, it is critical to factor in the performance of the firm's customers in Atlanta, Irvine, Chicago and Milwaukee. Mr. Lee testified that he was not aware of any similar data on the profitability of Momentum's customers in those offices.¹³⁰⁹ Fourth, Momentum's reluctance to rely on this profitability data in public discussion and its advertising suggests that the firm lacks confidence in either its methodology or the representativeness of the sample.¹³¹⁰

The best method of obtaining a true sense of day trading profitability for any given sample is to evaluate the net profit and loss of all traders over a sustained period of time. In this respect, some of the best profitability data can be found in an analysis of how many day traders continued to trade actively in excess of six months after they commenced trading in their accounts. The Texas Facts do not claim to perform such an analysis. It does state that "70 percent of Momentum's Texas customers have been day trading for longer than six months—many for multiple years."¹³¹¹ Under examination, however, Mr. Lee conceded that this statistic does not address how many of Momentum's Texas customers lasted six months or longer:

Q: So, just so that I understand conceptually what you're talking about in this survey is if you—if the universe of Texas customers was a—was 10, just take that as an example, this statistic meant that 7 of those 10 customers on that given day had been at Momentum for the—for six months or longer at that day?

A. Yes, I believe so.

Q. It does not mean—that statistic does not mean that out of every—those ten accounts that are open on day one, seven of those accounts last six months?

A. No, sir.¹³¹²

Mr. Lee also testified that Momentum did not possess such data.¹³¹³ For all of these reasons, the Subcommittee believes that the Texas Facts—while certainly an additional piece of probative evidence on the profitability of day trading—is far too limited in its sample and scope to provide a meaningful evaluation of the general profitability of day trading.

H. The Role of Suitability in Day Trading

During his Subcommittee deposition, Mr. Lee made clear that Momentum philosophically opposes any regulatory requirement which requires day trading firms to deny potential customers the

¹³⁰⁸ Lee Dep. at 339.

¹³⁰⁹ Id. at 342.

¹³¹⁰ Momentum also acknowledged that the Texas Facts included profitability data for three remote traders who lived in Texas. Declaration of James William Lauderback, Vice President of Momentum Securities, Inc., Jan. 12, 2000 (Feb. Hr'g Ex. 124). This is potentially significant because Mr. Lee testified that he does not consider Momentum's remote traders to be day traders but rather the equivalent of an investor who invests on-line with an E*Trade or Schwabb account. Lee Dep. at 298–99.

¹³¹¹ Feb. Hr'g Ex. 123, at 4.

¹³¹² Lee Dep. at 346.

¹³¹³ Id.

ability to day trade because the strategy is inappropriate for the customer's financial condition or goals. For instance, in the fall of 1999, Momentum began providing its new day trading customers a disclosure document that summarizes the testimony of SEC Chairman Arthur Levitt from the Subcommittee's Overview Hearing on September 16, 1999.¹³¹⁴ Momentum asked its day trading customers to review Chairman Levitt's remarks and sign the form indicating that they had done so.¹³¹⁵ During his deposition, Mr. Lee was asked about several of Chairman Levitt's statements regarding the risks of day trading. While he agreed with those statements in general terms, Mr. Lee took issue with Chairman Levitt's remarks in several respects.¹³¹⁶

For instance, Mr. Lee agreed with Chairman Levitt's testimony that "[m]ost individual investors do not have the wealth, the time, or the temperament to make money and to sustain the devastating losses that day trading can bring."¹³¹⁷ Mr. Lee also initially agreed with Chairman Levitt's comment that "day traders should only risk money they can afford to lose."¹³¹⁸ However, Mr. Lee disagreed with Chairman Levitt's further statement that, "[day traders] should never use money they will need for daily living expenses, retirement, take out a second mortgage, or use their student loan money for day trading,"¹³¹⁹ He disputed Chairman Levitt's use of the word "never" since it suggested that a person who chooses to trade such funds should be prohibited from doing so.¹³²⁰ When pressed on the issue further, Mr. Lee conceded that, as a general business practice, he would not encourage people to day trade these types of funds.¹³²¹

Mr. Lee also took issue with Chairman Levitt's testimony that "[d]ay traders typically suffer severe financial losses in their first months of trading, and many never graduate to profit-making status."¹³²² He explained that, in his opinion, day traders do not "typically suffer severe financial—severe is a word I wouldn't use."¹³²³ Mr. Lee also disputed Chairman Levitt's statement that, "[d]ay trading strategies demand using the leverage of borrowed money to make profits. This is why many day traders lose all their money and may end up in debt as well."¹³²⁴ Though he agreed that "some" day traders lose money, Mr. Lee took issue with the word "many", responding that "[m]any day traders do not lose all their money. That's, in my opinion, inaccurate."¹³²⁵ Mr. Lee's discomfort with the word "many" seems particularly odd since Momentum's own profitability survey—if accurate—indicates that a majority of all new traders lose money during their first three months.

