Home
Regulators
Congress
Legal Contacts
Media Contacts
Broker Executives
Broker Rankings
Laws & Regulations
News
Internet Boards
Investor's Store
Guest Book
Contact Us
Links to Us
Search Site

License to Steal

Online Investor Complaint Center

The original resource guide for the dissatisfied online investor

U.S. securities regulators criticize, warn online brokers—yet again

By Online Investor Complaint Center
February 26, 2001

A recent online trading report by U.S. securities regulators criticizes online brokers' trading systems, trade executions, Internet security measures, advertising practices, and investor education, warning firms to address a continuing surge in customer complaints.

The report, released on January 25 by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations, follows the SEC staff's examinations of "a wide range" of online brokers from among more than 200 firms. The New York Stock Exchange and the regulatory division of the National Association of Securities Dealers (NASD Regulation) participated with the SEC staff during the more than two years of examinations.

According to the report, *Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations*, many online brokers have not adequately informed inexperienced investors about basic investing terms and concepts. For example, many firms' websites failed to provide clear, accessible explanations of margin and cash accounts, the different types of stock orders, the trade execution process, and the IPO (initial public offering) allocation process, the examiners found.

They also found that many online brokers did not adequately warn their customers about the risks of margin investing, market volatility, poor trade executions, and trading system delays or outages.

The same trade execution problems and system disruptions have been highlighted in previous notices, bulletins, and reports by various securities regulators and government agencies. These include the SEC's Division of Market Regulation, NASD Regulation, New York Attorney General Eliot Spitzer, SEC Commissioner Laura Unger, and the U.S. General Accounting Office.

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

A November 1999 report by Unger, now acting SEC chair, and a May 2000 report by the GAO recommended that the SEC require online brokers to keep records of their computer failures and to clearly warn investors about the risk of delays or outages. The report by the GAO, the investigative arm of Congress, also recommended that the SEC monitor these records to better protect online investors.

Similarly, the new SEC report advises online brokers to keep records of system disruptions and to "provide conspicuous, plain English disclosure about the risks of securities trading, including the risk of systems outages or failures."

But instead of recommending that the SEC require these or any other practices, the SEC report "recommends that broker-dealers evaluate their own online trading programs in light of the issues described in this report." The report further advises online brokers to "consider" the various procedures and practices suggested in the report, including keeping records of system disruptions.

According to the report, some online brokers need to improve their procedures to prevent their trading systems from executing customers' duplicate stock orders. Customers may place duplicate orders, the examiners found, "when reports of cancellations are significantly delayed (by hours or even days) so that a customer may assume that his/her initial trade was not executed."

As a result, many online investors have complained to the SEC about "placing unintended short sales or buying beyond their available funds," last month's report says.

The report, like the November 1999 online trading report by Attorney General Spitzer's office, criticizes some online brokers for aggressive advertising that "could lead investors to have unrealistic expectations about the risks and rewards of investing."

The examiners do not name any online brokers or indicate that the SEC has taken any specific actions against firms with deficiencies.

But the SEC and NASD Regulation were formally investigating the advertising practices of Menlo Park, Calif.-based E-Trade Group Inc., the online broker disclosed last year in an SEC filing. In fact, according to the filing, E-Trade, which spent over half a billion dollars on marketing in its fiscal year 2000, agreed with securities regulators to submit

U.S. securities regulators criticize
Search or enter address

during a three-month period last year all their advertising to NASD Regulation for review and 10-day advance approval. E-Trade also disclosed in the filing that NASD Regulation had asked the firm "to revise certain marketing materials."

In addition to the regulatory scrutiny of E-Trade's advertising practices, several E-Trade customers have filed class-action lawsuits against E-Trade, alleging false and deceptive advertising by the firm.

According to the new SEC report, regulators are concerned that a common but controversial practice of brokerage firms known as "payment for order flow" may create a conflict between firms' financial interests and their legal duty to try to get their customers the best executions of stock trades, regardless of any financial incentives.

Payment for order flow, which some critics liken to legal kickbacks or bribes that harm retail investors, refers to the money, rebates, or credits that brokerage firms receive from market makers—third-party trade execution firms—for sending them customers' stock orders for execution. For instance, many online brokers, such as Ameritrade, E-Trade, and TD Waterhouse, may receive a payment from the major Nasdaq market maker Knight Trading Group Inc. for sending a customer's stock order to Knight. This middleman then executes the order and profits from the difference between the stock's buy price and sell price, known as the "spread."

Under this profit-sharing arrangement, many online brokers have violated their best-execution duty, the SEC report charges.

"They sent all of their order flow to their clearing firm and conducted no independent review of execution quality," the report says, adding that "they limited their review to those markets to which they currently routed order flow." As a result, many online brokers "were not adequately assessing execution quality in determining where to route customers' orders," the SEC staff found.

Arthur Levitt, who was SEC chairman until early this month, has also sharply criticized order flow payments, charging in a November 1999 speech that "some firms appear to be allowing payments for order flow or other inducements to affect which markets they send their orders to—at the expense of quality executions."

