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Report to Congressional Requesters

February 2000

SECURITIES OPERATIONS

Day Trading Requires Continued Oversight

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United States General Accounting Office
Washington, D.C. 20548

General Government Division

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The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce

The Honorable Ron Klink
Ranking Minority Member, Subcommittee on Oversight and Investigations
Committee on Commerce

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

The Honorable Edolphus Towns
Ranking Minority Member, Subcommittee on Finance
and Hazardous Materials
Committee on Commerce
House of Representatives

The Honorable Carl Levin
Ranking Minority Member, Permanent Subcommittee on Investigations
Committee on GovernmentalAffairs
United States Senate

This report responds to your February 11 and March 26, 1999, requests that we review a number of issues regarding day trading. Day trading is a strategy that generally involves making multiple purchases and sales of the same security during the day to profit from short-term price movements. You were concerned that day trading raises serious investor protection and market integrity issues, particularly that investors have lost large amounts of money from the questionable practices of day trading firms. You were also concerned about the adequacy of risk disclosures to investors by firms that specialize in day trading and the actions taken by regulators in overseeing day trading. As agreed with your offices, our objectives were to (1) determine the nature and extent of day trading, (2) assess regulatory actions taken to address the day trading risks, and (3) assess the actions day trading firms have taken to address regulatory concerns.

To address these objectives, we focused our work on seven of the largest day trading firms. These firms have about 5,300 day traders, or nearly 80 percent of the 7,000 day traders whom regulators estimate trade in the United States. An industry representative estimated that these seven firms accounted for over 80 percent of all day trading volume. We also reviewed the results of 67 examinations of day trading firms and their branch offices done by federal regulators.

Results in Brief

Day trading among less experienced investors is an evolving segment of the securities industry. Day traders, who represent less than 1/10th of 1 percent of all individuals who bought or sold securities, accounted for a growing part of trading on Nasdaq, estimated by industry officials to be about 10 to 15 percent of total Nasdaq volume. These traders all did their trading at specialized day trading firms, but the firms employed various structures and operating strategies that affected the risks the traders faced. Some firms encouraged any individual who wanted to be a day trader, and had the capital to begin trading, to use the firm's systems and facilities to trade, risking the trader's own capital. Others emphasized that they wanted only people who were qualified and able to be professional traders to trade, risking the firms' capital. These traders could be fired if they suffered significant loss, but they do not lose their own capital. Some firms employed a combination or variations of these strategies.

The effects of day trading on both the individuals who engage in it and the markets as a whole are uncertain. For example, day trading is risky, and state regulators have reported that most individual day traders they investigated lost money. However, officials at day trading firms we visited said that although most people lose money initially, the majority of their experienced traders (those that traded longer than 6 months) made money. Two firms supplied us records that showed many of their traders were extremely profitable; however, other firms did not supply records, and we could not verify the extent of profitability in the industry as a whole. From a market standpoint, day traders' access to the markets provides direct competition for market makers and institutional traders that may benefit all individual investors, but day traders' frequent trading during the day also could potentially make market prices more volatile. Gaining a better understanding of the effects of day trading on individuals as well as the markets could help regulators better ensure that investor protection and market integrity objectives are met.

Federal regulators have taken some actions to address the risks of day trading. The regulatory arm of the National Association of Securities Dealers, called NASD Regulation (NASDR), and the Securities and

Exchange Commission (SEC) have made a special effort to target their examination resources during the last 2 years on day trading firms, performing 67 examinations of day trading firms and their branches.[1] They were concerned that these firms were advertising day trading as a profitable strategy without fairly representing the risks associated with day trading. The rule violations found most frequently in their examinations of day trading firms related to supervisory procedures, net capital computations, and advertising. They also found violations involving margin and lending issues.[2] In addition to these examinations, NASDR has recently submitted proposed rule changes to SEC that require day trading firms to assess the appropriateness of day trading for each potential customer and to fully disclose the risks of day trading. NASDR and the New York Stock Exchange (NYSE) have also submitted proposed rule changes to SEC to tighten margin requirements.

Some of the day trading firms we visited recognized these regulatory concerns and told us that they have already taken steps to provide better disclosure; screen prospective traders; and restrict certain activities, such as customer-to-customer lending. The risk disclosure statements from all of the firms we visited contained language the same as or similar to that in NASDR's proposed risk disclosure statement. Determining the adequacy and extent of oral disclosures, screening, and planned restrictions presents a difficult challenge because neither the regulators nor we could directly observe the interactions between the firms and traders or potential traders. However, ongoing implementation of such controls by firms and oversight by regulators are important for ensuring that potential day traders understand that they are directly competing with professional market makers and institutional traders and can lose as much as, or more than, they have invested.

We are making a recommendation to the Chairman, SEC, in conjunction with NASD, to evaluate the implications of day trading on the integrity of the markets after decimal trading is implemented. We are also recommending that the Chairman, SEC, do at least one more cycle of targeted examinations of day trading firms to ensure that the firms take the corrective actions they propose in response to previous examination findings.

[1] SEC and NASDR are responsible for ensuring investor protection and market integrity in the securities markets.

[2] Margin is the amount of cash or securities a customer must maintain with a firm in order to obtain a loan.

Background

Day trading requires a continuous stream of current market data and the ability to trade without delay. Numerous day trading firms have developed sophisticated order routing and execution systems as well as software that can be used on computerized workstations. These systems enable day traders not only to monitor the market on a real-time basis, but also to trade on a real-time basis—similar to practices followed by professional traders at proprietary firms. The order routing and execution systems of these firms allow day traders to be linked directly to the stock markets, enabling the traders to send orders to a particular market or market maker without involving an intermediary firm. As a result, day traders have the tools to employ the trading strategies and techniques that were previously available only to market makers.

SEC has stated that over the last 3 years some day trading firms have focused on marketing day trading as a strategy to investors, and these firms have emphasized the opportunity for individuals to profit from day trading without fully disclosing the risks. Reports have surfaced about day traders who have lost money and claimed they were not informed of the risks. SEC and NASDR are focusing their efforts on trying to ensure that day traders completely understand not only the risks associated with day trading, but also that there are high costs that can result from frequent trading.

Although investing in securities always involves some degree of risk, day trading involves a higher degree of risk of loss because of the way it is conducted. Day traders try to anticipate market movements and profit from short-term price movements in individual stocks. Using this strategy, day traders trade frequently, incurring commissions and fees for computer and electronic services provided by the day trading firm that can significantly reduce a trader's earnings. Furthermore, unlike investing through a full-service broker-dealer, who may be responsible for determining whether a particular trade is suitable for the investor, day traders typically are the only ones accountable for their trading decisions.

Day trading typically requires direct electronic access to the markets. Day trading firms provide order entry terminals to Nasdaq as well as NYSE. Day trading is primarily transacted through Nasdaq, which is an electronic communications system where market makers display prices at which they are willing to buy or sell stocks for their own accounts or for their customers. In the last few years, day trading has also been transacted through electronic communications networks (ECNs), which allow customers to display their orders to other customers and also allow customer orders to be paired. ECNs are primarily used to access Nasdaq.

However, they may also be used to trade stocks listed on exchanges. Day traders also have electronic access to listed stocks through the Superdot system, which is an electronic order delivery system that links NYSE member firms to individuals on the floor of an exchange who execute their orders.

Electronic Day Trading Has Changed

Regulatory changes to Nasdaq spurred the development of electronic day trading. Nasdaq first introduced electronic executions when it developed the Small Order Execution System (SOES) in 1985.[3] The system was not fully implemented until 1988 when SEC required all market makers to participate.[4] Nasdaq also introduced SelectNet in 1990 as a system for market makers to communicate and to execute transactions electronically with each other.

