Internet Trading - Take a Walk on the Wild Side

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INTRODUCTION

They're back... and they are turning the U.S investment market upside down. Who? Individual investors. You know - the guys who left the stock market after the mutual fund crash in the seventies and the stock market crash in the early eighties. All through the eighties and early nineties we heard how the markets were dominated by the "institutional investor". Pension funds, mutual funds, program trades and hedge funds were what moved the markets.

Now the individual is back and he is reeking havoc and making demands as never before. And finally, he feels he is on the same playing field as institutions. Ever since the markets first opened, the little guy never could compete with the big boys. He was forced to deal with stockbrokers who charged from 1% to 5% to buy or sell a security. His access to information was limited to the Wall Street Journal, Lois Rukesyer, and what his stock broker chose to tell him. The brokerage firms he dealt with had so many conflicts of interest that it was rare if he got the full story or the "good deals". Not only were commissions high, but spreads on over-the counter-stocks were stifling. It took the SEC 30 years to finally condemn the NASD for allowing its members to take advantage of small investors.

Now it is time to get even. The Internet trader of today may be better equipped than the stock broker or money manager of just 10 years ago. The commission rates on the net are such that an Internet trader can make a trade that makes him only a sixteenth, 1/16, before commissions and still make money. He no longer has to wait for his broker to come back from another vacation or to finally show up at the office. The net trader has 24 hour access to enter trades. He now not only gets real time quotes but he can get 2nd level quotes on OTC stocks that previously only professionals had access to.

This new breed of Internet trader deserves respect. He is probably a better bet than the hundreds of "green behind the ears" MBAs who are managing billions of this country's money in mutual funds. He also might be more qualified than the bucket shop, micro-cap stockbroker who was a cars salesman just weeks before.

With all this praise for the new Internet traders, the brokerage industry is still taking a bite out of them. Who is the new abuser? The Internet brokerage firms - E*Trade, Ameritrade, Schwab, and the like. This chapter will explain five main problems encountered by Internet traders.

L ORDER FAILURE

The number one complaint to date against the Internet firms is order failure. Many attorneys shy away from order failure cases because they see them as too technical and a "he said/she said" case. It is true that order failure cases are more technical, because we have all the specifics of time and price, order tickets, telexes, and computer screens. But for an expert, order failure cases can be the most enthralling.

With Internet firms we have a whole series of computer screens with information on them. The client types out the order and it appears on the screen. An acknowledgment appears on the screen. There is a status order screen. Order execution or lack of execution, with key details, is given on the screen. There is a screen with execution history. And lastly, most all phone conversations are taped. If a customer calls and complains about an order, there should be a phone record. Thus, an order failure case against an Internet firm should have all the records one needs to prove liability.

I say "should" because it is not yet proven which firms keep backnps or records of the various screens if the investor fails to print them out or take a photo of them (by the way, it is possible to photograph your computer screen). Finally, order failure cases are not subjective. If the brokerage firm messed up the order, there should be no baby splitting which is so prevalent in the typical arbitration. The investor should be made whole including any consequential damages.

A. On-Line Evidence

Another unique item for trying Internet order failure cases, is the ability to bring the order environment right into the arbitration. With merely a phone line, laptop computer and a projector attached to the computer, the expert can connect directly to the Internet trading firm's website and demonstrate to the arbitrators exactly the same order process the claimant dealt with. Possibly, the scenario in question can be reenacted. Of course, if your expert does not already have an account with the respondent brokerage firm, you will need to have him open one to conduct such a demonstration.

B. System Failure

The client's inability to enter an order may also fall under the heading "system failure", instead of "order failure", although the cause of action may be the same. An example of order failure on the Internet includes orders that were not executed, which includes both market and limit orders. Clients complaining about not getting a proper fill on their order is not new, as brokers have been making mistakes for years. It is the reason order tickets are time stamped and time and price sheets are prepared each trading day.

What is new is that the Internet firms advertise a cheaper, more efficient system for investors to enter orders - when, in fact, for many investors, the process has been anything but faster or more efficient. And, if your order is filled at a price far from what you expected, the process is anything put cheap.

