NASAA

March 10, 1999

The Honorable John D. Dingell
Ranking Member
Committee on Commerce

The Honorable Ron Klink
Ranking Member
Subcommittee on Oversight and Investigations

The Honorable Edolphus Towns
Ranking Member
Subcommittee on Finance and Hazardous Materials

The Honorable Edward J. Markey
Ranking Member
Subcommittee on Telecommunications, Trade, and Consumer Protection

Dear Congressmen Dingell, Klink, Towns, and Markey:

Thank you for your letter of February 4, 1999, requesting information on the activities of state securities regulators with respect to online investing and day trading. In the United States, the North American Securities Administrators Association, Inc. ("NASAA") is the umbrella group representing the securities administrators of the fifty states, the District of Columbia and Puerto Rico.[1] As co-regulators of the securities industry with the Securities and Exchange Commission ("SEC"), state securities regulators have concerns regarding both online investing and day trading. The mandate of state securities commissions and agencies is investor protection. Aspects of both online investing and day trading invoke investor protection concerns.

At the outset, NASAA believes that a distinction must be drawn between online investing and day trading. Too often the news media use these descriptors interchangeably, when in fact they are distinct market segments although some commonality may exist. Definitions of these terms are of course not included in the securities laws, regulations or orders and sometimes the two areas may blur together.

When NASAA refers to day trading, the activity that is implicated is primarily the trading of equities based upon market movement or differentials in the quotes of market makers, by

[1] Other NASAA members include the Canadian Provinces and Territories and Mexico.

which a day trader buys and sells securities in a very short time frame. The trades are often done rapid fire, buying and selling the same security within several minutes with the goal of making a small gain in the transaction. To profit as a day trader, the participant must do numerous trades per day or do a large volume per matched, buy and sell, transaction. A day trader does not look to make a profit from a big price swing, but rather multiples of small price swings.

An important aspect of day trading is that the traders have direct access to the markets where they place their trades. Direct access is often in the form of both market information and execution. Day traders customarily have access to in-depth market information, including all broker-dealers' bid and ask quotations. This enables the traders to identify securities where the bid and offer price differential for a security presents the potential for doing a quick trade and receiving a small gain. Direct access to the markets in the sense of execution gives the day trader the ability to execute trades immediately at known prices. Immediate execution in day trading is of paramount importance for a day trader to lock in their small gains, often just pennies per share. Immediate execution also gives day traders the capability to focus on market momentum and ride an upward movement in price, knowing they have the ability to get out of the market quickly at a known price.

Day trading is usually done at day trading firm locations using computer equipment supplied by the firms. Another unique aspect of day trading is that the firms often provide training programs to teach customers how to day trade. Day trading is analogous to professional trading, i.e. portfolio managers or broker-dealer firm trading personnel, but day traders are risking their own capital, instead of the firm's or investors in a portfolio, and are often not securities professionals.

On-line investing or trading is different than day trading. On-line trading is generally the term used for more traditional brokerage arrangements between customer and firm but with using a different communication medium. For the most part, on-line trading is similar to traditional discount brokerage services, with trades being taken over the Internet. Investors access brokerage firm Web sites and submit orders to the firm electronically. Those orders are then processed through the firm's order routing systems for execution. The transaction is completed without assistance from a registered representative. The elimination of the registered representative has led to the tremendous reduction in commission fees over the past several years. On-line trading is normally done through one's own personal computer and not at a central location.

The distinctions between the two activities, day trading and on-line trading, implicate different securities law issues. Whereas the day trader has direct access to the market, on-line traders process their transactions through their broker-dealer firms. Execution for on-line traders is not assured at a particular price, unless it is a limit order. On-line investors have access to current market information, but usually not to the extent that day traders have. By having direct market access, day traders can see the quote montage, that is all the bid and ask quotes for the market from all broker-dealers firms. On-line traders generally have access to the last trade information and probably the best bid and best ask price, but usually not all bid and ask prices in the quote montage. Also, day trading is not investing at all, but rather it is playing the market by numbers and momentum. On-line investors may buy and sell the security within the same day or within a short time frame, hence doing a day trade, but they are not doing so with the same information that a day trader has access to at a day trading firm.

