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The Business of Turning Rookies into "Professional" Day-Traders: A Call for Improved Regulation of Day-Trading Training Firms

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COMMENT

THE BUSINESS OF TURNING ROOKIES INTO "PROFESSIONAL" DAY-TRADERS: A CALL FOR IMPROVED REGULATION OF DAY-TRADING *TRAINING* FIRMS

INTRODUCTION

In theory, day-trading is a great idea. Day-trading trainers promise that anyone with a computer and an internet connection can make a fortune in the stock market by quickly buying and selling stocks throughout the day.[1] In reality, day-trading is a losing proposition.[2] About ninety percent of day-traders lose everything they wager or more in the first few months.[3] Ninety-nine percent of day-traders run out of money later and eventually are forced to quit.[4]

1. *See Day Trading: Your Dollars at Risk*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/pubs/daytips.htm (last modified Apr. 20, 2005).

2. This argument is based on day-trading statistics, *see infra* note 3 and accompanying text, and the views of many notable financial economists who agree that "market volatility approximates a random and, therefore, highly unpredictable walk." Jeff Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 195 & n.86 (2010) ("Both behavioral-finance theorists, like Robert Shiller and Adrei Shleifer, and efficient-markets theorists, like Eugene Fama, agree on this phenomenon."). Because day-trading is based on trying to predict short-term movements of volatile securities and such movements are "highly unpredictable," it follows that day-trading is a losing endeavor.

3. *See* Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. L. 225, 239 (2001). *See generally* 2 BROMBERG & LOWENFELS ON SECURITIES FRAUD § 5:284 (2d ed. 2010); DAVID S. NASSAR, RULES OF THE TRADE: INDISPENSABLE INSIGHTS FOR ONLINE PROFITS 26, 205 (2001); *Introduction: Why Can't I Consistently Make Money Trading?*, TSUNAMI TRADING EDUCATORS, http://www.tsunami-trade.com/introduction.html (last visited Mar. 30, 2011). It is possible to lose more money than the original investment due to margin rules that often allow day-traders to hold positions worth four times the assets in the day-trading account. For an explanation of margin rules, see *Day Trading Margin*

Despite the bleak statistics, day-trading continues to attract new recruits,[5] one reason being the involvement of day-trading *training* firms. These firms make money by teaching people how to day-trade.[6] Currently, day-trading training firms operate largely under the regulatory radar and it is unclear what regulations apply to them.[7] As a result, the firms are free to advertise themselves as "trading universities,"[8] exploit the unique psychology of day-traders by luring them in with exaggerated promises of success,[9] and profit from

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Requirements: Know the Rules, FINRA, http://www.finra.org/investors/smartinvesting/advancedinvesting/daytrading/p005906 (last visited Mar. 30, 2011).

4. *See* David Segal, *Day Traders 2.0: Wired, Angry and Loving It*, N.Y. TIMES (Mar. 28, 2010), http://www.nytimes.com/2010/03/28/business/28trader.html?_r=3&pagewanted=1 (statement of Brad M. Barber) ("[I]f you were to look at the past performance of these traders, only 1 percent of them could be called predictably profitable."); Brad M. Barber et al., Do Individual Day Traders Make Money? Evidence from Taiwan 4 (May 2004) (unpublished manuscript), *available at* http://faculty.haas.berkeley.edu/odean/papers/Day%20Traders/Day%20Trade%20040330.pdf. (concluding that "more than eight out of ten day traders lose money in a typical semiannual period").

5. Statistics revealing the precise number of current day-traders are unavailable. However, evidence from various sources strongly suggests that day-trading continues, and a substantial number of people engage in it. *See, e.g.*, John Hechinger & Jeff D. Opdyke, *Day Trading Makes a Comeback and Brokers Vie for the Business*, WALL ST. J. (Sept. 30, 2003), http://online.wsj.com/article/0,,SB106487814397200100,00.html; Segal, *supra* note 4. In addition, MoneyShow (a prominent entity staging numerous trade shows such as the popular Traders Expos and other events catering to day-traders in all of the largest U.S. cities) states that its current membership is 115,978. MONEYSHOW, CORPORATE BROCHURE 15 (n.d.), *available at* http://www.intershow.com/pdf/MONEYSHOW/MONEYSHOW_BROCHURE.PDF.

6. *See Day Trading: Your Dollars at Risk*, *supra* note 1.

7. Caroline Bradley, *Information Society Challenges to Financial Regulation*, 37 U. TOL. L. REV. 307, 324 (2006); *see infra* Part III.A.4.