One of the most common complaints is that the market order executed at a price that does not seem reasonable or fair based on the prevailing price when the order was entered. Of' course the brokerage firms argue that fast markets and volatile stocks are the cause of these problems. The stock exchanges, as well as the NASD, have rules and guidelines as to timely filling of orders.

Brokerage firms must prove that the entering of the order was done on an immediate and timely basis. Anything short of that is a violation and may lead to a successful cause of action in arbitration.

II. INADEQUATE SYSTEMS AND SYSTEM FAILURE

You could not pick up a newspaper months ago without reading about a brokerage firm's computer trading systems going down. There are hundreds of stories about investors who, on a fairly regular basis, have had problems making an Internet connection to the brokerage firm, getting anyone to answer a phone in less than an hour, and not being able to check their order status. I could go on ad nauseum about the damage that can be done when an investor cannot enter a trade or check his account status.

A. Volume Problems

There are two distinct problems that the Internet firms have with their systems. The first problem is that the operations departments and computer systems are such that they cannot properly handle the volume of business. What makes it worse is that the Internet itself is responsible for the huge volume it has attracted. It is much like the brokerage firms who sold all of the real estate limited partnerships in the eighties and said it was not their fault that the real estate markets collapsed. In fact, the huge amounts of capital brokerage firms poured into poor real estate investments through the limited partnership vehicle was part of the reason for their demise.

Likewise, Internet firms have marketed like crazy the last few years to attract new customers. You can hardly connect to the net or buy a software product without some discount being offered to sign up to E*Trade or the others. Also, the marketing was very convincing that the benefits of Internet trading far outweighed trading at a traditional brokerage firm. The clients with their accounts flooded in. Yet, the Internet firms were unable to handle the volume that their marketing departments created.

The problems created by this volume influx include customers being unable to connect due to busy lines or due to the firm's website being down; being unable to enter a trade or check account status because of some glitch in the website; being unable to call the Internet firm when the website is malfunctioning or, alternatively, waiting on hold for upwards of an hour or more.

B. Causes of Action

Is an Internet brokerage firm liable for these computer failures? Claims are based on, among other claims, fraud (the firm represented 24 hour access, speedy and timely fills of orders and failed to deliver); violation of the Securities and Exchange Act of 1934 (the firm employed schemes and artifices to defraud and engaged in acts, practices and courses of business which operated as a fraud and deceit); negligence NASD rules violated regarding good and ethical business practices.

and manipulative, deceptive or other fraudulent devices); and violations of state deceptive trade practice statutes (firm's services did not have the characteristics and/or benefits which had been represented).

C. An Expert's Viewpoint

You cannot create a system where a client is restricted for some reason from buying and selling a security in his account. There is a reason you have previously never heard of a case where an investor called Merrill Lynch to sell a stock he owned and Merrill would not let him enter the trade.

D. System Problems

The second problem is different than the volume problem. It is a problem with the Internet firm's design of their system, not so much that those systems were inadequate. Traditional brokerages have what are called "screens". This does not refer to computer screens but rather computer programs which monitor the trading in their customer accounts. The screens are a compliance and supervisory requirement so that unsuitable or improper activities can be investigated. As an example, there might be screens to catch whether a client is attempting to enter a duplicate trade.

"Collars", on the other hand, are actual restrictions that prevent activity from taking place. An example is where a commodity account is precluded from going over certain trading limits. Or where a client tries to use margin improperly or in excess of a firm's margin requirements. I sympathize with the brokerage firms' conflict of interest when they want to make commissions, but they cannot have their cake and eat it too. Firms cannot allow the customer to take positions that may be very leveraged or risky, and then blow the client out shortly thereafter ("blowing out" or "selling out" is when a brokerage firm liquidates stocks or a portfolio to meet a margin call). If the firms refuse to limit the trades with collars, they should at least generate an automatic warning that notifies the client of the negative and somewhat arbitrary consequences.

Thus far, I have seen limited screens or collars being implemented by the Internet firms. Many of the order problems I have seen with the Internet firms could have been easily prevented with some proper screens or caps being built into the Internet firm's software systems. In E*Trade's online learning center they identify a number of alert messages, which seem to indicate they might have some monitoring. The problem seems to be that they are, in fact, not in place or not functioning properly.