*Day Trading*

NASAA does not take a position that day trading should be disallowed or permitted. That being said, state securities agencies have found significant problems at some firms that are part of the day trading industry. To address these and other issues, NASAA has strived to educate the public on the risks of day trading and has formed a project group to investigate the policies and regulation of the day trading industry.

Last fall, following several enforcement actions by the states of Massachusetts and Texas, NASAA issued a press release cautioning investors about the day trading "craze" and pointed out that day trading is extremely risky and a strategy only for people with the right temperament and money they can afford to lose. The release was picked up by both the Associated Press and Reuters wire services. In turn, it prompted follow up coverage by literally dozens of print and broadcast outlets, including: Dow Jones, *The Wall Street Journal*, CBS News, Marketplace Radio, National Public Radio, *BusinessWeek*, *Fortune*, CNBC, NBC News, the BBC. (Exhibit A)

The project group arose out of inquiries that the Pennsylvania Securities Commission made to other state regulators in early 1998. The Pennsylvania Securities Commission noted an increase in its jurisdiction of advertisements for day trading firms. Another issue that piqued the interest of the Pennsylvania Securities Commission was firm registration as broker-dealers. The firms while not identified as day trading firms had some unusual characteristics in their applications. At that time state regulators had not experienced a large increase in customer complaints and still have not. Regulatory issues and deceptive marketing have driven the issue at the state level.

In response to the Pennsylvania inquiries multi-state conference calls commenced to discuss the growth in the industry and focus on areas of concern. Several states began investigating day trading firms. In late 1998, NASAA formed a project group to look into these entities. The project group is chaired by David Shellenberger (Massachusetts Division of Securities) with Jay Cassidy (Colorado Division of Securities), Jerel Hopkins (Pennsylvania Securities Commission), and Joel Sayer (Texas Securities Board) also serving as members. The NASAA Board of Directors charged the project group to:

- Work with the NASD, SEC and exchanges on coordination of examinations and enforcement actions where appropriate.
- Detail abusive practices and advise states on state security laws implications.
- Assist states with expertise in enforcement analysis.
- Gather statistics on how widespread problems are in this segment of the industry and coordinate efforts.

To accomplish these tasks, the project group has outlined a plan to issue an internal report identifying day trading firms; analyzing issues presented by the day trading industry; analyzing profitability of customer accounts; and including a bibliography of books and articles. In addition to the report, the project group plans to create a guide for state regulators to assist in licensing day trading firms, conducting examinations, and investigating and prosecuting cases. As this material becomes available, NASAA will be happy to forward to you all non-confidential materials. The project group, individual states and NASAA have all been in contact with NASD Regulation and the Securities and Exchange Commission to exchange information.

State regulators have developed a list of issues and problems associated with day trading firms. However, it should be made clear that not all day trading firms exhibit all or some of these characteristics, but additional issues arise as state examination of these firms continue. In general the following are the concerns of state regulators with the day trading industry:

- Deceptive Marketing

  Day trading firms advertise to attract customers/traders. The advertisements emphasize the potential for gain and have little or no disclosures regarding risk. State securities regulators are concerned that the claims in advertising are not typical of an average or good day trader and are therefore misleading.

- Suitability

  In the most typical application, a broker's duty to determine "suitability" is keyed to a recommendation to a customer to buy or sell. If there is no recommendation, there is no requirement that a broker make efforts as to suitability. As a result, "discount broker," "on line trading" and "day trading" transactions, all usually placed pursuant to orders made by the customer without broker recommendation, do not seem to fall within classic suitability determination requirements.