Mr. Lee's philosophical opposition to rules that limit access to day trading may explain why, under his leadership, ETA has publically opposed the new rule proposed by the NASD to require day

¹³¹⁴ Id. at 206–207.

¹³¹⁵ Momentum Securities, Inc., "SEC Commentary 'Day Trading: Your Dollars at Risk'", New Account Paperwork of Jeff Peterson, Sept. 24, 1999, at 2 (Feb. Hr'g Ex. 125).

¹³¹⁶ Lee Dep. at 207–21.

¹³¹⁷ Id. at 207–208.

¹³¹⁸ Id. at 209.

¹³¹⁹ Id. at 212.

¹³²⁰ Id. at 214–15, 216–17.

¹³²¹ Id. at 217–18.

¹³²² Id. at 208.

¹³²³ Id.

¹³²⁴ Id. at 220.

¹³²⁵ Id. 220–21.

trading firms to open new accounts only for those customers whose financial status suggests that they are “appropriate” or suitable for the practice.¹³²⁶ Even though ETA generally supports the newly proposed rule on risk disclosure, Mr. Lee publicly stated ETA’s opposition to the “appropriateness” or suitability rule in a letter to the SEC.¹³²⁷ He wrote that “ETA believes that [the appropriateness rule] is fatally flawed by assuming day trading is a form of recommended strategy. In fact, day trading is an approach to the market characterized by multiple trading strategies, one or more of which are chosen by the customer.”¹³²⁸

VI. SUGGESTED REFORMS AND REMEDIES

The Subcommittee submitted to the SEC comments specific rule changes, and recommendations to the National Association of Securities Dealers, Inc. (“NASD”) that it initiate two additional rule proposals regarding the day trading industry. The Subcommittee’s recommendations are based on the three day trading hearings held by the Subcommittee and the Subcommittee’s eight month investigation of the day trading industry. Set forth are (1) the Subcommittee’s understanding of the pending rule change proposals for day trading; (2) the Subcommittee’s suggested modifications to those rule change proposals; and (3) the Subcommittee’s recommendations to the NASD for two new rule proposals.

A. The New Rules Proposed by the NASD and NYSE are Helpful Remedies to Many of the Problems and Abuses That Were Identified in the Subcommittee’s Investigation

The NASD and the New York Stock Exchange (“NYSE”) recently submitted to the SEC proposed rule changes for day trading. Significantly, these rule changes address many of the problems that the Subcommittee identified in its investigation. The NASD proposed changes to the 2300 Series of the NASD Rules to include two additional rules: Rule 2360 requires firms to approve new accounts for day trading and disclose the risks of day trading; Rule 2361 specifies the language of the required risk disclosure that is to be given prior to account opening. The NYSE then filed with the SEC a proposed rule change to amend its margin requirements, as set forth in Rule 431, to change the margin standards for customers who engage “in a pattern of day trading.” Finally, the NASD filed a proposed rule change to its margin requirements, Rule 2520, substantially similar to the NYSE’s proposed amendment.

(1) *NASD Proposed Rules 2360 & 2361.* NASD Rules 2360 and 2361 require firms to determine whether a day trading strategy is appropriate for, and provide a detailed risk disclosure to, day trading customers prior to account opening. The NASD drafted Rules 2360 and 2361 to work in tandem in order to address the “unique investor protection concerns” raised by day trading. Those concerns include: day trading requires a significant amount of capital; day trading requires investors to possess a sophisticated understanding of markets and trading strategies; and, investors must be able to withstand significant risk.

¹³²⁶ Letter from James H. Lee, President of ETA, to Jonathan Katz, Secretary of the SEC, Oct. 11, 1999, at 3–4 (Feb. Hr’g Ex. 126).

¹³²⁷ *Id.*

¹³²⁸ *Id.* at 4.