One example of how the screen could prevent a problem is when somehow an order is duplicated. The typical story is as follows. The client enters the order. Either because the client cannot ascertain if the order was filled or because the market moves away from the customer's order, he cancels the first order and enters a new, similar order. This is where the problem starts. The client is not always warned that he may not be able to cancel an order. Sometimes the firm acknowledges the cancellation when, in fact, the original order is either already filled or is too late to cancel. The client enters the new order, and again no warning is given that he may end up with a duplicate order. Either the investor ends up buying twice as much of a security or he sells too much and is short.

First, the client should receive a message along with the acknowledgment of the cancellation order to the effect that, "This acknowledgment does not mean that your order has been canceled. In order to confirm your cancellation, do the following..." In addition, there should be a warning to the client when he is about to enter a duplicate order. This warning should go not only to the customer, but also to the trading desk of the firm, as a backup measure. The trading desk, after receiving the warning, should take steps to ensure that there has been no change or a cancellation in the original order, thus preventing the duplication.

MARGIN

The second biggest complaint I have been hearing regarding Internet trading is centered around margin. Margin is not new to the brokerage industry. It is a huge profit center for the brokerage firms, second only to commissions. The conflict is that the brokerage firms make more money if clients use margin, but for the client, it increases the risks of trading. Internet firms are only following in the tradition, except now we have problems associated with this practice.

First of all, we do not have a broker explaining to the client exactly how margin works and the inherent risks of margin trading. Nor is there a broker monitoring a client's use of margin.

A. Margin Practices

Instead, margin accounts are given to anyone who signs a margin agreement. Since there are no minimums or limiting requirements, anyone can open a margin account - usually all you need is $2,000 or more and either an A or B blood type. A large number of investors have figured out what "initial" margin is, but very very few investors understand how maintenance margin works and how it is calculated. Unfortunately, this is also true for most stockbrokers. So, what Internet firms have created is a situation where you have some investors with very limited capital and experience using margin without full knowledge of the risks or how it works. When you combine this with volatile stocks and a volatile market, you get a very dangerous situation.

Firms have changed the margin rules on certain volatile Internet stocks, yet have put no program in place which warns an investor who enters an order to trade in such a security. Firms are selling investors out early and often when they become nervous about the trading or margin levels, yet agam they have no system that warns the investor. Many of these margin problems could be alleviated at the beginning if the Internet firms had caps, collars, and proper monitoring. The NASD has shown a great interest in the increase of margin use by investors trading through the Internet. NASD Notice to Members 99-33 discusses increasing margin requirements and maybe limiting the availability of margin to certain stocks and accounts, but it fails to address the timeliness issue.

To make matters worse, many of the Internet firms are not dealing fairly with their clients who use margin. I have seen many examples where investors' stocks are sold out to meet a margin call with no notice to the client. We are all familiar with the language in the customer agreement that gives the brokerage firms unlimited power in how to deal with a client's margin account. But selling the client out without first notifying the client and giving him an opportunity to meet the margin call is not the industry standard or norm. This is not a practice you find at Merrill Lynch or Goldman Sachs. So much for the advantage of the Internet firms. First, the brokerage firm pushes margin which is a profit center for them and then they do everything in their best interest to make sure that they never lose any money.

Internet firms have already covered themselves by issuing new restrictions on margin for certain volatile stocks and even disallowing margin on certain securities. Now, when a client has a margin call, Internet firms panic and instead of wiring or calling the client, they just sell the client out. I saw one case where the brokerage firm made a margin call in the middle of the trading day, before the market had closed. This is not proper. The firm sold the client out of all of his other securities all in the same day.

B. Margin Rules

Both the NASD and NYSE have specific rules on margin.2 The rules basically state that a client has 5 business days to meet a Reg-T margin call and 15 days to meet a margin maintenance call.3 Of course, both the NASD and NYSE give their member firms the ability to set whatever standards they want. Internet firms are not even coming close in many cases to these guidelines. One confusion is that most people are told that the margin call is due in three days not five or 15. Problems arise when clients are not even given the three days. The NASD and NYSE even have different rules for day traders; some are more lenient on margin and some are not.4

Brokerage firms have written into their client agreements language which basically states that brokerage firms can do anything they want and whenever they want with regard to selling out a client on margin. Reg-T margin calls were shorted from 7 days to 5 days a few years ago, but it has never been shortened to zero. An investor must be given the ability to meet the five day requirement.