  Closer scrutiny may at least raise some more subtle suitability questions. If a day trading firm teaches a particular strategy, could this be construed as a "recommendation" within the intent of the suitability rules, giving rise to a higher duty on the brokerage firm? What about the circumstance where the brokerage posts in the trading room each morning for all trader/customers to see a list of stocks projected to be active that day? What if the branch manager comes by and offers a little assistance to a customer whom seems to be faring poorly?

  In addition to consideration of whether current suitability rules apply, there is the broader question of whether some standard ought to be set for such firms to require some form of suitability or appropriateness review for customers. Suitability issues are two-pronged.

  First, do day trading firms make a determination of the suitability of this high risk trading strategy for their new customers/traders? Day trading is highly speculative and is not a suitable strategy for most Americans to invest or profit from the equities market. Day trading can lead to material losses in a very short time frame and a participant should be in a financial position to incur large losses.

Day traders, while not having to be financially literate, must have deep pockets. NASAA believes that many day trading firms do not screen new customers appropriately and that people enter the business without the necessary assets to weather early and often significant losses.

Suitability issues also arise after an individual enters the business. Does a day trading firm have any obligation to monitor their traders' accounts for suitability? Although, traditional suitability concerns of whether an investment is a proper one for a client probably do not apply, NASAA believes that suitability may arise in monitoring the traders' account status. Specifically, ascertaining the positions the trader is exposed to, both at the end of the trading day and during the day.

- Unregistered Securities Agent Activities

  NASAA also has concerns regarding the status of the day traders. The day trading firms take the position that the individual traders do not have to register as broker-dealer agents with the state securities agencies. Although these individuals are supposedly trading for their own accounts or for the broker-dealer firm account, there are reports that some may be trading for the accounts of others. If they are trading other people's money, broker-dealer agent registration is almost certainly triggered. Even if they are just trading for their own accounts, certain circumstances may implicate agent registration as well.

- Unregistered Investment Advisory Activities

  Investment adviser registration may also be implicated in several circumstances. One such scenario is if the day trader is trading for an account that consists of pooled money from other investors. Depending on the account parameters, the trader may have to be licensed as an investment adviser. Another investment adviser issue arises as to the advice or trading programs the day trading firms administer. How detailed are the advice and training programs of the day trading firms? Are specific recommendations given and to what extent? In most cases, registration issues would depend on the facts and circumstances; however, it appears to NASAA that the day trading firms could structure their enterprises to avoid these potential problems if they so desired.

- Loans and other lending activities

  Through examination of day trading firms, state securities agencies have identified instances of firm to customer loans and firm principal or related entity to customer loans. NASAA is concerned that these loans may not be fairly negotiated and that they may permit day traders to lose larger amounts of money than they can afford to lose. Additionally, NASAA has heard reports that day traders lend each other funds to cover capital requirements at the end of the day. The effect being that the accounts are within capital requirements established by regulators, but violate the spirit of the regulation.

- Margin

  Day traders often take big positions, albeit for a short time period, in the securities they are trading. To facilitate taking big positions, the day trading firms permit the day traders to trade on margin, thus only having to have a small percentage of the actual position in the account. It appears that the firms are extending customers' margin in amounts that are multiples of normal brokerage practices. Federal Reserve Regulation T requirements cap margin at 1.5 times a retail customers securities, day trading firms are extending margin to their day traders at up to 10 to 1. It is NASAA's understanding that the firms can be within the law but evade the spirit of Regulation T by closing all or most of their positions by the end of the day. So intra-day margin may be in excess of Regulation T requirements, but when the markets close they fall within the regulation. Extending margin in high multiples raises several potential risks; including the risk of firms becoming insolvent, customers losing amounts in multiples of their cash on hand, and effecting the trading of individual securities disproportionately.