Shortly after market maker participation in SOES became mandatory, a few firms realized that they could profit from using SOES. These firms became known as SOES day trading firms, and market makers called them SOES Bandits.[5] Nasdaq market makers did not like losing profits to SOES day traders. As a result, NASD proposed various SOES rule changes to limit the activity of day traders. However, a series of events between 1993 and 1996—including an investigation of market makers' possible collusion—affected how SOES day traders were viewed in the market. As a result of these events, NASD and SEC implemented several rules changes. In January 1997, NASD implemented SEC's order handling rules.[6] These rules required Nasdaq market makers to display customer limit orders and to disseminate the best prices placed by market makers in

[3] SOES allows small orders placed through it to be automatically executed against Nasdaq market makers at the best bid (buy) or ask (sell) prices displayed on the Nasdaq system. It allows customers to access and trade with market makers without having to call them on the phone.

[4] The requirement was a direct result of the market makers' poor performance during the 1987 crash. At that time, market makers failed to answer their phones to honor their quoted prices, and customers could not get orders executed at any price. In response, Nasdaq implemented an automatic electronic execution system for customers through SOES.

[5] The trading strategy used by SOES day traders was one of looking for the beginning and end of a trend—specifically the trends of market makers—and trying to buy and sell a stock using SOES and SelectNet while the stock was moving in price. Because of the automatic execution feature of SOES, day traders had a trading advantage over market makers and their customers in that they could execute trades faster than the market makers could update their quotes. This ability allowed SOES day traders to profit at market makers' expense from short-term price movements in stocks.

[6] SEC intended these rules to make the Nasdaq market a more competitive, customer order-driven market and thus reduce bid-ask spreads. As a result of the order handling rules, market makers have to fill or display any customer's limit order that improves on the inside price. This gives the customer's limit order protection in the market, as opposed to just having the market maker execute the order when conditions were favorable to the firm.

ECNs, which previously were not included in the Nasdaq market.[7] NASD also implemented actual size rules that allowed market makers to display quotes in minimum sizes of 100 shares for certain stocks, which had the impact of limiting the use of SOES by day traders because the trade size fell from 1,000 shares to 100 shares. As a result, SOES day trading firms began to develop and use ECNs in order to continue to provide day traders access to the market without the limitations of SOES that resulted from the rule changes. [8]

With the decline in the use of SOES, day trading firms began to evolve into customer-based firms that offered their traders direct access to ECNs, SelectNet, Nasdaq, and the major stock markets. Moreover, the inclusion of ECNs in the Nasdaq market enabled ECNs to explode in popularity, and these networks have become the choice of trading for day traders, according to industry officials.[9] According to industry statistics, ECNs account for 30 percent of the Nasdaq trades. In fact, one of the largest ECNs was created by a day trading firm.

Day traders' use of ECNs has meant that not only has the venue they use to trade changed, but whom they trade with has also changed. ECNs allow orders to be paired or traded with each other. By trading on ECNs, day traders are trading more and more with each other and less and less with market makers.[10] For instance, one firm estimated that 35 percent of its order flow would match internally if was conducted within a single ECN.

ECNs are also designed to handle limit orders, and the increased use of ECNs has resulted in the increased use of limit orders.[11] Before 1997, day

[7] Limit order is a customer order to buy and sell a security at a specific price.

[8] One ECN, Instinet, already existed, but it could be accessed only by institutions.

[9] One reason ECNs are popular is that as spreads narrow on volatile stocks, market makers are more inclined to step aside and post trades into ECNs, where investors can trade directly with one another. Another reason is that investors can save money because fees are low and because they can effectively negotiate prices with limit orders. ECNs match up potential stock buyers and sellers directly while allowing customers to maintain anonymity.

[10] When Nasdaq was first developed, it attracted illiquid stocks that did not meet the New York Stock Exchange's or the American Stock Exchange's listing requirements. Nasdaq market makers typically quoted wide spreads (the difference between the bid and the ask price), reflecting the nature of illiquid stocks. In addition to the wide spreads, Nasdaq ensured that market makers were able to earn the spread on every transaction. A market maker was always on the other side of every trade. This meant that customers were rarely allowed to trade with each other. They were forced to buy and sell stocks from a market maker who would benefit from wide spreads.

[11] The open limit order display system gives orders greater market representation, which increases the possibility of matches. Orders that are not immediately matched are typically displayed for all subscribers to see.

traders were submitting most of their orders as market orders through SOES. The Electronic Traders Association (ETA) estimated that limit orders constitute nearly one-half of day trader orders, which they said helps to improve prices. They stated that if a market maker quoted a stock at 50-50-¼, a customer limit order of 50-1/8 would effectively narrow that spread, thereby improving prices for all investors. Industry and regulatory officials have stated that limit orders are now a part of the quote montage (all listed quotes), and the inside price (best price) may well be set by a public order from a day trader.

Scope and Methodology

To determine the nature and extent of day trading, we collected data from day trading firms, SEC, NASDR, and ETA. We identified the largest day trading firms through industry and regulatory sources and focused our study on the seven largest firms. Officials from another large firm told us that officials from a firm we visited could speak for them, and they chose not to talk to us. We obtained data on the number of day traders from the firms that we visited. When possible, we also cross-checked those numbers with any data found in SEC and NASDR's examinations of those firms. To determine the nature of day trading, we interviewed officials of the seven day trading firms about how day trading was conducted at their firms. We also spoke to ETA about the overall nature of day trading, and we reviewed the regulatory examinations of day trading firms for information on the nature of day trading. To obtain opinions and data on the profitability of day traders, we interviewed officials from the seven largest firms about the profitability of their traders, and we reviewed data from two of the firms. We did not assess the reliability of data gathered from these sources.

To identify regulatory actions taken to address the risks of day trading, we reviewed the 67 examinations that NASDR and SEC did during 1998 and 1999. We determined the frequency of the violations and the actions SEC and NASDR were taking against day trading firms for the violations. We also interviewed state securities officials from Texas and Massachusetts, the two states that had taken action against day trading firms, and an official from the North American Securities Administrators Association (NASAA) who was the main author of that Association's report on day trading. Additionally, we interviewed NASDR and SEC officials about the proposed rules for day trading firms, and we reviewed the rules and public comment letters relating to the rules. Lastly, we reviewed related congressional testimonies of NASD, SEC, and ETA officials.

To identify actions day trading firms have taken to address regulatory concerns, we interviewed officials from the seven day trading firms we

visited about the initiatives they were taking pertaining to issues regulators were concerned about such as customer-to-customer lending, risk disclosure, margin issues, and appropriateness determinations. We also obtained each firm's risk disclosure statements and compared them to NASDR's proposed disclosure statement to determine if they appeared to be line with NASDR's proposal. Additionally, we talked to ETA, the Securities Industry Association (SIA), and legal representatives of day trading firms to get their views about the firms' initiatives. We also talked to Federal Reserve officials about current margin requirements that pertained to securities firms.

We requested comments on a draft of this report from SEC and NASDR. Their comments are discussed near the end of this letter and reprinted in appendixes I and II. We did our work in accordance with generally accepted government auditing standards between July 1999 and January 2000 in Washington, D.C.; Houston and Austin, TX; New York, NY; and Montvale and Jersey City, NJ.

Nature and Extent of Day Trading

Day trading is different from on-line trading or trading through a full service broker. Day trading is usually conducted on-site at firms that offer technology that is superior to the technology offered by on-line trading firms. These firms have developed order routing and execution systems that allow day traders to trade directly into the market with no intermediary, which is something an individual has never before been able to do. The firms that we visited had different structures and operating strategies, with the common characteristic that their traders used day trading strategies. Although state regulators have reported that most day traders lose money, officials at six of the firms we visited said that most of their experienced traders were profitable. The effects of day trading on the markets have been controversial, but we found no overall analysis of the benefits and costs of day trading.

How Day Trading Is Conducted

Day traders attempt to profit from small movements in the prices of stocks over a short time period. For example, they try to anticipate the likely move of a stock in the next few minutes or hours, buying and selling quickly, and generally hoping for a small profit (this could be as little as 25 cents a share) on a large number of shares (averaging about 1,000). Day traders are generally momentum traders—hoping to buy when prices are increasing and sell before prices fall or sell when prices are decreasing and buy back before prices rise. Most day traders also try not to carry positions overnight.

