
Online Trading Awards Survey

In Which We Identify the Most Common Claims and the Most Likely Outcomes

Introduction

As Bob Sullwold's feature article points out, the number of trades being done online has grown tremendously. One might expect that this sea change in America's investment habits would be represented in an ever-growing percentage of the securities arbitration filings and Awards. Indeed, there has been growth in disputes involving online trading activities, but, as a percentage of the whole, such disputes are not currently effecting a sea change in securities arbitration..

In this Survey, we seek to identify all of the Awards that issued during the three-year period from January 1998 to December 2000 that concerned disputes arising out of online trading activities. For the survey period, SAC's Award Database reflects 5,621 Awards of all varieties. Among those 5,621 Awards, we found 205 Awards that we could classify as online trading-related. There were 46 in 1998, 50 in 1999 and 109 in 2000. Eight of the 205 Awards were initiated by broker-dealers attempting to collect deficits in customers' accounts, so only 197 were customer-initiated. Of those 197 Awards, 130, or two-thirds of the Awards, were heard and decided by one Arbitrator.

Single Arbitrators decided only 1,750 of all 5,621 Awards between 1998-2000, so the two-thirds single-Arbitrator composition suggests that this genre of dispute generally involves less money than traditional brokerage claims. Online trading cases often involve disputes over point-in-time occurrences, as opposed to pattern-type disputes and the fact scenarios frequently unwind fairly quickly. These factors may help to explain why the damages involved tend to be generally lower on average.

Brokerage firms tend, too, to fare somewhat better in disputes with online customers. The "win" rate for customers in our survey was 43.6% overall, whereas customers in securities arbitration have historically enjoyed "win" rates in the 50-60% range. For this period in particular, customer-initiated claims reflected an overall customer "win" rate of about 57%. Among the online trading Awards, the "win" rate for cases decided by more than one Arbitrator was almost 50% (33 of 67 Awards). The 130 single-Arbitrator Awards revealed only 53 Awards in favor of the claiming customer, or a "win" rate of about 41%.

Whether this difference was actually due to the Panel composition or to some other factor (e.g., non-hearing cases, the conduct in dispute or size of claim), we could not tell. It does seem ironic that an Industry Arbitrator generally sits on three-member Panels, a fact that some advocates believe disserves the investor-Claimant. In any event, the lower "win" rate in this predominant class of single-Arbitrator disputes was one factor in the generally lower "win" rate for online investors overall.

It has seemed to us that there are other factors that would presage a lower "win" rate for online investors in their disputes with the unseen, behind-the-screens broker-dealer. Online investors are not churned in any traditional manner, unauthorized trades occur only in the sense that a late response to a margin call may result in an involuntary liquidation, and unsuspecting investors are simply not in a position to say, "you decide; just keep me posted." Online investing allows self-directed trading by investors who are the master of their own fates. They get into trouble, no doubt, and may even be lured there. Moreover, the technology is not as flawless as we would all like to suppose. Still, the idea of the malevolent broker,

oozing with avarice and poised to slaughter the lamb, is an improbable anachronism in the online world. The allegations are different today.

Methodology

The point of this Survey is to see what is being alleged by the online investor and how those allegations are being received by arbitrators. We need to concede at the outset that isolating our group of online trading Awards was not easy and, sorry to say, we are not fully confident that our universe is complete. In part, this uncertainty must be attributed to the increasing failure on the part of the SRO forums, particularly the NASD, to abide by rule requirements for a summary of issues in the Awards. NASD Awards have a "Case Summary" section, but too often it is devoid of any substantive information — of the color or flavor that SICA surely envisioned when it set information requirements and began the Public Awards Program.

As a result, oftentimes, there is nothing to advise the reader (or our Database inputters) that online trading is the medium in which the dispute arose. Moreover, if it is clear that online trading underlies the dispute, there is insufficient information about the nature of the dispute to permit confidence in classifying the dispute into an allegation category. We are not asking for an explanation of the Arbitrators' Award; we are asking for an explanation of the parties' pleadings. Drawing conclusions from past Awards will lose validity if this trend continues.

After word-searching the Award Database and the SCAN Awards Library for "online" disputes, we also added to our survey base Awards that were not otherwise designated for inclusion, but which involved fully online broker-dealers. Thus, we have the

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Awards of E*Trade, Ameritrade, DLJ Direct, and the others, but we cannot say that all wirehouse or retail brokerage disputes originating with online activity were accurately identified and included in our study.