(a) *NASD Proposed Rule 2360: “Approval Procedures for Day Trading Accounts.”*

NASD Proposed Rule 2360 requires firms that promote a day trading strategy¹³²⁹ to provide a detailed risk disclosure statement to all customers and specifically approve each customer’s account for a day trading strategy or, prior to account-opening, to obtain a written agreement from the customer that the customer does not intend to use the account for day trading. The rule prohibits the firm from approving a customer’s account for day trading if it does not have “reasonable grounds” to believe that a day trading strategy is appropriate for that customer and it has not prepared and maintained a record setting forth the basis for that determination. The rule provides certain criteria for a firm to consider in exercising “reasonable diligence” to determine whether to approve the account, including the customer’s financial situation, tax status, prior investment and trading experience, and investment objectives. In addition, if a customer submits to the firm a written agreement stating that the customer does not intend to engage in a day trading strategy, the firm may not rely on the agreement if the firm knows that the customer intends to pursue a day trading strategy. If a firm opens a customer account while relying on a written agreement that the customer will not engage in day trading, and the firm later learns that the customer is pursuing a day trading strategy in that account, the firm must approve the account for a day trading strategy within ten days of the date that the firm first learned that the customer was using the account for day trading. The substance of the risk disclosure required by Rule 2360 is set forth in Rule 2361.

(b) *NASD Proposed Rule 2361: “Day Trading Risk Disclosure Statement.”* Rule 2361(a) includes the following detailed risk disclosure for firms to provide verbatim to their customers pertaining to the risks associated with day trading:

- You should consider the following points before engaging in a day trading strategy. For purposes of this notice, a “day trading strategy” means a strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.
- Day trading can be extremely risky. Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses.
- Be cautious of claims of large profits from day trading. You should be wary of advertisements or other statements that emphasize the potential for large profits in day trad-

¹³²⁹ Under proposed Rule 2360(e), a “day-trading strategy” is “an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.”

ing. Day trading can also lead to large and immediate financial losses.

- Day trading requires knowledge of securities markets. Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.

- Day trading requires knowledge of a firm's operations. Under certain market conditions, you may find it difficult or impossible to liquidate a position quickly at a reasonable price. This can occur, for example, when the market for a stock suddenly drops, or if trading is halted due to recent news events or unusual trading activity. The more volatile a stock is, the greater the likelihood that problems may be encountered in executing a transaction. In addition to normal market risks, you may experience losses due to system failures.

- Day trading may result in your paying large commissions. Day trading may require you to trade your account aggressively, and you may pay commissions on each trade. The total daily commissions that you pay on your trades may add to your losses or significantly reduce your earnings.

- Day trading on margin or short selling may result in losses beyond your initial investment. When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day trading strategy also may lead to extraordinary losses, because you may have to purchase stock at a very high price in order to cover a short position.

If a firm does not wish to use the above risk disclosure, Rule 2361(b) provides an alternative. Under Section (b) of the rule, a firm may create an alternative risk disclosure statement that is "substantially similar" to the statement in Section (a) and must file the alternative statement with the NASD's advertising department for approval prior to use.

(2) *Amendments to NYSE Rule 431 and NASD Rule 2520 Governing Margin Requirements for Day Trading Accounts.* The NYSE and the NASD recently filed substantially similar amendments to their rules on margin requirements. The proposed amendments would "require that minimum levels of equity and margin be deposited and maintained in day trading accounts sufficient to support the risks associated with day trading activities." Both the NYSE and the NASD based their proposed amendments on recommendations made by a "an ad-hoc committee (the '431 Committee') [that] was formed to consider changes to the NYSE's and NASD's margin rules (NYSE Rule 431 and NASD Rule 2520, respectively)." Prior to making its recommendations, the 431 Committee formed a spe-

cial subcommittee to study the “risks associated with day trading in customer accounts.” In its rule amendment filing, the NASD stated that the amendments “will more appropriately protect the safety and soundness of member firms and ensure the overall financial well-being of the securities markets.”

The amendments change several provisions of the margin requirements for day trading. Under the amendments, “[w]henver day trading occurs in a customer’s account the special maintenance margin required for the day trades in equity securities shall be 25% of the cost of all the day trades made during the day.” In other words, under normal circumstances, customers day trading in margin accounts will be able to borrow funds intra-day at a 4:1 equity ratio. Under the existing rules, the special maintenance margin required for day trading is 50 percent of the cost of all trades made during the day, which allows day traders to borrow intra-day on a 2:1 equity ratio.

The proposed rule changes include special requirements for “Pattern Day Traders.”¹³³⁰ For example, a pattern day trader who generates a margin call will be limited to margin of two times the trader’s equity. Furthermore, if the day trader does not meet the special maintenance margin call within five days (currently seven) as required, then that customer will be limited to trading on a “cash available basis” for 90 days or until the call is met.