As a result of their trading strategies, day traders are not considered to be investors. They do not pay close attention to such factors, as price/earnings ratio or investing and earnings models, which investors are taught to follow. They do not hope to gain by buying and holding shares over extended periods of time.

Day trading is also different from trading on-line, although the distinctions between them are beginning to blur. On-line trading provides investors a cheaper, faster way to place orders with their brokerage firms than contacting them by telephone. On-line traders may use any number of trading strategies designed to profit from either short-term or long-term favorable price movements in the stocks they buy and sell. On-line traders may also employ day trading strategies, but these traders generally lack the access to the markets and instantaneous updated prices that day traders have.

Direct Access to the Markets Versus Payment for Order Flow

A day trading firm provides its traders with direct access to the markets through the firm's order router, which instantaneously sends orders to the market location with the best price by interfacing directly with the major stock markets and ECNs. As a result, day traders send their orders to a particular market without having an intermediate firm involved in routing the order. In doing so, day traders can receive a trade execution within seconds of placing their orders, which is necessary for them to be able to capitalize on small price movements in stocks.

Day traders' direct access is different from the access to the markets provided by many on-line trading firms. These on-line trading firms may take customer orders and either match them internally or sell them to a specific market maker in return for payment for order flow. In these arrangements, the market maker pays a penny or more a share for the order flow created by the on-line firm's customers and is to provide the customer an execution at the best prevailing quoted prices.

The distinctions between on-line firms and day trading firms are becoming less obvious as these industries develop. For example, on-line trading firms are beginning to provide their frequent traders news and price quote services similar to those already provided by day trading firms. Although market makers, institutional investors, and day traders have direct access to ECNs, a few on-line firms have decided to offer their customers some level of direct access to ECNs or funnel some of their customer order flow into ECNs. Additionally, some day trading firms are going after the active trader at on-line firms by promoting the advantages of direct access to the markets.

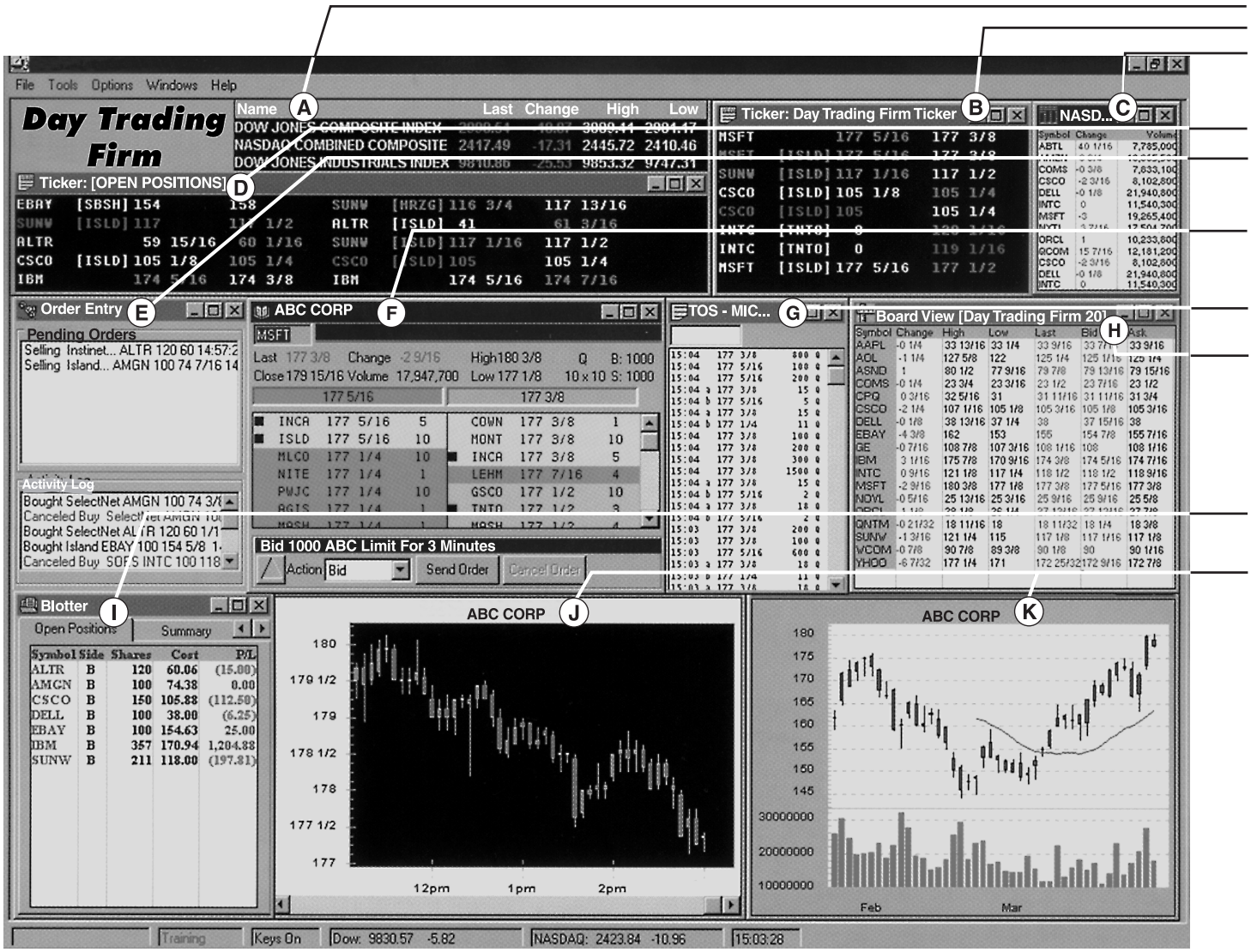
Technology and Software of Day Trading Firms

The technology and software that day trading firms provide enable day traders to have real-time data and information as well as direct access to the markets similar to what proprietary firms offer their traders. The computer facilities, high-speed access lines, and software packages that day trading firms use are specifically designed to support and accommodate day trading. For example, these firms provide day traders access to Level II data, which shows the best bid (buy) and ask (sell) prices and the number of shares available for every market maker and ECN. The Level II data are often provided by day trading firms with extreme speed that enables day traders to capitalize on momentary fluctuations in prices. Other software features of day trading firms include

- offering traders a broad view of the market, such as allowing them to open up a list of hundreds of stocks and watch them update in real time;
- point and click order-entry windows that allow traders to send out orders to different exchanges;
- real-time profit and loss windows;
- fundamental data on companies;
- ticker features; and
- programmable key strokes that allow traders to specify any function key combination for order entry functions;

Figure 1 provides an example of the type of information and software in a mainstream application that day trading firms offer day traders.

Figure 1: Typical Trading Screen for Day Traders



A Displays the high/lows in the Dow Jones and Nasdaq Composite.

B Displays the bid ask prices of stocks and where the stock is being traded.

C Displays the stocks that have the highest volume of trading on the Nasdaq and listed exchanges.

D Displays the day trader's open positions.

E Displays pending orders, including such information as the exchange, symbol, price, and time in the top half of the window. Displays executed, canceled, and declined orders in the bottom half of the window.

F Displays the last price, closing price, change in price, the high and low prices, and best bid and best offer for a specific stock in the top half of the screen. This is Level I data. Level II data is in the bottom half of the screen and shows the individual market maker's bid and ask prices and number of shares for that specific stock.

G Displays the day trader's stock trades, including the time of trade, price of stock, and number of shares.

H Displays the day trader's desired list of stocks, including the high and low prices, the last price, and the percent change.

I Displays the day trader's open position, including the number of shares, the cost of the shares, and the profit and loss.

J/K Display line charts, candlesticks, and bar charts. Various charts can be superimposed on a TradeChart for in-depth analysis.