8. *See* Bradley, *supra* note 7, at 324. For examples of such advertising, see DAY TRADING UNIV., http://www.daytradinguniversity.com (last visited Nov. 13, 2011) (advertising itself as a "day trading university"); ONLINE TRADING ACAD., http://www.tradingacademy.com (last visited Nov. 13, 2011) (advertising itself as a "trading academy"); PRISTINE.COM, http://www.pristine.com (last visited Nov. 13, 2011) (advertising itself as "the world's elite trading school").

9. *See infra* Part I.B.2. For examples of such promises, see BLACK JACK TRADER, http://www.blackjacktrader.com (last visited Nov. 20, 2011) (promising a "winning rate in the 85% area"); MENTAL EDGE TRADING, http://www.mentaledgetrading.com/trading-success-offer.php (last visited Nov. 20,

teaching unworkable strategies that contribute to large investor losses.[10] If training firms run into trouble with disgruntled trainees, they can simply shut down and re-start as new firms with new customers.[11] In this respect, the day-trading training industry resembles Ponzi schemes that also depend on constantly drawing in new recruits in order to benefit a select few.[12] The difference is that the "select few" in the day-trading context are the owners of the training firms.

Some of the reasons why day-trading training firms are able to operate under the regulatory radar are the complexity and ambiguity of the current regulations, and lack of enforcement of those regulations. Essentially, the current regulations do not fit the nature and modus operandi of day-trading training firms. Accordingly, this Comment proposes a twofold solution: simplification and

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2011) (promising to teach a strategy that will ensure that the investor is a "top-earning trader . . . in just 30 days").

10. *See generally supra* note 4 (analyzing day-trading strategies and statistics of day-traders' trading results).

11. The biography of the self-proclaimed "Messiah of trading" Oliver L. Velez serves as an illustrative example. After co-founding Pristine.com (a day-trading training firm), Mr. Velez left that venture to open a new training firm called Velez Capital Management in 2007. *About Oliver L. Velez*, OLIVER VELEZ, http://www.olivervelez.com/about.php (last visited on Sep. 24, 2011); *Velez Capital Management, LLC*, BLOOMBERG BUSINESSWEEK, http://investing.businessweek.com /research/stocks/private/snapshot.asp?privcapId=58140403 (last visited Sep. 24, 2011). After making several widely advertised presentations at Traders Expos nationwide where he promised to teach "high octane trading," Mr. Velez and Velez Capital Management disappeared from the day-trading scene. *See Spotlight on Velez Capital Management, LLC*, MONEYSHOW.COM, https://secure.moneyshow.com/ beta/directory/company.asp?acctid=7609 (last visited Sep. 24, 2011). However, in 2010 Mr. Velez was back with a new firm called iFundTraders, LLC, and a brand new day-trading training website. *See* OLIVER VELEZ, http://www.olivervelez.com (last visited Mar. 30, 2011); IFUNDTRADERS.COM, http://www.ifundtraders.com (last visited Mar. 30, 2011).

12. The term "Ponzi" scheme is "generally used to describe an investment scheme which it not really supported by any underlying business venture." Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 158 (1998) ("[U]sually those who invest in the scheme are promised large returns on their principal investments. The initial investors are indeed paid the sizable promised returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid.").

concentration. Simplification entails amending the SEC rules to make it clear that all day-trading training firms must register with the SEC. Concentration mandates that all enforcement authority should be placed in the hands of the Securities and Exchange Commission (SEC). To further improve investor protection, the SEC should require all day-trading teachers to do four things: (1) pass basic securities exams; (2) provide easy access to information they would file with the SEC; (3) make their SEC filings easier to understand; and (4) disclose their trading statistics. In addition, the SEC should create a register of training firms and teachers that have engaged in serious securities law violations.

The effect of the proposed changes would be threefold: (1) the end of unregulated operation of day-trading training firms; (2) an improved ability of the SEC to stop egregious scam operators; and (3) an enhanced ability of investors to discern trustworthy advisers from dubious ones. As a result, at least some investors would be prevented from losing their savings through unworkable investment strategies. In addition, the proposed changes could potentially protect the financial interests of millions of retirees. Developments such as the Social Security funding crisis and a shift from defined benefit plans to more hands-on savings mechanisms will require numerous retirees to self-direct their investments.[13] These developments might supply a wealth of potential customers for the day-trading training firms. To prevent them from losing their savings through unsuitable trading strategies, it is crucial that effective regulations and enforcement mechanisms are put in place.

While several authors have addressed the subject of protecting investors from losing money through day-trading, no one has focused on day-trading *training* firms. Instead, articles written in this area focus on protecting investors by regulating broker-dealers with whom traders open their accounts.[14] However, broker-dealers are only the

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13. *See, e.g.*, Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 545 & n.28 (2005).