Under the proposed rule changes, pattern day traders would be subject to a minimum equity requirement of \$25,000 in the customer’s account at all times. The amendments raise the minimum equity requirements from \$2,000 to \$25,000 in order to “more appropriately address the additional risks inherent in leveraged day-trading [sic] activities and better ensure that customers cover any loss incurred in the account from the previous day prior to day trading.” Regarding the \$25,000 minimum, the proposed rules state that “[t]his minimum equity must be deposited in the account before such customer may continue day trading and must be maintained in the customer’s account at all times.”¹³³¹

Subcommittee staff spoke with officials from NASD Regulation, Inc. (“NASDR”) and the SEC concerning the \$25,000 minimum equity requirement. The staff sought to confirm that, as the plain language of the rules suggest, a day trader whose account drops below \$25,000 would then lose access to margin privileges altogether. During Subcommittee staff’s first discussion with NASDR officials regarding this proposal, the NASDR officials were unclear whether in that scenario the customer would forfeit the ability to trade on margin.¹³³² The SEC officials initially stated their belief

¹³³⁰ “Pattern Day Traders” are defined as “any customer who executes four (4) or more day trades within five (5) business days. However, if the number of day trades is 6% or less of total trades for the five (5) business day period, the customer will no longer be considered a pattern day trader and the special requirements under paragraph (f)(8)(B)(iv) of this Rule will not apply.” Proposed NYSE Rule 431(f)(8)(B)(ii). Proposed NASD Rule 2520(f)(8)(B)(ii)’s language, although substantially the same, differs slightly and adds the following to its definition:

In the event that the organization at which a customer seeks to open an account knows or has a reasonable basis to believe that the customer will engage in pattern day trading, then the special requirements under paragraph (f)(8)(B)(iv) of this Rule will apply. If a pattern day trader does not day trade for a 90 day period, the customer will no longer be considered a pattern day trader.

Proposed NASD Rule 2520(f)(8)(B)(ii).

¹³³¹ The NYSE rule change uses slightly different language but is substantively the same.

¹³³² Meeting with NASDR officials, Dec. 28, 1999.

that day traders would be prohibited from day trading on margin if their account equity dropped below \$25,000.¹³³³ NASDR subsequently contacted Subcommittee staff, however, and after discussing the scenario with NYSE officials, determined that a pattern day trader whose account dropped below \$25,000 in equity, would still have access to margin trading pursuant to Regulation T.¹³³⁴ In other words, the day trader could still buy and hold Securities on a 2:1 equity ratio. The NASDR officials pointed out, however, that a firm could not prevent a customer who buys stock from selling it. Thus, if persons choose to make day trades on margin with less than \$25,000 in their accounts, there is no mechanism to stop them. The NASDR officials further stated that a person who day trades on 2:1 margin with less than \$25,000 in his or her account would not violate the rule. An SEC official later informed the Subcommittee staff, however, that he understood that the rule was intended to prohibit day trading by customers with less than \$25,000 in their accounts. The SEC official indicated that no determination has yet been made as to how the rule could be changed to prevent a person from day trading in an account with less than the minimum on deposit.

Additional proposed changes include that “[f]unds deposited into a day trader’s account to meet the minimum equity or maintenance margin requirements of this Rule * * * cannot be withdrawn for a minimum of two business days following the close of business on the day of deposit.” The purpose of this amendment is to discourage the inter-customer lending to meet margin calls that has become so prevalent at day trading firms. The rationale behind the amendment is to increase the risk to the lending customer by requiring the borrowing customer to retain the borrowed funds in his or her account for two business days after the funds are deposited to satisfy the margin call. In so doing, the NASD and NYSE expect lending customers to be more cautious about the lending of funds to other customers since the money will be tied up for longer periods of time. Also, the amendments prohibit pattern day traders from using the guaranteed account provisions¹³³⁵ of the margin rule to meet the requirements of Section (f)(8)(B), including for minimum equity and margin maintenance purposes.

B. While These Proposals Are Useful Starting Points for a Discussion of Reform, the Subcommittee Recommends Several Modifications to the Proposed Rules

Although the proposed rules address many of the problems discovered during the Subcommittee’s investigation of the day trading industry, we believe that they need further modification to more fully address and resolve those problems. Most of the modifications that we recommend are premised on two factual findings, both of which are derived from a thorough review of the evidence gathered by the Subcommittee. The first finding is that possessing “adequate risk capital” is the single most determinative factor in the success or failure of the average day trader. Second, under current market

¹³³³ Meeting with SEC officials, Dec. 17, 1999.

¹³³⁴ Telephone Conversation with NASDR official, Feb. 4, 2000.