Source: Information on the screen was provided by TradeCart as modified by GAO.

Structures of Day Trading Firms Pose Different Risks to Day Traders

Day trading firms are typically organized as (1) broker-dealers that have customers who open accounts with the firm and use the assets in their own accounts to trade; or as (2) limited liability companies (LLC), which sell an interest in the firm to individuals wishing to day trade. As broker-dealers, these firms must register with SEC, and they are subject to SEC rules and regulations. Broker-dealers with customers are also required to be members of NASD and are subject to NASDR rules. LLCs are also registered broker-dealers, but individuals who day trade at these firms typically are not customers; they become part owners of the firms and are called associated persons. These firms allow their associated persons to trade using a portion of the firms' capital contribution. Many LLCs are members of the Philadelphia Stock Exchange and are subject to its rules. The seven day trading firms we visited were all registered broker-dealers, six were NASD members, and one was an LLC that was a Philadelphia

Stock Exchange member. These structures affect the risks faced by the day traders at the firms.

The structures and operations of the firms we visited were very different. Three firms had mostly registered proprietary day traders, who traded on behalf of the firms and the firms' customers. They also had a few nonproprietary day traders who traded using their own capital and the firms' software and facilities. One of these firms was completely unique in that it had only four registered proprietary day traders trading on behalf of about 19 investors and had no nonproprietary day traders. This firm did 80 percent of its trades automatically through specially designed software programs and 20 percent by its proprietary traders, and it traded almost 10 million shares a day. The other four firms had mostly nonproprietary day traders and a few proprietary traders.

Officials at five of the day trading firms we visited asserted that they were selective about whom they allowed to trade at their firms. They said they looked for individuals who would approach day trading in a professional manner and eventually become professional traders similar to the traders at market making firms. In general, these firms tended to already have a high percentage of proprietary traders and were looking to hire more individuals who would be proprietary traders. One firm said that it was moving away from having nonproprietary day traders towards having only proprietary day traders. However, officials at two firms said that as long as individuals met the initial capital requirement, which was at least $25,000, they would allow anyone to trade.

Nonproprietary day traders trade using their own money and risk losing as much as, or more than, they have invested. Proprietary day traders who trade at LLCs typically are limited partners that have invested their own money into the firm in order to trade, risking the accumulated capital of the limited partners. In many cases, these proprietary traders' potential losses are limited to the amount of their initial investments. Rules designed to ensure that day traders understand their risks of loss and the pitfalls of trading on margin or with borrowed funds carry added significance for any day trader whose own money is at risk. However, we found some non-LLC day trading firms that hire proprietary traders to trade, risking the firms' money or that of investors in the firms. These traders can be fired if they continually lose the firms' money, but their risk of loss is different because they do not risk their own money. None of the investors in these firms had filed any complaints with securities regulators.

Extent of Day Trading

Day traders are few in number, but they account for a growing amount of the Nasdaq trading volume. SEC estimated that about 7,000 people are day traders at day trading firms. By comparison, about 80 million individuals own stock, and more than 5 million use on-line brokerage firms. As a whole, day traders represent less than 1/10th of 1 percent of all individuals buying and selling stocks. SEC also estimated that there are about 100 day trading firms operating, with hundreds of offices around the country, which is a small part of the nearly 8,000 registered broker-dealer firms. However, NASDR and SEC officials said they could not be sure of the total number of day trading firms because these firms are required to register only as broker-dealers, not as day trading firms. ETA estimated that there are 62 on-site day trading firms.

Day trading firms account for an estimated 10 to 15 percent of the total Nasdaq trading volume in 1999, according to industry officials. Their trading volume has steadily increased over the last few years. In 1997, day trading firms as a whole represented an estimated 7.7 percent of the Nasdaq trading volume. As of year-end 1999, we estimated that the seven firms we visited represented about 9 percent of Nasdaq's trading volume. An industry report estimated that on-site day traders were responsible for 11 percent of the Nasdaq trading volume during the first quarter of 1999.[12] ETA has consistently said that day traders represent about 15 percent of the Nasdaq trading volume.[13]

Day traders trade more often than the average trader placing orders through a brokerage firm or on-line. The firms we visited told us they generally executed anywhere from about 2,700 trades a month to about 1.8 million trades a month. On a yearly basis, day traders at the firms made anywhere from 33,000 trades a year to about 22 million trades a year.[14] In contrast, one industry study stated that the average full-service brokerage customer conducts between 6 and 12 trades a year, and the average on-line investor conducts between 15 to 25 trades a year.

Profitability of Day Traders

Whether day trading is profitable is the subject of much debate within the securities industry. State securities regulators have estimated that more than 70 percent of day traders lose money, and only about 12 percent demonstrate the capacity to be successful. Moreover, ETA officials stated

[12] See Gregory W. Smith, "The Electronic Brokerage Industry," Hambrecht & Quest, October 5, 1999.

[13] Ibid.

[14] Our figures are based on the average number of daily trades done by all the traders at each firm, assuming 20 working days in a month.

that the risk of loss in day trading can be substantial. It estimated that the learning period for day trading is about 3 to 5 months, and not only will most people lose money in that period but a substantial number of day traders will never be successful. However, officials at six of the seven firms that we visited said that the most of their experienced traders were profitable.

All of the firms we visited agreed with ETA's estimate that it takes individuals from 3 to 5 months to be profitable. Some of the firms said that although they have had individuals leave during the 6-month period, none had experienced a high turnover rate because of unprofitability. However, two firms said that they had asked individuals who, in their estimation, could not be profitable day traders to leave.

One of the firms that we visited published the profitability of its day traders on its Web site. The data showed that 47 percent of its traders made money after commissions in 1998, and 52 percent made money in 1999.[15] We estimated that of the 47 percent who made money, 74 percent—35 percent of the total number of traders—beat the return of the Standard & Poor's index of 500 (S&P 500) stocks in 1998.[16] In 1999, 55 percent of this firm's traders made money. We estimated that of the 55 percent who made money, 78 percent—43 percent of the total number of traders—beat the return of the S&P 500. In comparison, industry statistics show that less than 25 percent of all stock mutual funds have been able to beat the return of the S&P 500 in the last few years. The other six firms that we visited told us that many of their experienced traders were profitable. These firms did not, however, publish data on the profitability of their traders on their Web sites. Further, day traders have achieved these results during an extended bull market.

Day trading firms we visited said they make a profit from day traders' activities. These firms charge commissions on each trade made by day traders as well as fees for computer and electronic services provided by the firms. The firms that we visited said that they net about $2 or more on each trade. Using the data from 1 firm that had 500 traders conducting about 20 trades a day, we estimated that the firm nets about $20,000 a day.

[15] This particular firm required $75,000 initial capital contribution. Our estimate was based on the individual having $100,000 in capital. The 1998 return of the S&P 500 was 19.3, and the 1999 return was 19.5. We did not assess the reliability of these numbers from the firm.

[16] The firm provided more specific data to us on individual traders. We did not assess the reliability of these data.

Some firms netted more than that amount, and others netted less. Officials at one firm said that the firm's daily net profit was about $150,000.

Effects of Day Trading

The effects of day trading in its current form are unknown. When day traders primarily traded through SOES, several studies analyzed the effects of SOES trading on spreads, liquidity, and volatility. Our previous review of these studies found that they could not isolate the effect of SOES trading from that of other changes in the market.[17] The effects of day traders in the more recent environment, which depends less on SOES and more on ECNs, have not been similarly assessed.

Industry officials have said that day traders have provided some benefits to the markets. For example, as evidenced by their growing share of the Nasdaq volume, day traders bring substantial liquidity to the markets. These officials also said that the increased use of limit orders by day traders has helped to improve price efficiency for all traders. For example, when day traders enter a limit order that is between the best bid and ask spread, they improve prices for all retail orders. Additionally, day trading firms have also been an impetus behind the development and use of some ECNs, which has enabled individuals, for the first time, to have direct access to the securities markets.

