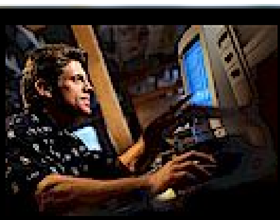

Online Investor Complaint Center
The original resource guide for the dissatisfied online investor

Schwab's apology for service shortfalls falls short

Are online brokers' service failures growing pains or legal, regulatory violations?

By Online Investor Complaint Center
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"Poor trade execution, poor customer service, and high commissions. Not a good combination." No, these are not a good combination, especially when an investor on a popular Internet message board is talking about the nation's largest discount and online brokerage, which prides itself on providing "a full-service investing experience," Charles Schwab & Co.

Unfortunately, this dissatisfied investor is not alone. Since early 1999, many Schwab customers have not always received the advertised "full-service investing experience" implicit in Schwab's relatively high $29.00 commission fee. These sometimes frustrated and angry Schwab customers have endured what they probably never expected when Schwab's aggressive advertising campaign lured them to sign up: well-publicized and repeated computer glitches and outages, difficulty accessing accounts, difficulty making trades, delayed order executions, difficulty reaching the trading desk or customer service, long telephone hold times, and delayed email responses.

Responding to these continuing computer and customer service failures, Charles R. Schwab and David S. Pottruck, Schwab's co-chief executive officers, apologized two weeks ago in a one-page letter to their almost 7 million customer accounts. According to the March 24, 2000 "Schwab Apologizes for Service Shortfalls," by Bloomberg News, Schwab and Pottruck wrote, "Schwab prides itself on delivering great service, and we are afraid that we may be falling short of your expectations." They also wrote, "If you are one of our clients who has experienced inconvenience, we extend our sincere apology and thank you for your ongoing patience."

Although Schwab's apology for its service shortfalls went far beyond other online brokers' responses to their own service

One of "the best" online trading sites.
—*Consumers Digest* July/August 1999

"I love your site... it is a great service to the investing public."
—Mark E. Maddox, Former State of Indiana Securities Commissioner

SEC Criticizes Brokers
Schwab Class-Action Lawsuit
Schwab Fee Controversy
Datek-Mohr Controversy
Schwab Apology
SEC, NY Atty. Gen. Failures
SEC Privacy Violation

shortfalls, Schwab's apology did not go far enough. Apologizing for their customers' "inconvenience," Schwab and Pottruck failed to acknowledge, apologize for, or offer to compensate for money losses that some customers have blamed on Schwab's computer and service failures. In other words, Schwab and Pottruck failed to say in their letter that they would make any customers whole, as Schwab did around March 1999, when it settled for up to $1.2 million with around 300 customers who could not cancel their market orders before TheGlobe.com (TGLO) started trading during its November 1998 initial public offering. Schwab and Pottruck also failed to say they would temporarily scale back their aggressive advertising campaign and new account acquisitions while struggling to beef up trading systems and customer service capacity to keep pace with the surge in new accounts and record trading volume. Instead, Schwab and Pottruck merely thanked their customers for their "ongoing patience."

As a result, if Schwab continues to advertise aggressively, Schwab will continue to be plagued by further technological failures. According to Scott Thurm's "For Frazzled Online Brokers, Technology Is the Problem," in the March 4, 1999 *Wall Street Journal*, online brokers cannot scale their online trading systems with the current account growth rate because online brokers' cutting-edge computer hardware and, especially, software are highly complex and inadequately tested. These computers and software are also prone to glitches and failures mainly because "the crucial software knitting these computers together is unproven and vulnerable." Although Schwab conducts simulation tests during hardware and software upgrades, "the unpredictability of loads in businesses such as online stock brokerages can make simulations a crapshoot," says Jeffrey Schwartz's "Schwab Outage: IT Wake-Up Call," in *Internet Week* on February 26, 1999. Consequently, according to Thurm, online brokers "pushing the limits of computer systems and software into uncharted territory" will continue to suffer further trading system glitches and outages until the current account growth rate subsides.

Other reporters, industry experts, and securities regulators have also warned online investors about and correctly predicted these persistent computer glitches and outages. For example, in the February 24, 1999 "Glitch Derails Online Trading at Schwab," The Associated Press said, "With no end in sight to the surging demand for online trading, Schwab and its rivals will be forced to continually upgrade their systems, opening the door to more glitches." According to the article, Julio Gomez, of the e-commerce research and consulting firm Gomez Advisors, warned online investors that "it's not a matter of 'if the system crashes,' it's a matter of 'when it crashes.'" Gomez explained that "[online brokers] are still marketing aggressively, and they're not yet ready to handle all that volume." The November 22, 1999 200-page report on online trading *From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry*, by New York Attorney General Eliot Spitzer's Investor Protection and Securities Bureau, also warned online investors that the "[major] online brokers will continue to suffer problems with their trading systems."