¹³³⁵ The Guarantee Provisions permit traders to consolidate their accounts with those of other traders for purposes of determining the amount of margin that is due. NYSE Rule 431(f)(4). These are often referred to as “cross-guarantees.”

conditions, \$50,000 of risk capital is a “limiting minimum” below which day traders significantly impair their chances of success.

During the Subcommittee’s investigation, industry leaders agreed that a day trader’s chance of success is directly and proportionally related to the amount of capital with which a person starts trading. For example, All-Tech Direct, Inc.’s (“All-Tech”) President, Mark Shefts, and Senior Vice President of Operations, Harry Lefkowitz, both said that the amount of capital a person has to trade is directly related to the trader’s likelihood of success.¹³³⁶ The more risk capital, the greater one’s chance of profitability.¹³³⁷ Mr. Shefts told Subcommittee staff that, if you trade with less than \$100,000, your chance of success decreases because you cannot make as much with less.¹³³⁸ All-Tech’s Chief Executive Officer, Harvey Houtkin, testified similarly: “I think a day trader, an active day trader, should have \$100,000 on deposit. * * *”¹³³⁹ Indeed, in his 1999 book, *Secrets of the SOES Bandit*, Mr. Houtkin wrote as follows:

Before the market was booming to new, record-setting highs every other day and stock prices were uniformly lower, you could have had success trading with \$50,000 on margin. Today, probably \$150,000 is the most advantageous amount of capital for trading, \$100,000 is adequate, and \$50,000 is a limiting minimum.¹³⁴⁰

Thus, according to Mr. Houtkin, a day trader should ideally have at least \$150,000 of risk capital, with \$50,000 as an absolute minimum.

Cornerstone Securities Corporation (“Cornerstone”) requires \$50,000 in minimum capital for day trading.¹³⁴¹ In response to Subcommittee interrogatories, Cornerstone acknowledged that “[t]he establishment of an adequate minimum beginning equity for an account is an appropriate component of policies designed to ensure that day trading is an appropriate strategy for specific customers.”¹³⁴² Cornerstone stated its considered view that the beginning equity of a day trader is the most important factor in determining a trader’s likelihood of success or failure:

Cornerstone’s experience is that a person’s beginning equity capital corresponds more directly to success or failure as a professional day trader than the person’s income or general net worth. A person who wants to begin a career as a professional trader must have significant equity capital, that the person can place entirely at risk. A professional trader must be able to withstand some losses and still have the financial capacity to trade securities. There-

¹³³⁶ Lefkowitz Int. at 2; Shefts Int. at 8.

¹³³⁷ Lefkowitz Int. at 2.

¹³³⁸ Shefts Int. at 8.

¹³³⁹ Houtkin Dep. at 182. Despite Mr. Houtkin’s belief that \$50,000 “is a limiting minimum” for day trading success, All-Tech recently lowered its minimum account opening standards from \$50,000 to \$25,000 in response to competitive pressures from other day trading firms with lower standards. Id. at 187–88; Shefts Int. at 8; Lefkowitz Int. at 2.

¹³⁴⁰ Harvey I. Houtkin and David Waldman, *Secrets of the SOES Bandit* at 42 (1999) (emphasis added). Mr. Houtkin stated that those “sums are based on the availability of margin under Regulation T of the Federal Reserve Board.” Id. In reality, however, Subcommittee staff found that day traders regularly trade using well beyond a 2:1 margin ratio, thereby generating margin calls that they often cannot meet without obtaining loans from other customers.

¹³⁴¹ Apparently, the minimum capital determination at Cornerstone is made by the individual branch managers. Letter from Joan C. Waller, Counsel for Cornerstone, to Joseph M. Gonzales III, Investigator for the Texas State Securities Board, Oct. 26, 1999, at 1.

¹³⁴² Id. at 2.

fore, Cornerstone places more emphasis in sufficient opening account equity than on income or general net worth.¹³⁴³

(1) *Recommended Modification of Rule 2360.* Although Rule 2360 makes significant strides to ensure that firms will determine the suitability of day trading for their customers before opening an account, we believe that the rule should be strengthened. The proposed rule provides certain criteria for firms to evaluate when determining whether day trading is appropriate for a prospective customer, but it does not place a priority on any particular factor. In other words, a day trading firm is required to consider income, tax status, net worth, and experience among several factors. As a result, firms could justify opening a day trading account for a customer who has insufficient risk capital to have any reasonable chance of success by simply citing other factors like high income or investment experience, factors which the Subcommittee's investigation determined were relevant but not as predictive of success or failure as available risk capital.