On the other hand, as we reported in 1998, market participants have said that day trading through SOES caused increased volatility in the market.[18] They stated that the trading strategies of SOES day traders, such as the momentum-based strategy of buying in "up trending" markets and selling in "down trending" markets, have led to increased volatility. The studies that examined volatility and trading through SOES showed that they were related. However, the studies did not clearly establish whether SOES trading caused volatility or whether other market forces caused volatility, which then attracted SOES trading. Market and regulatory officials have been concerned that the effects of day trading through ECNs are similar to those they attributed to SOES trading. However, they have not yet attempted to evaluate these effects. They have been primarily concerned about the practices of day trading firms because some day trading firms have violated securities rules and regulations and misled customers.

[17] See Securities Market Operations: The Effects of SOES on the Nasdaq Market (GAO/GGD-98-194, Aug. 31, 1998).

[18] GAO/GGD-98-194.

Securities Regulators' Oversight of Day Trading Firms Found No Widespread Fraud

Over the last 2 years, securities regulators have focused their oversight efforts on day trading firms through both targeted examinations and proposed rule changes. NASDR and SEC performed 67 examinations of day trading firms and their branches during this period.[19] Although they found no widespread fraud among the day trading firms, they found a number of violations and are concerned about compliance with some rules. The most frequently occurring violations involved rules relating to written supervisory procedures, net capital computations, short sales, and advertisements. The examinations also found violations relating to margin and customer lending. During the same time period, NASDR and NYSE have also proposed rules that would address some of the risks of day trading. SEC is reviewing the rule proposals.

SEC and NASDR Targeted Examination Resources at Day Trading Firms

NASDR, NYSE, and SEC examine all securities broker-dealers on a cyclical basis based on the risks they pose to their customers and the securities markets. NASDR and NYSE examine all their member firms on a regular schedule, and SEC examines a sample of broker-dealers each year to assess the effectiveness of NASDR and NYSE examinations and to ensure compliance with securities laws. These routine examinations review various aspects of broker-dealer operations, including sales practices, advertising, and financial integrity, among others. NASDR, NYSE, and SEC also do "cause" examinations to address particular problem areas identified through various means, such as customer complaints. They also target high-priority areas for annual on-site inspections. During 1997 and 1998, NASDR and SEC targeted day trading firms because they were concerned that the firms were marketing unrealistic expectations and unsubstantiated representations about the profitability of day trading, but not adequately describing the risks.

SEC and NASD officials told us that the violations found at the day trading firms were generally similar to violations they find at most securities firms. They said that when they find violations, they notify the firms and give them 30 days to respond in writing, stating the steps that they are taking to correct the violations. SEC officials said that if firms do not agree to take necessary corrective actions, SEC examiners would either refer the matter to SEC's Enforcement Division for review or take other action. As of January 2000, neither SEC nor NASDR had reexamined any of the firms or branches they targeted in 1997 and 1998.

[19] SEC did 47 examinations of 41 separate firms and their branches. NASDR did 20 examinations, 15 of which were of different firms than SEC examined. In total, SEC and NASDR examined 56 separate day trading firms.

SEC and NASDR examiners may also refer firm conduct or violations that they consider warrant investigation to SEC's Enforcement Division for further review. Their examiners referred 15 day trading firms to the Enforcement Division. SEC officials said that the Enforcement Division's investigations of these firms relate to margin lending, net capital, broker-dealer registration issues, short sales, supervision, and advertising. The investigations were ongoing as of February 16, 2000.

Written Supervisory Procedure Violations

NASDR rules require each broker dealer to establish, maintain, and enforce written procedures that enable it to supervise its registered representatives and associated persons and that are designed to ensure the member complies with applicable securities laws. Examiners are to review a firm's procedures and its books and records to determine if the firm is enforcing and complying with the procedures.

During their day trading examinations, NASDR and SEC found 29 instances in which day trading firms failed to enforce their own written supervisory procedures. Of the seven firms that we visited, two had such violations. SEC and NASDR examiners found that firms violated rules or failed to enforce internal supervisory procedures that

- forbade a registered representative or any person associated with the firm from recommending securities or trading strategies,
- directed supervisory personnel to evaluate prospective clients by reviewing a client's income and type of employment,
- prevented employees from arranging for credit to a customer on terms more favorable than available through other means, and
- required an annual review of branch offices.

In some cases, violations resulted from a firm's failure to have appropriate written supervisory procedures. For example, some firms

- failed to have procedures that addressed the lending of funds between customers;
- failed to have procedures that addressed the types of business in which it engaged;
- failed to have procedures that specifically supervised the type of business in which it engaged (one firm advertised itself as a broker-dealer that

specialized in on-line day trading, but it did not have procedures that specifically supervised this type of business);

- failed to have procedures pertaining to short sale transactions; and
- failed to have procedures that addressed the disclosure of credit terms between customers.

Short Sale Violations

SEC and NASDR's short sales rules prohibit investors from selling an exchange-listed stock short unless the stock's last trade or bid was at the same price as or higher than the previous trade or bid.[20] The purpose of these rules is to keep firms and investors from exacerbating price movements when markets are declining. NASDR also requires that securities firms mark all sales as either "long" or "short" and that the firms determine if they can obtain shares of the security sold short to deliver to the buyer.[21] SEC and NASDR examiners found 14 violations of short sales rules. Of the seven firms that we visited, the regulators found two firms that had violated the short sale rules.

The regulators also found that some day trading firms lacked the surveillance systems needed to prevent and detect short sale violations by day traders. They found that this was particularly true of day trading firms that were organized as LLCs.[22]

Net Capital Violations

Day trading firms, like all other broker-dealer firms, are required to comply with the net capital rule. The net capital rule is a liquidity-based capital standard that requires broker-dealers to (1) maintain a minimum level of liquid capital sufficient to promptly satisfy all of its obligations to customers and other market participants and (2) provide a cushion of liquid assets to cover potential market, credit and other risks.[23] Examiners

[20] A short sale refers to any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.

[21] NASD rule 3370 also requires that broker-dealers keep written records of short sale affirmative determinations that include, among other things, the identity of the individual and firm that offered the assurance and the number of shares needed to cover the short sale.

[22] A firm is supposed to have procedures that are designed to prevent a trader from selling on a downtick when the firm's aggregate position in the stock is short. However, when the firm does not aggregate all of the positions of the traders at LLCs—known as associated persons—then the firm does not know whether it is holding long or short positions in an individual security and could end up marking short sales as long sales and vice versa.

[23] Generally, a firm's net capital is computed by deducting illiquid assets from its "net worth," as determined under Generally Accepted Accounting Principles, adding to that amount properly subordinated debt under Appendix D of the net capital rule, and further deducting certain prescribed percentages, known as haircuts, from securities held in the firm's proprietary accounts.

usually evaluate a firm's net capital as of a given date. They are to check to see whether the firm has computed its net capital and whether the calculations were done according to the rules. Inaccurate computations result in firms either overstating or understating their net capital or having net capital deficiencies.

SEC and NASDR examiners found 16 examples of day trading firms either not maintaining the required minimum net capital amount or not preparing their net capital computations in accordance with the rules. Of the seven firms we visited, one firm had violated the net capital rules.

Advertising Violations

NASDR reported that 80 percent of the day trading firms that it examined had potentially problematic advertisements that had been referred to its Advertising Regulation Department for review. The problem areas ranged from exaggerated statements of profits that can be generated from day trading to day trading Web sites and other communications with the public that have indicated that losses can be controlled or minimized through the use of certain strategies or techniques. SEC has also stated that it is concerned about Web sites that, although not operated by day trading firms, are trying to capitalize on day trading. Many of these sites appear to advertise the potential rewards of day trading by use of the sites' recommendation. SEC said it is looking into whether these sites are violating the federal securities laws.