14. For some relevant examples, see Caroline Bradley, *Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets,"* 26 J. CORP. L. 63, 88-95 (2000); Bradley, *supra* note 7; Renee Barnett, Comment, *Online Trading and the National Association of Securities Dealers' Suitability Rule: Are Online Investors Adequately Protected?*, 49 AM. U. L. REV. 1089, 1095 (2000); Allison C. Gordon,

second step on a typical investor's path to becoming a day-trader.[15] The first step is the day-trading training firm because most people new to day-trading need advice about where to begin, what to trade, and how to open a trading account.[16] Accordingly, this Comment focuses on improving the regulation of the first step—the day-trading training firms.

Part I explains day-trading, how it began, and how inexperienced investors become "professional" day traders. Part II describes the reasons why the SEC needs to improve the regulation of day-trading training firms. Part III discusses current financial industry regulations (as they apply to day-trading training firms) and proposes new ones. Part III is divided into two subsections. Subsection A analyzes whether day-trading training firms are required to register under the current regulatory regime, and whether the current regime, if enforced properly, would provide adequate investor protection. Subsection B argues that the current regime is ineffective and proposes a new method for regulating day-trading training firms.

I. OVERVIEW OF DAY-TRADING

A. Day-Trading: What Is It?

1. Day-Trading Basics

Day-trading is the practice of rapidly buying and selling stocks throughout the day in an attempt to lock in quick profits.[17] While most day-traders trade stocks, others trade different types of securities, such as options, commodities, foreign currencies, or e-minis.[18] Day-trading

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Comment, *The "Day Trading" Phenomenon: An Educated Investment or a Day at the Casino?*, 30 SW. U. L. REV. 353, 359 (2001).

15. Interview with Leonard A., former day-trader, in San Diego, Cal. (Aug. 24, 2010).

16. *Id.*

17. *Day Trading*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/daytrading.htm (last modified Feb. 10, 2011).

18. E-minis are "mini-sized futures contracts." Noble DraKoln, *Trading E-Minis*, FORBES.COM (Apr. 6, 2008), http://www.forbes.com/2008/04/06/eminis-commodities-futures-pf-education-in_nd_0406investopedia_inl.html. "A security futures contract is a legally binding agreement between two parties to buy or sell a specific quantity of shares of an individual stock or a narrow-based security index at

is different from online investing.[19] Unlike online investors who typically execute only a few trades per month, day-traders are on their computers daily for hours at a time, using various stock charts and trading platforms to quickly enter and exit the trades.[20] This process can be repeated numerous times, and many day-traders end the day having traded tens of thousands of shares in various companies.[21]

While some day-traders research the companies whose stock they trade, others use a different approach called "technical analysis."[22] Technical analysis "is a way of looking at the market through chart formations and mathematical formulas designed to find and uncover patterns that have a high likelihood of either repeating or changing."[23] Thus, the day-trader who primarily uses technical analysis may not evaluate the fundamentals of a company before buying its stock. Instead, the day-trader may only look at the developments in the company's stock chart.[24] At the extreme end, the day-trader does not

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a specified price, on a specified date in the future . . . ." *Security Futures–Know Your Risks, or Risk Your Future*, FINRA, http://www.finra.org/Investors/Investment Choices/P005912 (last visited Sep. 20, 2011).

19. *See generally* Segal, *supra* note 4. One major difference is online investors leave their money invested for a longer period of time and generally expect lower risk than day traders. *See* Barnett, *supra* note 14, at 1099. In addition, online investors typically do not have access to electronic communication networks ("ECNs"), "where prices are driven by actual orders, not simply quotes by dealers," and Nasdaq Level II (a "universe of bids and offers from other market makers in a particular stock"). Gordon, *supra* note 14, at 358. This is because the speed of trade execution is not as critical for online investors. *See infra* Part I.C. Day-traders, on the other hand, rely on direct access to markets and rapid trade execution through Level II and ECNs. *See* Gordon, *supra* note 14, at 357-58. The brokerage relationship is also different because day-traders tell their brokers which orders to execute, as opposed to online investors who look to their brokers for advice and typically trade portfolios "consisting of stocks recommended by a broker." *Id.* at 357.

20. *See generally* Segal, *supra* note 4 (describing Mr. Lindloff sitting in front of a home computer in his living room, looking at charts, executing seventeen trades from the opening bell to lunch time, and trading 60,000 shares by the end of the day).

21. *Id.*

22. *See* NASSAR, *supra* note 3, at 136.