- SIPC coverage

  SIPC protects customer investments when a broker-dealer firm declares bankruptcy. It does not however insure against loss in accounts. With day trading firms extending relatively high margin to day traders, NASAA believes that there is the potential of an increased risk of insolvency for day trading firms as compared to traditional brokerage firms. Are customer funds protected if a day trading firm declares bankruptcy? Does SIPC protection only apply to day traders accounts if the accounts are in the trader's name, or will it attach if the day trader's funds are part of the firm's account?

- Record keeping

  How are day traders accounts maintained at the firm? Are they part of the firm's account or are there individual accounts for each day trader. How does the firm keep track of trader positions and does it maintain records of all trades done in the account? Does the firm keep other required books and records?

- Failure to supervise

  Does the day trading firm have supervisory requirements over its traders? Are safeguards in place to prevent traders from over extending themselves or putting the firm in jeopardy by placing trades that the trader can not cover? Do day trading firms owe any duties to the traders to review their accounts on a daily or periodic basis? If the trader commits violations of the securities laws, what responsibility does the firm have to prevent or discover the violations? The relationship between the day trading firm and trader needs to be more clearly defined and firm responsibilities should be established. NASAA believes that day trading firms do have supervisory responsibility, to what extent is still an open issue. At a minimum, the firm should be responsible to monitor trading positions and leverage to prevent a trader from jeopardizing the firm in its entirety. Additionally, the firm should supervise the traders to monitor compliance issues and to prevent legal violations.

- Day Trading firm organizational structure

  For the most part, organizational structure in the day trading industry follows one of two models. One structure is the day traders have accounts at the firm and it is similar to a traditional brokerage account. The money that a trader starts off with is in his or her own account and they trade through the day trading firm and not for the firm's own account. In the other organizational structure the traders are owners of the firm. The money that they put up to day trade is deposited into the firm's account and they in essence become part owners of the firm. Trades are made for the firm's account and then segregated for each trader. This second organizational structure seems to be the minority approach.

  Generally, it appears that if the firm is an NASD member firm, the structure is the more traditional model. State investigations have found the ownership structure to be associated with firms that are members of other SROs, specifically the Philadelphia Stock Exchange.

- Clearing Firms

  Since most day trading firms do not have the ability to clear their own trades, they contract with a clearing firm to handle clearing and settlement. What responsibilities does the clearing firm have with respect to the day trading firms capital? With the firm's customers trading at multiples of traditional leverage arrangements there would appear to be a risk that the day trading firms do not maintain adequate capital. If they are undercapitalized, what risk does the clearing firm take on behalf of the day trading firms and are these risks unreasonable.

- Training Programs

  One of the lures of some day trading firms is their offer to train the novice trader. These training programs usually cost in the thousands of dollars. Thus the day trading firm is assured of making money on all of its traders, regardless of their success. Some firms will refund the training costs to traders if they stay at the firm long enough to generate significant trading commissions. How effective are the trading programs and as noted above, do they trigger investment adviser registration? Another concern of state regulators is the viability of the trading programs. Can traders actually implement the programs in the marketplace?

As your letter indicates, several states have taken action against day trading firms for alleged violations of state securities laws. Below are summaries of state day trading actions. As this letter is transmitted, several other states are beginning investigations in addition to some ongoing investigations. Additionally, NASAA has attached a couple of state complaints as exhibits.

Colorado

*Generic Trading Associates, LLC and Generic Trading of Philadelphia, LLC*

On May 27, 1998, the Colorado Securities Commissioner issued orders granting Colorado broker-dealer licenses to the above exchange member day trading firms, imposing conditions on their operations. The firms were required to institute internal policies and procedures to limit traders to using only their own funds to trade, and not anyone else's money. Individual traders were required to obtain Colorado sales representative licenses, and to file affidavits with the Commissioner in which they averred they were utilizing only their own money to day trade. The firms were also required to file advertising with the Commissioner for a year.