SEC and NASDR examiners found over 20 advertising-type violations. One of the seven firms that we visited had advertising violations. The types of advertising violations found at day trading firms included

- failure to maintain and evidence written approval by a registered principal on one piece of sales literature utilized during the day trading seminar sponsored by a branch office of the firms;
- failure of an affiliate of a day trading firm to file a pamphlet, which appeared to contain misleading or exaggerated statements, with NASDR's advertising department;
- failure to refrain from making recommendations in advertisements;
- exaggerated or unbalanced statements advertising a trader's profit; and
- failure to file initial advertisements with NASDR.

Fewer Violations Relating to Margin and Customer Lending

SEC and NASDR found fewer violations relating to margin and lending issues. Although these violations tended to be isolated, margin and related customer lending are two issues that regulators believe are potential problems with day trading firms because of the nature of day trading and the way it is conducted.

Margin

Day trading generally occurs in margin accounts.[24] Generally, a customer that trades in a margin account is subject to the initial margin requirements of Regulation T and the maintenance margin requirements imposed by the SROs. The initial margin requirements under Regulation T permit a firm to lend its customers up to 50 percent of the initial purchase of stock.[25] To comply with Regulation T, the customer would have to deposit funds or margin securities equal to 50 percent of the purchase price of the stock bought during the day and held in the account at the end of the day. For instance, a customer who wants to buy $150,000 worth of stock can put up $75,000 and then finance the other $75,000 with a loan from the broker-dealer. Once stocks have been purchased, NASDR and NYSE maintenance margin rules require a customer to maintain equity in his or her account equal to at least 25 percent of the value of the stock held in the account. For instance, a customer who bought $150,000 of stock on margin would have to have equity in a margin account of at least $37,500. If a customer does not satisfy these requirements, the broker-dealer must ask the customer to deposit additional cash or margin securities to satisfy the margin deficiency, known as a margin call. Thus, there are two separate margin requirements for each account: one for the initial purchase of stock and the other for the amount that has to be maintained on margin once stock has been purchased. Both calculations are made at the end of the day, and if a customer has not met the appropriate margin requirements, a margin call is issued. Regulation T margin calls must be satisfied within one payment period after the margin deficiency was created or increased, which is generally 5 business days. NASDR and NYSE maintenance margin calls must be satisfied as promptly as possible, and in any event within 15 business days from the date the margin deficiency occurred.

Because initial and maintenance margin calculations are made at the end of the day, the above requirements are generally not applicable to day traders because their stocks are sold by the end of the day before the

[24] A customer may purchase and sell a security on the same day in a cash account if the customer has the money in the account. However, if the customer does not have the money in the account, a day trade may amount to free riding—purchasing a stock and then selling it without having paid for the purchase.

[25] Regulation T is a Federal Reserve rule that specifies margin requirements. For example, it requires an initial margin of 50 percent for new purchases of stocks in margin accounts.

margin calculations are made. Accordingly, NYSE and NASDR have also established separate margin rules for day traders in order to addres this and other concerns. Under NYSE and NASDR rules, when day trading occurs in a day trader's account, the margin requirement is calculated at the end of the day based on the total cost of all the day trades made during that day. [26]

Regulators have found that some day trading firms that are structured as LLCs allow their day traders to be highly leveraged. Under an LLC, a day trader contributes to the firm's capital and, as a result, is permitted to trade using the firm's capital. Accordingly, the day trader is not subject to the margin requirements outlined above; rather, the day trader's leverage is limited by the firm's overall net capital requirement. This enables a day trader who is a member of an LLC to be leveraged far higher than the 2-to-1 leverage allowed day traders under initial margin and maintenance margin rules. Regulators implemented margin requirements not only to protect the financial integrity of broker-dealers that provide credit, but also to protect customers from taking on too much leverage. The leverage afforded through LLCs enables their day trading members to have much more capital with which to trade, and their exposure to loss is much higher than would be afforded to day traders of a broker-dealer firm that has a more traditional structure and treats day traders as customers. As a result, some day traders can be leveraged to a greater extent than was intended by margin rules.

NASDR and SEC examiners found five margin violations. Of the seven firms that we visited, one firm had margin violations. Margin violations included the following:

- An account was allowed to trade when Regulation T margin requirements had not been met.
- One firm's customers did not make the required deposits of additional margin into their accounts.

[26] However, under a NYSE rule interpretation, if the broker-dealer keeps a record showing the "time and tick" of each trade as evidence of the sequence of the day trades, the day trader may maintain margin based on the largest aggregate open position during that day. In effect, this requires day traders to demonstrate that they have the ability to meet the initial margin requirements of Regulation T for at least their largest open positions during the day. For example, a day trader who makes 20 buy and sell trades during the day and ends the day flat would receive a margin call based on 50 percent of the largest open position held during the day, assuming that there was a margin deficiency in the account. NASDR margin rules are substantially the same as NYSE's rules. However, NASDR has not adopted the "time and tick" interpretation regarding day trading margin.

- An associated person of the day trading firm extended credit to day traders of the firm in amounts that exceeded the amount the firm is allowed under under Regulation T.

Lending

SEC and NASDR found that some day trading firms allow the use of customer-to-customer lending, where one customer lends money to another who requires funds to meet margin calls.[27] NASDR found that half the firms that were examined allowed customer-to-customer lending. Combined, SEC and NASDR examiners found 23 day trading firms that allowed customer-to-customer lending. Of the seven firms that we visited, three allowed customer-to-customer lending.

Although customer-to-customer lending is not illegal, regulators are concerned about the practice, especially when such lending is used to satisfy day traders' margin requirements. Regulators believed that some day traders would be unable to continue to trade without the infusion of capital from the loans. NASDR expressed concern about customer-to-customer loans that were arranged by the day trading firm or one of its employees for the purpose of meeting margin calls. NASDR's concern was with the role of the day trading firm and what type of information was conveyed to the borrower about the risks.

The lending violations that the regulators found related to disclosure of credit terms in margin transactions and disclosure and other requirements when extending or arranging credit in certain transactions. For instance, Regulation T was promulgated to regulate the extension of credit by broker-dealers; it defines a creditor to include any person associated with the broker or dealer as defined in the Securities Exchange Act. Examiners found that some day trading firms were extending credit to day traders at the firm in violation of the rules. Examiners also found instances where associated persons of the day trading firms extended credit to customers without establishing procedures to ensure that day traders were given disclosures related to the terms of the loan. Of the seven firms that we visited, examiners found two firms had violations relating to lending.

Proposed Rules Address Some Regulatory Concerns

NASDR and NYSE have proposed rules that would require day trading firms to tighten margin requirements. NASDR has also proposed rules that would require day trading firms to assess the appropriateness of day trading for each potential customer and fully disclose the risks of day

[27] Regulators have also found that customer-to-customer lending may be facilitated by a day trading firm that would work with its clearing firm to identify day traders with credit balances who would be in a position to lend money to other customers.

trading. Although NASDR's Board had approved the rules, as of February 16, 2000, SEC had not approved them. SEC has issued the NYSE rules for public comment.

Proposed Rules on Margin

Both NASDR and NYSE have proposed tightening the conditions under which active day traders may trade stocks on margin. The NASDR proposal would require that a pattern day trader—a day trader who trades four or more times within 5 days—maintain a minimum equity of $25,000 at all times. If the account falls below $25,000, the day trader would be barred from further day trades until the account is restored. In addition, the proposed rules would require a special maintenance margin requirement of 25 percent of the cost of the highest open position during the day. The proposed rules would also reduce the time frame for day traders to meet a margin call from 7 days to 5 days. Under the proposed rules, if a day trader received a margin call, until the call is met, the trader's buying power would go to 50 percent and would be calculated based on the trader's cumulative positions, not the single highest position as is currently permitted under NYSE interpretation. Moreover, if the margin call is not met within the required 5 business days, no trades on margin would be allowed for 90 days or until the margin call is met. Furthermore, the funds that day traders deposit to meet their margin requirements would have to stay in the account for at least 2 business days in order to provide greater financial stability to day trading accounts.