Firms must properly notify a client in three methods not necessarily to the exclusion of the others. First, they must make a posting on the client's Internet page telling him of the call, the amount and what will happen if he does not meet the call. Second, they must make a phone call to the client. The firms must have at least one phone number which the client has listed as his primary number. At a minimum, a message must be left. Third, written notice must go out, preferably overnight, or it may be of no value. It is not fair for the firm to just use one of these methods and assume that notice was received. No doubt the brokerage firms argue that by selling a client out quickly, they are only attempting to protect their capital. Timely notice allows the client to take steps to protect the investor's capital.

IV. SUITABILITY

Internet firms would have us believe that the securities markets have changed to a "buyer beware" market just because an individual chooses to trade through the Internet. Their argument is twofold. First, they argue that if a person is trading through the Internet, he must be knowledgeable and to some degree a sophisticated investor (not unlike their argument that because an individual has money, he must be sophisticated in investments). Brokerage firms are not allowed to make such assumptions. Mounting complaints in this area show that all we do know about these traders is that they like to save on commissions. But many of them can be quite naive when it comes to investing.

Second, Internet firms believe that because there is no "broker", all of the trades are unsolicited and thus the firm has no need for a suitability determination. This is not the rule. The New York Stock Exchange rule on suitability does not limit its applicability to recommendations. Rule 405 of the NYSE, which requires brokerage firms to know each customer and to supervise each account, has no caveat which says this rule does not apply to clients and accounts where the client places his own trades. Also, the duty of suitability has always been a dual responsibility of the broker and the brokerage firm. Clearly the NASD is also very concerned about suitability of the trading on the Internet.5

A. "Unsolicited" Orders

Every customer who opens an Internet trading account is asked to provide information about his net worth, trading history, and investment goals. Why do the firms require this information? At the most elementary level, the securities rules require the gathering of this information. But the rule also exists so that firms can fulfill a suitability duty.

The oldest analogy applies very well here. If a little old widow in tennis shoes walks into a brokerage firm and tells them that all the money she has in the world is $10,000 and she wants to risk it on index options, should the brokerage firm take this "unsolicited" trade order? Can a firm let a client knowingly blow himself up, or can a firm knowingly let a client make unsuitable trades? We now enter into the area of dram-shop arguments and this is too lengthy a discussion for this chapter and may be best left to legal briefs, but a few comments are necessary from this expert's point of view.

My view is no - the firm should not enter that trade for that client. Brokerage firms are licensed firms and, like doctors, cannot allow a client to do something they know is not in the client's best interest, i.e. unsuitable. Major brokerage firms have tried to argue in some suitability cases that the broker presented a number of investments to a client. Some were safe and some were risky. The fact that the client then chose the risky investments is not the broker's fault, they argue. That defense does not fly. A doctor cannot line up a row of medicine in front of his client and say you pick the one that you think might cure your ailment. Is that not what the net firms are doing? "Hey investor - here at your disposal is the entire laundry list of investments to choose from and an easy and cheap way to buy them. Have fun at your own risk!"

B. E*Trade

When it comes to suitability, Internet firms are trying to bypass NYSE Rule 405 and quote the NASD rule, which says "when recommending a security it must be suitable." Then, the firms say they do not make recommendations. E*Trade states in writing "E*Trade does not offer investment advice... or recommend the suitably of an investment strategy" Yet, E*Trade offers initial public offerings (IPOs) and stock recommendations, both of which E*Trade benefits from financially. Now that E*Trade and others have crossed the line, their footnote no longer has much meaning.

Just because Internet firms offer these services and advice via the computer, it does not lessen their duties. Wirehouse firms have been held responsible for solicitation for merely mailing a research report to a client, even if it was a research report produced by another firm. E*Trade makes some of the following claims on its web site:

.charts, and analysis plus high powered research, screening tools...

.save on margin rates...

... we give you more ways to access your account...

high-quality trade executions...

... We take pride in routing orders to markets and market makers based on their ability to provide rapid and high-quality executions. We seek price improvement for all eligible orders. Market orders place when the markets are open are typically executed and confirmed electronically in seconds...