*Bright Trading, Inc.*

On September 22, 1998, the Securities Commissioner issued the last in a series of orders under which Bright Trading, and exchange member day trading firm, was licensed as a Colorado broker-dealer, with limitations and conditions imposed. The firm was required to institute internal policies and procedures to limit traders to using only their own funds to trade, and not anyone else's money. Individual traders were required to obtain Colorado sales representative licenses, and to file affidavits with the Commissioner in which they averred they were utilizing only their own money to day trade. The firm was also required to file its advertising with the Commissioner for a year.

Indiana

*Self Trading Securities, Inc.*

On February 16, 1999, the Indiana Securities Division summarily suspended the broker-dealer license of this Texas based day trading firm with an office in Fort Wayne, Indiana. The summary suspension order was entered following the filing of an administrative complaint against the firm.

In the administrative complaint, the Indiana Securities Division alleged that Self Trading violated the Indiana Securities Act by failing to file financial reports with the Division, failing to notify the Division of the existence of the firm's Fort Wayne branch office, and failing to notify the Division of changes in the firm's management.

The Securities Division and the firm are currently in settlement discussions.

Maryland

*Generic Trading Associates, LLC and Generic Trading of Philadelphia, LLC*

On July 10, 1998, the Maryland Division of Securities entered into orders with the above respondent day trading firms. The Division alleged that the firms were effecting securities transactions prior to their registration as a broker-dealer firm in the state. Additionally, the Division alleged that upon application to the state for broker-dealer registration that the firm may have filed a document with the Division that was false or misleading with respect to a material fact.

Pursuant to the consent orders, the day trading firms agreed as a condition to being registered to not permit any trader to trade any funds other than the trader's own funds and to institute procedures to that effect. Additionally, the firms were fined $9,000 and were required to forward all customer complaints, written and oral, to the Division.

The effects of the conditions consented to by the firm address two major concerns of state securities regulators, that is the investment adviser and securities registration issues. By limiting the traders ability to trade only his or her own funds, the day trading firm and trader agree to not pool assets of other investors for a trader to trade.

<u>Massachusetts</u>

*Block Trading, Inc. et al.*

The Massachusetts Securities Division filed a complaint and obtained a cease and desist order against Block Trading and several individuals on October 19, 1998.

In the complaint, the Division alleged that Block used deceptive advertising to promote day trading at its offices, implying that customers were likely to profit from day trading. This seems to contradict the testimony of the President and Chief Operating Officer that 67 of the 68 accounts maintained at the Boston office lost money. It is also alleged that Block promoted loans to customers apart from the margin the firm extended its customers. Block advised customers of parties willing to loan funds to traders and encouraged traders to take advantage of these loans so they would have more money to trade with. Of the 68 accounts at the Boston office, 44 of them borrowed funds from other day traders or third parties, including the father of the firm's president. The Division also alleged that a day trader in the firm was providing investment advice without being registered, that customers were allowed to commingle accounts and unlawfully allocate trades, that there was unauthorized trading, and that the firm and its principles failed to supervise the Boston office.

The action is still pending.

*Bright Trading, Inc.*

On November 9,1998, the Massachusetts Securities Division filed an administrative complaint against the firm and ordered Bright Trading to cease and desist from transacting business in Massachusetts as a broker-dealer. Bright Trading was alleged to have been operating a day trading branch office in Hingham, MA without being registered as a broker-dealer in the state.

This action is still pending.

*All-Tech Investment Group, Inc.* (Exhibit B)

The Securities Division filed a complaint against All-Tech and its principles on December 10, 1998. The complaint seeks revocation of the firm's broker-dealer registration, revocation of several of the firm's principles' broker-dealer agent registrations, and restitution for several of the accounts maintained at the Watertown, MA branch office.

All-Tech, through its Watertown, MA branch manager and sole employee, was alleged to have engaged in the following abuses: exercised discretion in day trading accounts without written authorization; commingled customer funds; forged customer signatures on authorization forms; created fraudulent accounts; and engaged in unregistered investment advisory activities.

The complaint is still pending.