Proposed Rule on Appropriateness and Disclosure

NASDR's proposed rule to require day trading firms to assess the appropriateness of day trading for each new customer is similar to the suitability rules NASDR imposes on broker dealers. Suitability rules require broker-dealers that recommend securities products to investors to make sure that the products are suitable for the investors, given the broker-dealers' knowledge of the investors' objectives, finances, risk tolerances, and so on.[28] Because day trading firms do not generally recommend particular products, they likely are not subject to the suitability rules.[29] However, the proposed appropriateness rule would require NASD firms that promote a day trading strategy to (1) assess whether such trading would be appropriate for each customer before opening an account for the customer or (2) get a signed document indicating that the customer is not going to use the account for day

[28] Suitability Rules refer to NASD Rule 2310 Recommendations to Customers.

[29] Suitability applies only when a broker makes a recommendation. There can be no claim against the broker for unsuitable investments when the broker does not make a recommendation.

trading.[30] The proposed rule does not expressly define what promoting a day trading strategy would be. However, it does state that a firm would be promoting a day trading strategy if the firm promoted day trading through advertising, training seminars, or direct outreach programs. In essence, to approve a potential day trader for trading, the day trading firm would be required to determine whether day trading is appropriate for the individual by reviewing such things as the day trader's financial situation, investment and trading experience, and investment objectives. Day trading firms would be required to prepare a written record setting forth the basis on which the firm had approved the account for day trading.

Risk Disclosure Statement

The proposed account approval procedures would also require a day trading firm to provide a potential day trading customer with a disclosure statement on the risks of day trading. A day trading firm's risk disclosure statement would be required to point out that day traders should be prepared to lose all of their funds and that trading on margin may result in losses beyond the traders' initial investment. Specifically, information that should be disclosed could include the following statements:

- Day trading is extremely risky.
- Be cautious of claims of large profits from day trading.
- Day trading requires knowledge of securities markets.
- Day trading requires knowledge of a firm's operations.
- Day trading may result in paying large commissions.
- Day trading on margin or short selling may result in losses beyond the initial investment.

Ensuring that day trading firms provide their potential traders an appropriate risk disclosure statement does not address what firms tell the traders orally. This presents a difficult challenge to regulators because they generally do not directly observe the interactions between firms and traders or potential traders. Also, unless they have a criminal investigative function, the regulators are precluded from posing as potential traders to test the oral disclosures firms provide.

[30] According to NASDR, a day trading strategy is an overall trading strategy characterized by the regular transmission by a customer of intraday orders to effect both purchase and sale transactions in the same security or securities.

Day Trading Firms Have Taken Steps to Mitigate Regulatory Concerns

Officials at some of the largest day trading firms have recognized regulatory concerns and said that they have taken steps to mitigate those concerns. For example, these officials said that they already screen prospective traders; have improved the disclosure they provide; and have restricted certain activities, such as customer-to-customer lending. Although day trading firm officials generally agreed with regulators that some day trading firms need enhanced oversight, they said they did not believe that the abuses at those firms warranted the new rule proposals. Most of these officials said that the proposed rules would not have much effect on their operations because they were already complying with much of what was being proposed.

Day Trading Firms Actions Regarding Appropriateness

Officials at six firms said that they screened potential customers to determine if an individual was the type they wanted trading at their firms. Although the criteria that each firm used were very subjective, all but one of the firms' officials said that they would not take just anybody off the street who wanted to day trade. These officials said that potential traders had to meet their firms' initial capital requirements. Additionally, they said that they would not allow the capital that individuals used to start trading to be money that they would need to meet a mortgage or other important expenses.

Some day trading firm officials expressed concern about the part of the proposed appropriateness rule that dealt with promoting a day trading strategy. They said their concern was that if they used the term day trading in advertising, training seminars, or direct outreach programs and received customers from such efforts, they could be subject to being sued by any individual who lost money day trading. They also stated that regulators were holding day trading firms to a higher standard than the rest of the industry in that the suitability requirement that applies to the securities industry applies only when a broker recommends a product. The appropriateness rule, they contend, seems to apply more broadly than the specific recommendation of a product required before the suitability rule applies.

Another concern expressed by officials from these firms was that because of the nature of day trading, it would be very difficult for them to determine beforehand whether or not day trading was appropriate for someone. They claimed that an individual would have to actually engage in day trading before a determination could be made about whether day trading was appropriate for the individual.

Officials from some of the firms we visited said that the appropriateness rule would have very little impact on their firms. They said this was because very few obtained day traders through advertisements or training seminars, which are two ways the appropriateness rule indicates that a firm would be promoting a day trading strategy. For instance, only two of the firms offered training seminars. Most of the firms said that their traders came to them through referrals. Furthermore, most of the firms said that they did not promote day trading strategies. Instead, they educated traders about how to limit their losses when trading. For example, some firms said that they would start individuals trading by allowing them to trade in increments of 100 shares. Once the traders learned how to limit their losses, the firm would then allow them to trade increasing numbers of shares.

Day Trading Firm's Actions Regarding Disclosure

According to officials at the seven firms we visited, they were already implementing NASDR's proposal that day trading firms be required to give potential customers a risk disclosure statement, even though SEC had not approved the risk disclosure proposal. Moreover, some of the firms had some type of risk disclosure form before the rule proposal. For instance, officials of one firm said they have had a disclosure statement since 1995, and officials at another firm said they have had one since 1997. Officials from both firms said that they had revised the form periodically. Five of the firms had started requiring customers to sign disclosure statements in 1999.

In February 1999, before NASDR had issued its disclosure proposal, ETA had proposed that its member firms adopt a risk disclosure statement. This statement not only reflected the risk disclosures proposed by NASDR, it also pointed out additional risks, such as the inability to liquidate positions because of market conditions and the possibility of loss through systems failures. As a result, one of the firms began to require its potential customers to sign disclosure statements. When NASDR issued its proposed appropriateness and disclosure forms in April of 1999 for comment, three of the firms implemented risk disclosure forms similar to what NASDR had proposed.

The disclosure forms of the seven firms that we visited generally appeared to be in line with NASDR's proposed risk disclosure. Those firms that had not exactly copied the NASD proposal had covered risks that NASDR's proposal had not included. For instance, one firm had a statement that persons who are new to electronic day trading should strictly limit both the number of trades they do and the size of their trades to reduce the risk of large dollar losses during the learning process. Another firm had a

statement that said the firm would neither make recommendations about general market conditions nor recommend any particular transactions to the day trader. It also said that all day trading decisions pertaining to the trading of a stock or the timing of a transaction would be the individual's own decisions. However, none of the firms that had their own distinct risk disclosure statement had mentioned that day trading through short selling could result in losses beyond the trader's initial investment. NASDR's recommended disclosure statement includes such a warning.

Officials at the seven firms we visited agreed that disclosing the risks of day trading was very important. The general consensus was that if firms disclosed the risks up front, they were limiting their liability in the long run. Some of them clearly supported informing individuals about the risks of day trading, and others said that when considered appropriate, they tried to talk people out of day trading. A few of the firms said that disclosure of the risk was not enough, and education about how the securities markets worked was also important.

Day Trading Firm's Actions Regarding Customer to Customer Lending

Three years ago the Federal Reserve amended Regulation T in a way that permits firms to arrange loans from one customer to another or find third parties who would lend to their customers. We found that day trading firms and their traders have been fully utilizing the change in the regulation. However, this type of lending at day trading firms has raised concerns among regulators. At issue is whether some day traders are allowed to continue to trade when they no longer have sufficient capital and whether the traders understand the potential risks of these loans. Margin rules generally limit how much customers could borrow to buy stocks, but lending to cover margin calls enables traders to continue trading when they otherwise might not be able to do so. The customer-to-customer loans are generally made on an overnight basis to traders who would otherwise face a margin call. The day traders who lend typically receive interest payments equal to one-tenth of 1 percent daily, which amounts to 36.5 percent on an annual basis.