Instead of banning payment for order flow, the SEC decided to adopt last November two new disclosure rules to help investors choose online brokers providing the best trade executions. The rules are supposed to be phased in starting this April.

One rule will require brokerage firms to disclose quarterly the names of the market centers—stock exchanges, market makers, and electronic communications networks (ECNs)—to which they send orders for trade executions. The rule will also require firms to disclose the financial relationships that they have with these trade execution centers.

The other SEC disclosure rule will require market centers to publish monthly data on their execution quality of investors' stock orders, including speed, price, and spreads.

The SEC expects the financial press, analysts, and ratings services to compile and analyze this raw trade-execution data and then publish rankings of brokerage firms' and market centers' trade-execution quality. The SEC is counting on the rankings to improve execution speeds and prices for investors by spurring brokerage firms and market centers to compete to improve their rankings.

But investors may have to wait until sometime after April for the new disclosure rules to actually begin to take effect, Dow Jones Newswires reported Friday. The SEC may delay the rules for a month or more to give market centers and brokerage firms more time to gather the information they will need to publicize, Dow Jones said.

The SEC would have to vote to approve the delay.

Besides warning many online brokers to comply with their best-execution duty, last month's SEC report warns some firms to improve their procedures to ensure that their trading systems have adequate capacity to handle high trading volume.

"About a quarter of the firms examined either did not conduct any assessment of their operational capability or had difficulty responding to questions regarding their capacity," the report says.

It points out further that some online brokers have not used the most secure form of encryption on their websites and that most firms have failed to use any form of email encryption. Some online brokers sent and received

customers' private, confidential information, such as Social Security numbers, passwords, and account numbers, via unsecured, unencrypted email, the SEC examiners found.

The report warns about another Internet security risk with some firms' websites that fail to restore password protection and deny unauthorized account access on customers' computers unless customers log out after logging in. If a customer using this type of website does not log out when finished, any unauthorized person using the customer's computer can access the customer's account, the report says.

Although Levitt, Unger, Spitzer, SEC examiners, NASD Regulation, and the GAO have all warned online brokers to improve their business practices, the new SEC report says customer complaints have continued to soar. According to the report, the number of online trading complaints that investors filed with the SEC's Office of Investor Education and Assistance surged from 259 in the SEC's fiscal year 1997, which ended September 30, to 4,258 in its fiscal 2000. And since late 1999, online trading complaints have surpassed all other categories of customer complaints filed with the New York Stock Exchange, the report adds.

The five most common complaints against online brokers for the SEC's fiscal 2000 were order execution delays and failures, account access problems, margin position sellouts, order processing errors, and poor trade executions, according to the SEC's Office of Investor Education and Assistance.

Some investor advocates claim that the complaints have continued to grow due to the SEC's decision only to warn and jawbone deficient online brokers.

"We commend you for these [SEC] actions, but more needs to be done," wrote four House Commerce Committee Democrats in a June 2000 letter to Levitt regarding the GAO's online trading report. "Jawboning, for example, is only effective if it yields results, and some people clearly have not gotten the message."

"Parents know that you yell at children the first time, yell a little louder the second time, and then begin a progressive series of disciplinary actions intended to get their attention," says Mark Maddox, a former Indiana securities commissioner who is now an Indianapolis securities arbitration attorney representing investors. "Since the SEC is only willing to yell at the online industry, their serious misconduct and gross negligence simply continues

The five most common complaints against online brokers for the SEC's fiscal 2000 were order execution delays and failures, account access problems, margin position sellouts, order processing errors, and poor trade executions, according to the SEC's Office of Investor Education and Assistance.

Some investor advocates claim that the complaints have continued to grow due to the SEC's decision only to warn and jawbone deficient online brokers.

"We commend you for these [SEC] actions, but more needs to be done," wrote four House Commerce Committee Democrats in a June 2000 letter to Levitt regarding the GAO's online trading report. "Jawboning, for example, is only effective if it yields results, and some people clearly have not gotten the message."

"Parents know that you yell at children the first time, yell a little louder the second time, and then begin a progressive series of disciplinary actions intended to get their attention," says Mark Maddox, a former Indiana securities commissioner who is now an Indianapolis securities arbitration attorney representing investors. "Since the SEC is only willing to yell at the online industry, their serious misconduct and gross negligence simply continues unabated."

Al Lapins, the branch chief of the SEC's Office of Investor Education and Assistance, responded to three detailed email requests for comment two weeks after the first request sent to his office. He declined to comment, instead referring the Online Investor Complaint Center to John Walsh, chief counsel of the SEC's Office of Compliance Inspections and Examinations.

Walsh has not responded to three detailed telephone messages seeking comment on the statements by Maddox and the four House Commerce Committee Democrats.

If you would like to respond to this article, please email the editor.

Copyright © 1999–2005 Online Investor Complaint Center