*On-Line Investment Services, Inc.*

The Massachusetts Securities Division filed a complaint against On-Line Investment Services after an examination of the Pittsfield, MA office. The Division's complaint and accompanying order summarily suspended the firm's broker-dealer license and obtained a temporary cease and desist order.

The Complaint alleged that On-Line engaged in deceptive marketing by stating that 85% of its customers made money by day trading. Further On-Line referred in a description of its customers to their success rate, and failed to disclose the material risks associated with day trading. Further, the complaint alleged that the branch manager of the office opened an account at the firm for a relative. This account was then traded excessively in relation to the interest of the beneficial owner of the account. In certain months, account statements were in excess of 70 pages and commissions were generated equal to almost the account value.

On-Line and its branch manager settled the complaint with the Division. The firm consented to a $10,000 fine and agreed to withdraw its broker-dealer registration from the state and not reapply for a period of one year. The branch manager similarly agreed to a $10,000 fine, but agreed to withdraw his broker-dealer agent registration from the state for a period of two years.

*TCI Corporation, et al.*

On March 2, 1999, the Massachusetts Securities Division obtained a cease and desist order against TCI Corporation (Tim Cho Investment Corporation) and filed an administrative complaint.

In the complaint, the Division alleges that TCI engaged in deceptive advertising through its newspaper advertisements and web site, promising a 6 or 7 figure income. The Division additionally alleges that TCI was acting as an unregistered investment adviser and that it was engaged in an alleged Ponzi scheme involving trading of bank instruments.

This complaint has not yet been resolved.

Tennessee

*Van Buren Securities, LLC*

The Tennessee Securities Division entered an emergency cease and desist order against Van Buren and its manager for unregistered broker-dealer and agent activity at its Brentwood, TN location. Van Buren is contesting the order, claiming it does not have to register its day trading operations as a broker-dealer or individuals as broker-dealer agents. A hearing is set for April 29, 1999, to litigate the dispute.

*Carlin Equities Corp.*

An emergency summary suspension order was issued against Carlin Equities Corp. and the supervisor of its Brentwood, TN location. The Division also issued an emergency cease and desist order against an unregistered broker-dealer agent working in the office.

The grounds for the action were the employment of an unregistered agent, dishonest or unethical business practices, fraud (for a false filing with the Division), and failure to supervise the location and the unregistered broker-dealer agent. Amongst other things, the Division alleged that the firm required customers, regardless of their experience level, to complete a form for its clearing broker that represented them all as professional traders. Further, the Division alleged that the unregistered broker-dealer agent offered to trade the account of a prospective customer, which was an undercover Tennessee investigator, if she thought it would be too difficult to take on herself.

The summary suspension against the firm was lifted pursuant to an agreement entered into by Carlin and the supervisor regarding business conduct of the firm and the branch while the action is pending.

Texas

*The Exchange House, Inc.*

On September 30, 1997, the Texas State Securities Board entered into a consent order with The Exchange House, Inc ordering a $20,000 fine, withdrawal of the firm's broker-dealer registration, and the president of the firm consented not to act as a firm principal for a period of one year.

The firm was a SOES (Small Order Execution System) firm. It attempted to utilize the SOES system for trading NASDAQ stocks to profit in small increments, 'banditing' off of discrepancies in a dealers bid and ask price and the prevailing market price. The complaint alleges that the firm was running an unregistered branch office and that individuals were taking public orders without being registered as a broker-dealer agent.

*Infinitum Management Company, Inc. and Infinitum Capital Management, Inc.* (Exhibit C)

On January 6, 1999, the Texas Securities Commissioner issued an administrative order ordering Juan Carlos Nieto, Infinitum Management Company ("IMC"), and Infinitum Capital Management ("ICM") to cease and desist from acting as unregistered dealers. The order further required IMC and ICM to pay administrative fines of $30,000 each. Administrative fines were also levied against Nieto for $20,000 and eight trades, each fined $3,000.