Due to the increased regulatory interest regarding these loans, four of the firms we visited had stopped allowing customers to lend to each other. Of the firms that discontinued the practice, two did so because their clearing firms would no longer allow the lending to continue. The three firms that did allow customer-to-customer lending did not have a problem with the practice. One official said that customer-to-customer loans allowed individuals who accumulated wealth through day trading to move their earnings into long-term growth investments such as mutual funds instead of keeping the money at the firm.

Conclusions

Since it began in 1985, electronic day trading has been evolving in response to various regulatory and market changes. At the time of our review, it accounted for a growing segment of securities trading. Day traders provide competition for market makers and institutional investors that may benefit themselves and other individual investors. However, day traders may also cause adverse market effects, such as greater volatility in stock prices. Gaining a better understanding of the effects of day trading on the individuals who engage in it as well as on the markets could help regulators ensure that controls are in place to protect both.

The purpose of SEC's and NASDR's targeted examinations of the day trading firms was to ensure that day trading firms adequately informed day traders of the risks of their activities and had appropriate controls for their ongoing operations. Although they did not find widespread fraud and abuse in the industry, they found a number of problems, some of which they referred to enforcement officials for further investigation. Day trading is a particularly risky activity for individuals because they are competing with professional traders and can potentially lose considerable money. Further, the way day trading is done has changed rapidly and may continue to evolve. The new rules proposed by NASDR address some of the problems found during the reviews of day trading firm activities. However, because day trading has become a growing part of the Nasdaq market and because of the uncertain effects of such trading on investors and the markets, continuing to target day trading firms for annual examination could benefit both the traders and the market.

The actions taken by the seven largest day trading firms to improve disclosure about the risks of day trading should help ensure that appropriate information is available to a large percentage of prospective traders. In addition, if the firms take the actions they plan to improve their operations, including better screening of prospective traders; restricting customer-to-customer lending; and enhancing compliance systems for short selling, margin, and net capital, these actions should address a number of the problems regulators have found. Ongoing implementation of such controls by firms and oversight by regulators are important to ensure that potential day traders understand that they are directly competing with professional market makers and institutional traders and can lose as much or more than they have invested.

Recommendations

Because the effects of day trading in an environment that depends less on SOES and more on ECNs are uncertain, we recommend that the Chairman, SEC, in conjunction with NASD, evaluate the implications of the growing use of ECNs by day traders on the integrity of the markets. We recognize

that major changes are occurring in the structure of securities markets, especially the change to decimal trading, and recommend that the evaluation of day trading begin after decimal trading is implemented.

Also, day trading is risky for individual investors, represents a large and growing portion of the Nasdaq trading volume, and is an evolving part of the securities industry. Therefore, we recommend that the Chairman, SEC, do at least one more cycle of targeted examinations of day trading firms to ensure that the firms take the corrective actions they propose in response to previous examination findings.

Agency Comments and Our Evaluation

In commenting on a draft of this report, SEC concurred with our conclusions and agreed to implement our recommendations. NASD said that this report provided insight into the public policy issues related to day trading. It also pointed out that our report covers a complex and changing area where there may be different approaches on how best to protect investors and ensure marketplace integrity. NASD also stated that it had one substantive observation, that we had not addressed the impact of margin lending practices on the profitability of day trading firms, which it suggested merits further scrutiny. Although determining the impact of margin lending on firms' profitability may provide useful information not only for day trading, but also for the securities industry as a whole, it was not in the scope of our review. Both SEC and NASD provided technical comments that we incorporated as appropriate.

We will provide copies of this report to Representative Tom Bliley, Chairman, House Commerce Committee; and Senator Susan M. Collins, Chairwoman, Senate Permanent Subcommittee on Investigations. We are also sending copies to the Honorable Arthur Levitt, Chairman, SEC; and Frank Zarb, President and Chief Executive Officer, NASD. Copies will be made available to others on request.

Major contributors to this report are listed in appendix III. Please call me on (202) 512-8678 if you or your staff have any questions about the report.

Richard Hillman
Associate Director, Financial Institutions
and Markets Issues

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Abbreviations

ECN	Electronic Communications Networks
ETA	Electronic Traders Association
LLC	Limited Liability Corporations
NASD	National Association of Securities Dealers
NASDR	National Association of Securities Dealers, called NASD Regulation
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SIA	Securities Industry Association
SOES	Small Order Execution System

Comments From SEC

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF COMPLIANCE
INSPECTIONS AND
EXAMINATIONS

February 17, 2000

Mr. Richard Hillman
Associate Director
Financial Institutions and Market Issues
United States General Accounting Office
Washington, D.C. 20548

Re: GAO Draft Report Entitled: "Day Trading Requires Continued Oversight"

Dear Mr. Hillman:

Thank you for the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled Day Trading Requires Continued Oversight. The GAO sought to determine the nature and extent of day trading, assess regulatory actions taken to address the day trading risks, and assess the actions day trading firms have taken to address regulatory concerns. While your report focuses largely on identifying specific issues germane to day trading, it highlights the general regulatory consensus that day trading is risky for individual investors, represents a growing portion of the Nasdaq trading volume, and is an evolving part of the securities industry.

As the report indicates, the Commission's Office of Compliance Inspections and Examinations ("OCIE"), in conjunction with the National Association of Securities Dealers Regulation, Inc. ("NASDR"), have made a special effort during the past two years to target examination resources on day trading firms, examining collectively a total of 67 firms. Additionally, the report notes that the Commission is currently reviewing proposed rule changes submitted by the self-regulatory organizations that would require day trading firms to assess the appropriateness of day trading for each potential customer, to fully disclose the risks of day trading, and to tighten day trading margin requirements.

The Commission concurs with the conclusion of the GAO -- that follow-up examinations are important to ensure that deficiencies are corrected. Accordingly, the Commission and the NASDR will conduct additional targeted examinations of day trading firms to ensure that firms have taken corrective action in response to previous examination findings. In addition, in conjunction with the NASDR, we plan to examine during 2000, all remaining day trading firms that were not examined by either the Commission or the NASDR in 1999. The staff also anticipates conducting additional oversight, specifically designed to assess compliance with any rule changes adopted this year.

Mr. Richard Hillman
February 17, 2000
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Furthermore, we appreciate the GAO's recognition that major changes are occurring in the structure of the securities markets, particularly the impending conversion to decimal pricing. Pursuant to your recommendation and following the implementation of decimal pricing, the Commission, in conjunction with the NASDR, intends to evaluate the growing use of electronic communication networks by day traders on the integrity of the markets.

Thank you and your staff for your courtesy during this assessment.

Very truly yours,

Lori A. Richards
Director

Comments From NASD

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Alden S. Adkins
Sr. Vice President and
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February 16, 2000

Mr. Thomas J. McCool
Director, Financial Institutions and Market Issues
General Government Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

The NASD appreciates this opportunity to review and provide formal comments on the GAO draft report entitled *Day Trading Requires Continued Oversight* (job code 233611).

We have reviewed the draft report internally and have provided your staff with a series of technical edits to further enhance the report's accuracy. Other than those technical changes, which your staff has agreed to make, we have one additional substantive observation at this point. Specifically, the report does not address the impact of margin lending practices on the profitability of day trading firms, which we suggest merits further scrutiny. We have not had sufficient time to review the report to determine whether we will have additional substantive comment.

The draft report covers a complex and changing area where there may be different approaches on how best to protect investors and ensure marketplace integrity. The draft report provides insight into the public policy issues relating to the day trading industry. Thank you again for the opportunity to comment.

Sincerely,

Alden S. Adkins

GAO Contacts and Staff Acknowledgments

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Acknowledgments

In addition to the persons named above, Tamara Cross, Edwin J. Lane, Bob Pollard, and Gregory True made key contributions to this report.

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