The Subcommittee recommends the addition of a "rebuttable presumption" to Rule 2360, such that a firm must initially presume that a day trading customer who does not have \$50,000 with which to open the account is inappropriate for day trading. This presumption could be overcome, however, by other factors that the firm concludes outweigh the inadequate risk capital. If the firm determines that day trading is an appropriate strategy for the customer who does not possess \$50,000, the firm would be required to prepare and maintain a record setting forth the reasons that it deemed that customer to be appropriate for day trading. Thus, the proposed rule would still vest day trading firms with the discretion to open accounts for customers who have less than the \$50,000 minimum, but it would require the firm to examine more closely whether the prospective customer is truly appropriate for a risky day trading strategy.

(2) *Recommended Modification of Rule 2361.* The Subcommittee believes that Rule 2361 is extremely helpful for informing potential customers of the significant risks of day trading. It is especially significant that the rule requires firms to provide the risk disclosure to potential customers prior to account opening. The Subcommittee recommends an added disclosure, however, for potential customers who do not possess \$50,000 of risk capital to open the account. If a firm deemed a potential customer with less than \$50,000 appropriate for day trading under Rule 2360, then Rule 2361 would require the firm to provide that customer with a separate and additional risk disclosure form. The form would state that day trading with less than \$50,000 of risk capital substantially diminishes a person's chances of profitability. The firm would then be required to obtain the customer's signature on that form to acknowledge that the customer has read the added disclosure. This would give notice to potential customers who lack adequate trading capital that they will be trading at a significant disadvantage. In doing so,

¹³⁴³ Letter from Joan Conway Waller, Counsel for Cornerstone Securities, Inc., to K. Lee Blalack, II, Chief Counsel & Staff Director to Subcommittee, Nov. 15, 1999, at 4 (emphasis added).

Rule 2361 should encourage a more informed decision by the day trader about whether to pursue the opening of an account.

In addition, the Subcommittee believes that the risk disclosure should include a stronger warning concerning the significant commission fees that day traders pay before earning one cent of profit. Through its investigation, the Subcommittee found that, 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. This figure is based on the fact that day traders paid approximately \$16 per trade at the fifteen firms examined in this investigation. These firms estimated—in the aggregate—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. Moreover, at our most recent day trading hearing, the SEC released a report that included a study of average commission costs and related fees under three scenarios called low, medium and high fee structures. The SEC's report concluded that day traders in a medium fee structure must generate \$16,850 each month to break even and recoup the costs of commissions and fees. Under that scenario, a day trader would have to make \$202,200 per year day trading before making any profit.

In light of these astounding figures, the Subcommittee believes that the risk disclosure in proposed Rule 2361 should state that there is substantial evidence that most day traders will need to generate at least \$100,000 per year just to cover commission costs and trading fees.

(3) *Modification of NYSE Rule 431 and NASD Rule 2520 Amendments.* The Subcommittee believes that the proposed amendments to the margin rules were designed primarily to protect the securities firms rather than investors. It is true, however, that the proposed amendments could have an incidental benefit for investor protection. In that regard, we find the proposed amendments to be helpful reforms that will have the ancillary result of stopping some of the more troubling practices discovered during the Subcommittee's investigation. The Subcommittee recommends, however, that the proposed \$25,000 minimum equity requirement be raised to \$50,000. Thus, customers would be required to maintain at least \$50,000 of equity in their accounts at all times if they wish to day trade on margin. If, at the end of the trading day, the equity in a customer's account is less than \$50,000, then, unlike the currently proposed minimum, the customer would not be allowed to day trade on margin the next day. In other words, a day trader with less than \$50,000 on deposit would not be permitted to make new purchases on margin until that person's account equity returned to \$50,000. This standard is not meant to interfere in any way with the operation and/or timing of margin calls.

It is not at all clear to us how the NYSE selected the \$25,000 figure it proposed. Because the evidence is strong that \$50,000 is a limiting minimum for day trading success, margin requirements should reflect that seminal standard. It is important to note, however, that customers with less than \$50,000 in their account could still day trade in a margin account on a cash available basis. The Subcommittee's proposal would simply deny the continuation of le-

veraged trading until the customer raised the equity in his or her account to the \$50,000 minimum standard.

Furthermore, the Subcommittee does not support the amendments' recommended margin increase to a 4:1 equity ratio. It is the Subcommittee's belief, based on the evidence that was collected during the Subcommittee's investigation and hearings, that providing day traders with even more leverage than under the current rules will only increase the risk of day trading for customers, as well as for the firms. Day trading customers already stand to lose far more money than the funds they deposited. The Subcommittee's hearings showed that a large number of day traders do not even have sufficient capital to meet their margin calls—rather, they borrow funds to meet those calls. It is counterintuitive to provide those customers with a significantly higher amount of leverage that could substantially add to their losses. Thus, the Subcommittee strongly opposes the increase of day trading margin to a 4:1 equity ratio.