Surely, if Internet firms are participating in IPOs and offering stock recommendations, as well as making claims like the above, they are looking more and more like the major wire houses.

You will note some very interesting items when you read E*Trade's comments surrounding its offerings of IPOs. First, it requires a special "Eligibility Profile". Why - if E*Trade has no responsibility? It would seem that E*Trade wants the best of both worlds. On the one hand, E*Trade tries to distance itself by saying "E*Trade is not endorsing any particular investment by making it available to customers. Yet, on the other hand, it heavily markets the sale of IPOs, from which it benefits:

We've put the "public" back into IPO! As an E*TRADE customer, you can apply to participate in equity offerings lead-managed by some of the world's most respected investment banks.

Sounds like a solicitation to me. Also, E*Trade now has the E*TRADE S&P 500 Index Fund. How do you not solicit your own mutual fund? But E*Trade says it had no involvement. That would be like a doctor saying she is not responsible for her patient dying when the patient took the wrong medication. The doctor's defense was, "I gave the client a choice of several prescriptions. The client chose the wrong one.

V. CLIENT UNDERSTANDING

In a large percentage of the Internet complaints I have seen thus far, an item that causes significant problems is the investor's lack of understanding of either the securities markets or the Internet trading system. Margin is just one example. Obviously, the marketing by Internet firms has been directed at the masses, and there is nothing in their system to distinguish between the novice or the sophisticated investor. So, the firms knew or should have known that they would attract inexperienced investors, as well as knowledgeable investors.

It has been a long time since the enactment of the Securities and Exchange Act of 1934 and there have been a world of changes. But the heart of the 1934 Act is still in place - the recognition of a naieve, investing public. In terms of the number of people investing, there are probably more naive investors today than ever before.

Having totally removed the stockbroker from the picture, Internet firms have effectively eliminated the one safeguard for many individuals. In an ideal world, we should see the Internet firms paying more attention to the inexperienced, unsophisticated investor. Yet, that is not what we are seeing. In a sense, Internet firms are trying to take the liability of the brokerage firm out of the picture completely, a distressing thought.

CONCLUSION

Individuals may be glad for once that they are in arbitration instead of court, where a technical enforcement of contract terms is more likely. Internet firms have done an excellent job in their customer agreements of excluding liability for just about everything. A perfect example is DeanWitter' 5 agreement, which states: "You flirther agree that Discover Brokerage and its affiliates will not be liable for any consequential, incidental, special or indirect damage (including lost profits, trading losses and damages) which result from delays in or loss of the use of Discover Brokerage services, even if Discover Brokerage was aware, in the ordinary course of business, of the possibility of such delay or loss."

Next year, for Securities Arbitration 2000, there will be a follow up to this chapter. In the coming months, Internet claims will start to be arbitrated en masse. Attorneys and experts will then have an in-depth opportunity to investigate the inner workings of Internet firms, other than just from the computer screen. Supervisory, compliance, operations, and computer system staff will be subpoenaed and cross examined, and the story will further unravel. Stay tuned.

NASD Notice to Members 99-33 is one of the many recent releases by the NASD addressing margin use by investors trading on the Internet.

2 Regulation-T governs initial margin calls, that is the amount of money required 0 n the original purchase of a security. The current rule is 50% of the purchase, and the money must be deposited T-plus 2 which is five business days. Maintenance margin i 5 when a security being held in the account drops below a certain value based on the equity in the account. The NASD and NYSE both have rules on maintenance margin. The rule is the same for both NASD and NYSE - no less than 25% equity and if a margin call is made, the money is due in 15 business days. See NYSE 341(f)(6) and NASD 2520(6)(f).

3 In practice, firms rarely allow a customer the 15 days to meet maintenance calls, because the NASD can charge the firms' capital account for not meeting these margin calls within five business days.

4 Under NYSE rules, a person who has a pattern of day trading is normally given two extra days to meet margin calls. There are also provisions for extensions that allow a customer extra days for meeting margin calls.

5 NASD Notice to Members 99-32 discusses the need for Internet brokerage firms to "exercise diligence to ascertain the essential facts relative to the customer" to determine if allowing day trading is suitable. The NASD also suggested a more detailed Risk Disclosure Statement.