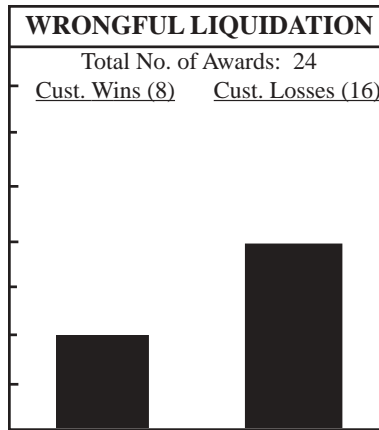
With an Award base of 197 customer-initiated Awards, we established categories that reflected the most common claims we came across in reading the survey Awards. Classifying the claims was admittedly subjective and, due to often vacuous “Case Summary” descriptions, even fraught with uncertainty. In addition, the results of this particular survey must be weighed with care, because the sample itself is not large and breaking it down into subcategories reduces reliability even further.

The Seven Allegation Classifications & Statistical Results

Wrongful Liquidation

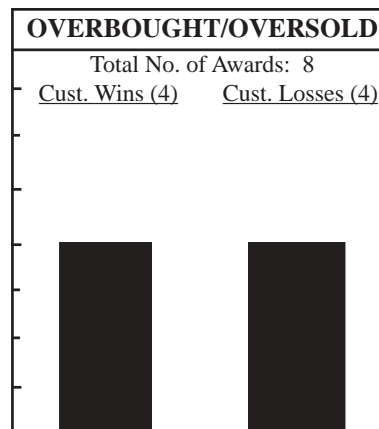
The “margin call” cases that arose with market breaks in particular stocks or with a general decline in the markets fall into this category. Where unauthorized trading was alleged, we would place the case in this category, as that charge is often the reaction that elicits from the customer whose stocks are sold in an involuntary liquidation. In addition, though, charges of margin miscalculations, excessive liquidations or imprudent selection of the securities to be sold fit into this category.

Only eight of the 24 Awards granted customers a monetary award or favorable relief (such as the replacement of securities). Disputes in this category generally produce solid damage figures, but both sides can lay claim to equities in their favor. It is worth noting, in evaluating these outcomes, that all eight of the Member-Customer Awards (usually, collection actions following margin sell-offs) were broker-dealer victories. Broker-dealers are in the position of lender in margin liquidation situations — at arm’s length with the customer and occupying a position of risk. *(ed: To be clear, the Member-Customer Awards are not included in the Chart figures.)*



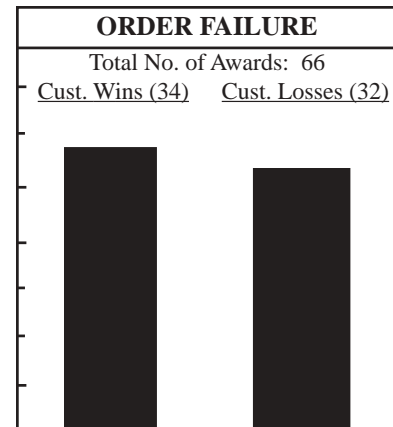
Overbought/Oversold

This class of claim includes the market order-limit order conundrum that has plagued many investors caught in volatile markets. Classified here is the unlucky investor who places a market order for ABC stock in a fast market and gets filled at a multiple of the expected execution price. The issue here, a subset of the third scenario in the Sullwold article, is often whether the broker-dealer, seeing that an execution would lead to an account deficit, should have completed the trade. Another scenario in this category is the double execution — an occurrence that results from a customer’s repeating an order when a delay in reporting an execution causes the investor to believe his/her initial order was not acted upon. The outcomes in this category are evenly split between investor wins and broker-dealer wins.



Order Failure

Order failure describes the many situations where affirmative, negligent acts allegedly occur in the execution phase of the transaction. In this category resides the close cousin to the double execution — the buy-and-cancel. In these situations, the customer, not hearing word of his initial order, decides to cancel. The cancellation is often acknowledged, but the initial purchase or sale still gets done. This category corresponds roughly to the second scenario in the Sullwold article. Wrong option exercises, executing a buy instead of a sell, making errors unwinding errors, and significant execution delays fall into this broad category and, as a consequence, it is the largest category of the seven we established. The outcomes, we note, are fairly evenly balanced.