(4) *The NASD Should Propose a Rule Prohibiting Firms from Arranging Loans Between Customers to Meet Margin Calls.* The Subcommittee recommends that the NASD propose a new rule to prohibit firms from arranging loans between customers to meet margin calls, which the Subcommittee's investigation found was a common practice at day trading firms. The Subcommittee learned that day trading firms affirmatively arrange loans among customers so that day traders can meet margin calls and continue to trade. For example, All-Tech's former San Diego branch manager, Barry Parish, admitted to Subcommittee staff that he helped customers to find others who would loan them funds to meet margin calls.¹³⁴⁴ One former San Diego customer told the Subcommittee staff that Mr. Parish acted as a "middleman" to arrange loans. That customer also said that Mr. Parish sometimes called out to the trading room to see if anyone could loan another customer money. Former San Diego customer, Carmen Margala, informed the Subcommittee staff that some of the loans Mr. Parish solicited were for customers in other branch offices. According to Ms. Margala, Mr. Parish occasionally approached individual customers and told them how much they had in their accounts, and asked them to make specific loans to others. Ms. Margala recalled an incident in which Mr. Parish solicited customers to lend \$100,000 to another day trader. Another former San Diego customer allowed Mr. Parish to use her account to make loans on a routine basis. Mr. Parish admitted that he had customer accounts available to him for the purposes of lending funds to customers to meet margin calls.¹³⁴⁵ In addition, a customer of All-Tech's Beaverton, Oregon office told Subcommittee staff that the branch manager frequently arranged loans for her when she had margin calls. That customer said that she never knew which particular customer loaned her money.

Likewise, Momentum employees arranged loans between customers despite the firm's claim that it remains passive in the lending process. A Momentum branch manager specifically told Subcommittee staff that he informs customers with margin calls that they may obtain loans from customers at other branch offices.¹³⁴⁶ One of the accounts examined by Subcommittee staff was used to

¹³⁴⁴ Deposition of Barry Parish, Nov. 30, 1999, at 94 ("Parish Dep.").

¹³⁴⁵ Parish Dep. at 95–96.

¹³⁴⁶ Interview of Justin Hoehn, Dec. 21, 1999, at 2 ("Hoehn Int.").

loan almost \$10,000,000 to 52 Momentum customers in the span of a single month. At Providential, the Los Angeles, California branch manager informed Subcommittee staff that his partner opened a Providential account for the sole purpose of lending funds to customers to meet margin calls.¹³⁴⁷

Similarly, Subcommittee staff asked Cornerstone officials to describe the firm's procedures relating to customer-to-customer loans to meet margin calls. In a letter dated November 15, 1999, Cornerstone stated that it "believed" many customers loaned money to one another to meet margin calls, but that Cornerstone played an essentially passive role in the lending process. For example, Cornerstone said that it "suggested" to customers who made such loans that they obtain a signed promissory note from other customers who borrowed the funds. Cornerstone officials told Subcommittee staff that certain branch offices provided such notes as a "courtesy" to their customers. Cornerstone discontinued the practice of permitting customers to borrow funds from one another in August 1999.

Subcommittee staff also obtained information, however, regarding customer lending activities at Cornerstone's Houston, Texas office suggesting that the firm actively promoted these loans rather than simply providing promissory notes to lenders as a "courtesy." Subcommittee staff obtained account records for five former day trading clients of Cornerstone's Houston office, and found that each of these clients signed multiple promissory notes shortly after they opened their accounts. For example, one customer signed fourteen different promissory notes several weeks after he opened his account in early April 1999. Each of these promissory notes authorized the customer to borrow \$5 million to meet margin calls. The promissory notes also identified fourteen separate lenders for these funds. In addition, Subcommittee staff interviewed a former Cornerstone client who said that the Houston office's former assistant branch manager asked her to sign promissory notes when she received her first day trading margin call.

These lending programs effectively undermine the margin requirements and could likewise evade the purpose of the proposed minimum equity requirements. The Subcommittee believes it is a significant conflict of interest for firms to arrange loans for their customers, because the firms are dependent on commission revenue generated by the day traders who are allowed to continue trading through use of these lending programs. Our proposed rule would not impinge on a firm's ability to perform the purely ministerial tasks associated with lending between customers, such as making journal transfers at the customers' behest. There is nothing inherently improper about customers negotiating agreements between themselves to provide short-term credit to cover a margin call or any other legal activity. It would, however, prohibit firms from supplying lenders to those in need of funds, asking customers to lend funds to other customers, and other similar activities that could be reasonably construed as "arranging" loans.