Although Schwab executives have apologized for their trading system and customer service problems, neither their apology nor the Schwab customer agreement absolves Schwab of the following legal and regulatory obligations regarding adequate trading systems capacity, an adequately staffed order room, and advertising practices:

1. The Securities and Exchange Commission (SEC) Division of Market Regulation's Staff Legal Bulletin No. 8 advises brokerage firms to maintain adequate trading systems capacity to handle extreme market volatility and surges in trading volume.

2. Section 15(b)(7) of the Securities Exchange Act of 1934 prohibits registered brokerage firms from handling or executing any securities transactions if the brokerage firms do not meet "standards of operational capability [e.g., adequate online and telephone trading systems capacity] and . . . standards of training, experience, competence, and such other qualifications as the [Securities and Exchange] Commission finds necessary or appropriate in the public interest or for the protection of investors."

3. National Association of Securities Dealers (NASD) Conduct Rule 2320(d) requires member brokerage firms to maintain and "adequately staff an over-the-counter order room or other department assigned to execute customers' orders" to handle customer orders even during market volatility and surges in trading volume.

4. Finally, NASD Conduct Rule 2210 strictly prohibits member firms from making false, misleading, or exaggerated statements or claims or *omitting* material information in all advertisements and sales literature directed to the public. As a result, Conduct Rule 2210 requires member online brokers to advertise the *complete* truth about the risks of online trading and about the speed, reliability, accessibility, and capacity

of their trading systems and telephone customer service lines.

In fact, SEC Chairman Arthur Levitt has reminded and warned online brokers about these legal and regulatory obligations. For example, in his May 4, 1999 speech "Plain Talk about On-line Investing," Levitt told online brokers that "firms should remember that while on-line trading may place significantly more responsibility in the hands of investors, it doesn't absolve the firms of their obligations to customers." Levitt warned, "If you're marketing your firm to new customers, you'd better be able to provide them service when they do business with you." He also reminded online brokers about their legal "obligation to ensure the best execution of their customers' orders." Finally, Levitt urged online brokers to create realistic expectations in advertising and to clearly disclose the "risks or what to do in the event of system capacity and outage problems."

But because the SEC, NASD Regulation, and state securities regulators, such as Spitzer's Investor Protection and Securities Bureau, are reluctant to act on behalf of online investors by strictly enforcing laws and regulations against the new and vulnerable online brokerage industry, Schwab customers will have to act on their own behalf. Aggrieved Schwab customers who have suffered losses due to Schwab's trading system or customer service failures will have to ask Schwab to acknowledge not only their "inconvenience," but also their actual losses. These customers will also have to ask Schwab to make them whole, as Schwab and other online brokers, such as Fidelity, Merrill Lynch, and Ameritrade, have already done for victims of trading system delays and failures. In addition, Schwab customers who expect fast and reliable trading systems and a supposedly "full-service investing experience" for the relatively high $29.00 commission fee will have to ask Schwab to temporarily scale back its aggressive advertising and new account acquisitions while it increases trading systems and customer service capacity.

Will Schwab voluntarily satisfy these customer requests and adequately respond to its computer and service shortfalls? In today's poorly regulated online brokerage industry, Schwab is unlikely to voluntarily acknowledge and compensate for anything beyond its customers' "inconvenience." Acknowledging and compensating for losses are costly, and if Schwab wanted to acknowledge customers' losses, Schwab and Pottruck would have done this in their apology letter.

Schwab is also unlikely to temporarily scale back its aggressive advertising because Schwab and its rivals, such as have already done for victims of trading system delays and failures. In addition, Schwab customers who expect fast and reliable trading systems and a supposedly "full-service investing experience" for the relatively high $29.00 commission fee will have to ask Schwab to temporarily scale back its aggressive advertising and new account acquisitions while it increases trading systems and customer service capacity.

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Schwab is also unlikely to temporarily scale back its aggressive advertising because Schwab and its rivals, such as E-Trade, Ameritrade, TD Waterhouse, and Datek Online, are locked in a fierce, do-or-die battle to gain market share and survive the inevitable shakeout in the crowded, competitive online brokerage industry. According to Sam Zuckerman's "Busy Signals Plague Online Investing: Brokers' Customer Service Phone Lines, E-Mail Can't Handle Surge of New Business," in the March 28, 2000 *San Francisco Chronicle*, Maurisa Sommerfield, Schwab's manager of retail client services, explained that "turning [advertising] on and off has long-term ramifications" for "a growth company."

Schwab and the other aggressive advertisers, however, should understand that failing to adequately respond to computer and service failures also has long-term ramifications for growth companies. These include numerous customer complaints, arbitration cases, class-action lawsuits, negative publicity, damaged reputation and brand image, reduced growth, loss of market share, and eventual elimination. As Chairman Levitt said, "It doesn't take a regulator to tell you what unhappy customers mean to a company's future, or more broadly, to the future of on-line investing."