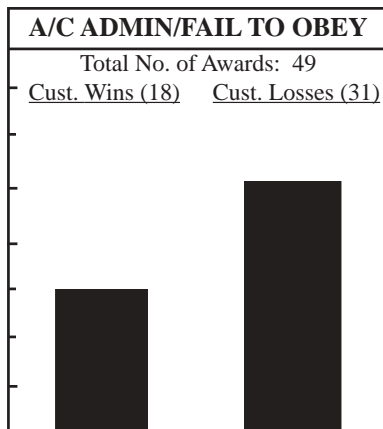
Account Administration/Fail To Obey

Errors of omission, rather than commission, mark the alleged failures in this category. Where alleged acts of misconduct are affirmative in nature, the problem will often lie with the type of order or security, not the execution function directly. Similarly, this category deals with matters that relate more to account administration than the execution function, such as misinformation about order procedures, such as advice that stop loss orders cannot be placed when they can, or nondisclosure of rules, risks or material information. One theme that repeated itself in a couple of the Schwab cases was dissatisfaction

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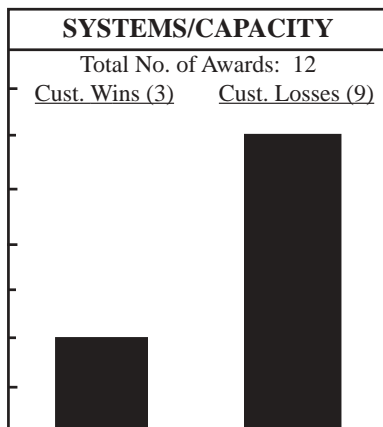
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and unexpected expenses arising from the use of Schwab's StreetSmart software. These "administrative" complaints constitute the second largest category of claims in our Survey, yet the 37% "win" rate for customers seems quite favorable for the broker-dealer. Damages and causation are often the troublesome factors in these cases.



System Failures/Capacity Problems

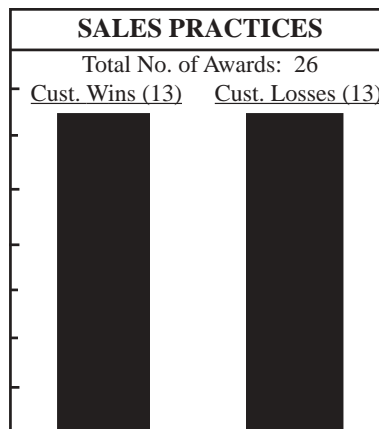
These complaints focus upon a general event, where the system goes down for an extended period, or other general deficiencies in the broker-dealer's performance that the Claimant blames for losses in a particular transaction or failed transaction. SRO examination and surveillance focus on capacity issues has remedied many of the problems here. System and capacity limitations are discussed in the first scenario of the Sullwold article and, according to our Survey, such claims do not fare especially well. Causation poses a difficult proof issue and damages may be speculative, where trades did not get executed.



Sales Practices

We found a surprising number of claims by online investors that charged the broker-dealer and, sometimes, a registered individual at the firm, with improper sales practices. We say the number is "surprising," because the relationship in the online situation is not one-on-one between broker and client and direct solicitation of transactions is rare. These sales practice allegations tend, as a result, to be of a more generic nature.

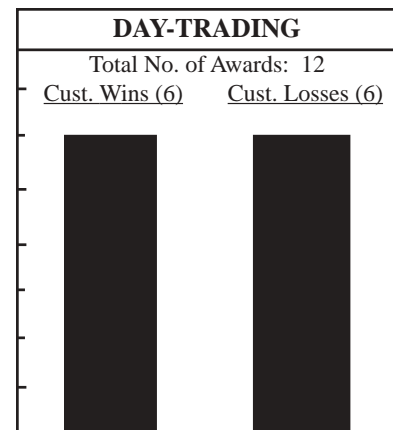
For example, suitability claims focus not on individual recommendations, but on the broker-dealer's aggressive marketing of margin or options transactions to clients generally. Alleged misrepresentations do not relate to the fundamentals of a particular issuer, but to the risks inherent in strategies or instruments about which the customer inquires. Customers do fairly well in these complaints, perhaps because the root cause of the sales practice problem, if proved, generally points to deficiencies in the member's marketing practices and the customer shares less of the blame. It is the ship that needs repair, not a loose cannon, and the responsibility lies clearly with the firm.



Day-Trading

Day-trading is arguably its own genre of dispute, but just as clearly the practice requires online trading. In the day-trading environment, investors are generally skilled, if not sophisticated, and high commissions, extremely high turnover, disregard of issuer fundamentals, and speculation are, definitively,

aspects of the activity. On the other hand, personal communication is usually an ingredient in this category, so the reliance factor is more concrete. Sympathy is muted here, we would guess, but, with the closing of the technological "wormholes" that invited SOES banditry and the disclosure requirements that counteract unrestrained marketing, day-trading's deficiencies and drawbacks have been fully exposed. That some investors may have been lured by earlier hype possibly explains the fairly high "win" rate that day-trading investor-Claimants seem to have experienced (*ed: see a recent example in our discussion of Cook v All-Tech Investments, SAA 01-35, in which four sets of day-trading Claimants were awarded almost half a million dollars.*)