(5) *The NASD Should Propose a New Rule Regarding Day Traders Who Act As Investment Advisers.* The Subcommittee recommends that the NASD propose a rule requiring member firms to do the following before allowing a day trader to exercise discre-

¹³⁴⁷ Interview of Tae Goo Moon, Dec. 9, 1999, at 7 ("Moon Int.").

tionary trading authority over another customer's account for compensation: (1) determine whether the trader's proposed activities at that firm alone would require the trader to register as an investment adviser, or whether the trader would qualify for an exemption from registration; and (2) if registration would be required, verify that the trader is registered with the appropriate regulatory body.

The Subcommittee learned during this investigation that most firms have no policies in place to determine whether day traders who trade the accounts of others for compensation are properly registered as investment advisers, where required by law. The most egregious example Subcommittee staff found was at Providential, where unregistered trader, Huan Van Cao, traded the accounts of at least twenty customers in apparent violation of Texas and California securities laws, and generated significant losses and commission charges in their accounts.¹³⁴⁸ For example, Mr. Cao convinced a part-time sales clerk, Amy Le, to permit him to day trade her life savings and, in the process, generated about \$35,000 of losses and commission charges in her account over eight weeks.¹³⁴⁹ Ms. Le said that Mr. Cao told her that he could guarantee a twenty percent investment return for his clients, and that he was a registered broker, attorney, and former government auditor who examined broker-dealers.¹³⁵⁰ Subcommittee staff have determined that these were all false statements.¹³⁵¹

Some firms, such as All-Tech, require day traders to sign a form affirming that the trader is currently registered as an investment adviser if he or she will have discretionary trading authority over another customer's account. While that is a step in the right direction, All-Tech does not require the trader to prove that he is registered, and the firm takes no independent steps to verify registration. Summit Trading, on the other hand, has a commendable policy that requires each person seeking to trade other people's money for compensation to submit proof that he or she is registered as an investment adviser unless exempt from registration. The Subcommittee believes Summit Trading's policy is a best practice that should be implemented for the day trading industry as a whole.

VII. CONCLUSION

The Subcommittee's eight month investigation found many disturbing business practices by day trading firms, some of which appear to be even criminal. Securities regulators will need to devote more resources and scrutiny to policing this growing industry. Until new reforms are adopted for the day trading industry, however, regulators will not be able to stop the most troubling abuses by day trading firms relating to risk disclosure, suitability, and improper lending to encourage trading beyond a customer's means.

Ultimately, however, the leading day trading firms must do more to clean up their own industry. As explained above, the technology of day trading has prompted several positive developments for the markets and the average investor. Yet, the marketing and pro-

¹³⁴⁸ Mr. Cao claimed to have day traded for twenty-one or twenty-two customers. Cao Dep. at 136.

¹³⁴⁹ Le Int. at 2, 6.

¹³⁵⁰ Id.

¹³⁵¹ For example, Texas and California Securities regulators and NASDR have no listing of Mr. Cao as a registered broker-dealer. Mr. Cao also told Subcommittee staff that he is not a licensed broker or registered representative in the Securities industry. Cao Dep. at 51.

motion of a strategy predicated upon short-term, high volume trading necessarily implicates speculation and, for some customers, outright gambling. Given the poor profitability rates for most day traders, it is therefore imperative that day trading firms take all reasonable steps to ensure that their prospective customers appreciate the risks of this speculative strategy. Even more important, it is critical that day trading firms discourage the opening of day trading accounts for customers who do not possess the financial means or goals to suitably pursue day trading as a career. It is a promising development that some of the leading day trading firms have recently taken steps in this direction. However, prompt adoption of new regulations to set uniform rules for the entire industry is clearly needed. This staff report sets forth a comprehensive factual record in support of a new regulatory framework for day trading.

The following Senators, who are members of the Permanent Subcommittee on Investigations, have approved this report:

SUSAN M. COLLINS.
 WILLIAM V. ROTH, Jr.
 TED STEVENS.
 GEORGE V. VOINOVICH.
 PETE V. DOMENICI.
 THAD COCHRAN.
 CARL LEVIN.
 DANIEL AKAKA.
 RICHARD DURBIN.
 MAX CLELAND.
 JOHN EDWARDS.

Other Senators, who are Members of the Committee on Governmental Affairs, approving this report are:

JUDD GREGG.