The Securities Commissioner found that Nieto contracted with Colombian residents to have money invested in the U.S. equities markets utilizing SOES. Nieto set up ICM to handle the relationship between himself and the Colombian investors. IMC was then set up to handle the relationship between Nieto and the individuals that would be trading the Colombian's money. Nieto's traders conducted thousands of transactions even though they never had contact with the investors.

The Securities Commissioner found that Nieto, IMC, and ICM acted as securities dealers, the individual traders acted as agents of the dealer, and the firm and individuals were not registered as required under the Texas Securities Act.

<u>Wisconsin</u>

*Block Trading, Inc.*

The Wisconsin Division of Securities filed an order against Block Trading for the unregistered sale of a franchise in the state. A Wisconsin resident traveled to Houston, TX to discuss a business opportunity with Block Trading after responding to an advertisement in *Inc. Magazine*. The Wisconsin resident then wired $25,000 to Block Trading for a site reservation fee and training in the operating procedures of the firm. Further, included in the fee was a visit to Wisconsin from Christopher Block to attend a seminar and solicit customers.

Your letter indicates an interest in any private sector initiatives or necessary regulatory reforms to improve the day trading industry. NASAA has had informal discussions with the Electronic Traders Association regarding customer disclosures and industry problems. At this point, there are no private sector initiatives that NASAA endorses. However, an open dialogue between the industry and state securities regulators is a positive first step. With respect to regulatory reforms, NASAA is hesitant to make specific recommendations at this time. As typical with new products and services in the securities industry, new regulation looks like an easy fix. However, amending the securities laws to address issues of first impression is not always the best policy. A few areas that NASAA feels may be ripe, after further investigation, for increased or clarified regulation are the margin arrangements, customer disclosures, and firm registration requirements. As state regulators continue to examine and explore this segment of the securities industry, NASAA will keep you apprised of any conclusions reached.

*On-line Investing*

With the advent of widespread use of the Internet, investing and trading with Internet brokers has increased exponentially. Most prognosticators anticipate this trend to continue for quite some time. Currently, web sites with financial content, from on-line brokerage firms to stock chat rooms, are some of the most visited web sites on the Internet.

On-line investing and the Internet in general have brought incredible amounts of information to individual investors supposedly leveling the playing field between securities professionals and individual investors. On-line investing has also impacted the commission structure of brokerage firms. The cost of executing a trade is now a commodity and investors have saved immeasurable dollars in fees because of that. For this, NASAA and state regulators applaud the on-line brokerage industry.

On-line investing however is not a panacea. Many individual investors falsely believe they are empowered by the wealth of information available on the Internet. More and more people are moving to self-directed brokerage. In a bull market, such as the one we are currently in, everyone assumes that there is easy money to be made. However, many individuals would be wise to rely on the advice and guidance of securities professionals. Additionally, as with most new technologies, the on-line brokers have been experiencing technical difficulties.

State regulators have generally not reported widespread increases in complaints by on-line investors. Although systemic increases in complaints have not yet occurred, the complaints they have received give reason to give pause. With the stock markets still experiencing gains, NASAA believes that the on-line brokerage community needs to address several issues before the market trends downward. To that end, the NASAA Board of Directors recently authorized the formation of a multi-state project group to explore the issues facing on-line brokerage firms. Unfortunately, the members of the project group have yet to be identified so NASAA is not in the position to supply individual names.

It is expected that the project group and individual states will be addressing the following issues with respect to on-line investing:

- Capacity

  The growth in the Internet community coupled with the American public's infatuation with securities and the markets is creating huge demands on the computer systems of on-line broker-dealers. Do they have the infra structure to allow for continued growth? Are they well enough capitalized to keep up with growth? Is growth outpacing technology? Is this new form of commerce stressing existing regulatory structures?