Online BD Award Results

As we indicated at the article's beginning, after using our own Key Word finder in SAC's Award Database and word-searching for the term "online" in the SCAN Awards Library (which is itself online), we added to our Survey base all Awards rendered during the Survey period for certain online brokers. In other words, while we could not tell directly from the Awards, we assumed that the claims involved in these additional Awards must relate to online investing. We found additional candidates on www.gomez.com in its listing of top-rated discount brokers with online services and checked their Award records during the Survey period. If they were Respondents in more than three customer-initiated Awards during 1998-2000 and appeared to do a

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fully online business, we included all of their Awards. Listed below are the online brokers for which we found more

than three relevant Awards, along with the customer "win" rates and the amounts claimed and awarded. We

also included the Gomez standing (top 1-20) for the discount, online broker, if provided.

| ONLINE BD AWARD SURVEY CHART 1998-2000 (Customer-Initiated Awards Only) | | | | | | | |
|---|--------------|----------------|----------------------|----------------------|------------------------|----------------|------------------|
| BD Name | No. of Awds. | No. Cust. Wins | Total Clmd (\$000's) | Comp. Clmd (\$000's) | Total Awards (\$000's) | Cust. Wins (%) | Online BD Rating |
| All-Tech Investments | 4 | 1 | 294.1 | 294.1 | 14.1 | 25% | N/R |
| Ameritrade, Inc. | 28 | 14 | 1202.1 | 579.4 | 408.2 | 50% | 8 |
| Datek Online Finl. Svcs. | 9 | 5 | 1896.7 | 1646.7 | 262.5 ¹ | 55% | 13 |
| DLJ Direct, Inc. | 9 | 4 | 704.1 | 703.3 | 72.1 | 44% | N/R |
| E* Trade Securities | 67 | 27 | 2378.3 | 2298.2 | 430.6 | 40% | 3 |
| MorganStanley Online ² | 20 | 9 | 1516.8 | 1208.7 | 118.1 | 45% | 19 |
| SureTrade, Inc. ³ | 4 | 1 | 33.8 | 26.3 | .06 | 25% | 9 ⁴ |
| TD Waterhouse | 41 | 19 | 1761.7 | 1558.6 | 637.8 | 46% | 5 |

1. \$45,000 of the \$262,500 awarded in Datek cases was a punitive damage assessment in a single case. This punitive assessment was the only punitive damages award to appear in the Online Survey.

2. Awards attributed to MorganStanley Online include those from Lombard, Discover Brokerage and MSDW Online. Three Lombard Awards were excluded, as no mention of any affiliation with MorganStanley or predecessor firms appeared.

3. SureTrade was not one of the online BD's for which SAC included all Awards rendered in the time frame surveyed. Only one SureTrade Award was included in the 205-Award Survey base.

4. SureTrade is merging with Quick & Reilly, Inc., so we used the Gomez standing next to Q&R's name. All other rankings are taken from www.gomez.com.

Conclusion

A great deal may be said for the traditional way of managing one's investments and determining the trades to be done; so, too, for the wisdom and value of consulting with the "customer's person" before ordering a trade. Among the less-recognized virtues of online investing, on the other hand, may well be the legal and compliance benefit that appears to derive from limited contact with the customer.

For years, the old saw that "stocks are sold, not bought" has driven sales efforts, commission compensation, and cold calling. Stocks have been selling themselves, it seems, in the explosion of online investing that preceded the recent market downturn. Whether

online trading will continue to flourish in a bear market we may soon discover.

In any case, it can be said, strictly from the branch of the investing pipeline that ends at arbitration, that online investing and securities arbitration will likely find but a small amount in common. Arbitration, we have always reasoned, forms a keystone, along with regulation, fair disclosure, good compliance, and technological efficiency, in assuring investor confidence in the U.S. securities markets. If an investor cheated by a broker or member firm of \$5,000 or \$100,000 cannot find an economical and speedy method of resolving her grievance, she will simply leave the market. Arbitration offers practical redress and it has proved itself in the 90's through its part in ridding the in-

dustry of some bad houses and bad products.

Will this remain the case? Certainly for the foreseeable future it will, but dispute resolution generally will need to keep pace with the times. We have found in this small survey of recent online Awards that the disputes involve smaller dollar amounts, the answers frequently lie more in the documents than in credibility determinations, and, most importantly, the numbers suggest fewer overall claims. Just as arbitration has permitted more investors to have their grievances quickly and inexpensively heard (relative to court), dispute resolution services may need to streamline much further to address grievances arising in the new online investing environment. ■