- Advertising

  Due to the low commission structure, or because of it, the key to a successful Internet brokerage firm appears to be market share. Volume can ostensibly make up for the fractional profit margins. To get market share, on-line brokers advertise aggressively. Are they creating false impressions in these advertisements regarding availability of the trading platform? Are capital expenditures being put off to fund advertising expenses?

- System Outages

  Perhaps the most reported on issue to date. What happens to customers when the Internet or the brokerage firm's web site is unavailable? What obligations, if any, does the firm have to its customers at these times? Does it matter if the outages are due to technology glitches or market activity?

- Best execution

  With commission rates at such low levels, the on-line firms must rely on payment for order flow to recoup expenses. Payment for order flow is the industry practice of refunding a portion of the cost of doing a trade to a brokerage firm if the brokerage firm routes significant trading volume to a specific market maker. While this practice is widespread in the industry, in the on-line brokerage business there are increased pressures on the firms to amplify payment for order flow. Are commission rates so low that payment for order flow concerns replaces the firm's desire to obtain best execution for its customers? Investors now have access to market information such that they know what the current best bid and ask quotes are and know they are not getting the best price execution.

- Suitability

  Do on-line brokers have any suitability obligations to their customers? Generally, suitability is not an issue for unsolicited transactions. However, on-line brokerage firms are offering ever-increasing amounts of research on their Internet sites. If and when does suitability become an issue in the on-line trading area? When does information rise to the level of being analogous to a recommendation?

- Execution in general

  A frequent complaint from on-line investors is execution of orders, particularly of initial public offerings of securities that are in high demand, such as Internet stocks. Customers have placed market orders to buy shares of a recent IPO and their trades are not executed until the price is multiples of the initial public offering price. They are then asked to pay for their transactions, which when the order was placed may have amounted to several thousand dollars, but when it was actually executed it costs in the tens of thousands of dollars. What is the remedy for these circumstances? Should there even be a remedy? This problem can most likely be addressed through increased disclosures to put the customer on notice and education about use of limit orders and other strategies to reduce risk.

- Contingency Plans

  In the case of system outages or market events, are the on-line firms ready to handle the volumes? If their systems collapse are there contingency plans? Can a broker-dealer agent be reached by telephone? Do the firms have a stable of registered persons to take orders if necessary? This is one area that the regulators and firms need to work together to insure that adequate access is available.

- Privacy

  Privacy concerns do not seem to be problematic at this point, but on-line firms and regulators need to monitor and address concerns as they arise. Given the sensitive nature of financial information and the vulnerability of computer systems this is an issue that will likely grow in importance. The same technologies that bring immeasurable benefits to investors can also work against them in the hands of the wrong people.

The New York Bureau of Investor Protection and Securities, under the New York Attorney General, on February 4, 1999, announced an inquiry of on-line brokerage firms based on a "recent surge of customer complaints." (Exhibit D) It sent a letter to 8 of the major on-line firms based upon customer complaints about frequent system crashes, server unavailability, and long delays in executing trades. The Attorney General has also established an on-line questionnaire for investors to complete to relate their experiences and complaints with on-line brokerage firms. (http://www.oag.state.ny.us/surveys/brokerage.html)

State securities regulators are committed to protecting investors and preserving the integrity of the U.S. capital markets. Investigations and inquiries into both day trading and on-line trading are works in progress. NASAA is pleased to share with you our experiences to date and will maintain a dialogue with you to keep you informed as new information develops. Both day trading and on-line brokerage are a testament to the ingenuity of the participants in the securities markets. State regulators believe that innovation can only lower the cost of raising capital, level the playing field for participants, and decrease the cost of market entry. However, none of this can and should come at the cost of investor protection.

NASAA appreciates the interest you have shown in exploring the issues associated with day trading and on-line investing. We are committed to assist you in further fact finding.

Sincerely,

Philip A. Feigin
Executive Director

cc: The Honorable Tom Bliley
The Honorable Michael G. Oxley
The Honorable W. J. "Billy" Tauzin
The Honorable Fred Upton