23. *Id.*

24. The stock charting programs used by day-traders range from simplistic (featuring only candlestick bar-charts, price averages, and trading volume indicators) to very sophisticated (featuring exotic trading strategy indicators like

even care about company news because the day-trader believes the news "will be reflected on charts."[25] As a result, the day-trader may buy and sell the stock of an unfamiliar company without even knowing what it does.[26]

2. Margin Rules

Typically, day-traders do not hold open trades overnight. Instead, their trades usually last for a very short time, anywhere from a few hours to a few minutes or even a few seconds (the so-called "scalping" method).[27] Because short-term trades typically produce only small gains, the trader has to buy a large amount of shares to multiply the incremental profit.[28] In order to hold large positions, day-traders rely on margin.[29] At a very basic level, margin means that many day-traders can hold intra-day positions four times the size of their trading accounts.[30] For example, a day-trader with the minimum $25,000[31] in

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Fibonacci number analyzers and Elliott waves). Interview with Leonard A., *supra* note 15. Some day-trading training firms (such as Pristine.com) offer their own charting software, while others offer training using third-party charting software. *Id.* Some of the more popular charting software programs are eSignal and Ninja Trader. *Id.*

25. NASSAR, *supra* note 3, at 136; *see also The Pristine Method*, PRISTINE.COM, http://www.pristine.com/Welcome/PristineMethod.aspx (last visited Nov. 13, 2011) ("Question: Why technical analysis, shouldn't we use fundamental analysis? Answer: No, not even as a blend, or partially. Technical analysis is what works in the market . . . .").

26. Segal, *supra* note 4 (describing the founder of a small day-trading training forum telling his chat room listeners he just bought and sold stock of a company called Rackspace Hosting, and that he does not know what the company does).

27. Interview with Leonard A., *supra* note 15; Gordon, *supra* note 14, at 353-54, 356; *How to Be a Day Trader*, TRADESTOCKSAMERICA.COM, http://www.tradestocksamerica.com/day-trader.php (last visited Mar. 30, 2011).

28. *See* Interview with Leonard A., *supra* note 15.

29. *Id.*

30. For an explanation of margin account rules, see *Day Trading Margin Requirements: Know the Rules*, *supra* note 3. *See also Margin: Borrowing Money to Pay for Stocks*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/pubs/margin.htm (last modified Apr. 17, 2009) ("'Margin' is borrowing money from your broker to buy stock and using your investment as collateral. Investors generally use margin to increase their purchasing power so that they can own more stock without fully paying for it.").

his or her day-trading account would be able to buy securities worth $100,000. The $75,000 difference is a loan from the broker, for which the broker charges interest.[32] The four-to-one margin helps explain how day-traders can lose more money than they put in their trading accounts.[33]

The margin rules are complex, and the complexity is increased by the fact that each broker can add additional rules or "house requirements."[34] There is, however, one ironclad rule that applies to all margin accounts in all situations. If a day-trader exceeds the margin, the trader will receive a "margin call."[35] This call means that a trader must deposit additional money in the account, typically within a few days.[36] In addition, if the trader exceeds the maintenance margin requirements during the trading day, the broker might liquidate some or all of the trader's open positions without notice in order to bring the account back to the required level.[37] Such automatic liquidation can

31. *See Day Trading Margin Requirements: Know the Rules*, *supra* note 3. FINRA rules require "pattern day traders" to maintain at least $25,000 in their trading account to have access to a four-to-one intra-day margin. *Id.* Generally, an account is marked as a "pattern day trading" account if the trader completes four or more round-trips (buy/sell or sell/buy transactions) within five business days. *Id.*

32. *See Investing with Borrowed Funds: No "Margin" for Error*, FINRA, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MarginAndBorrowing/P005973 (last visited Mar. 30, 2011) (indicating that margin loans can be very profitable for broker-dealers). The precise interest charged depends on the margin agreement the day-trader signs with the broker. *Id.*; *Margin: Borrowing Money to Pay for Stocks*, *supra* note 30 (cautioning prospective day-traders to read margin agreements very carefully to ensure they understand the rules and financial risks).

33. *See* sources cited *supra* note 3.

34. *Investing with Borrowed Funds: No "Margin" for Error*, *supra* note 32 (stating that each brokerage can set additional requirements, such as raising the maintenance margin for volatile stocks, as long as such additional requirements are higher than the minimum requirements of Regulation T and securities exchanges).

35. *E.g.*, *Margin: Borrowing Money to Pay for Stocks*, *supra* note 30.

36. NASSAR, *supra* note 3, at 19-20; *Investing with Borrowed Funds: No "Margin" for Error*, *supra* note 32.

37. An example provided by FINRA helps illustrate the complexity of margin rules:

> [I]f you buy $100,000 of securities on Day 1, Regulation T would require you to deposit initial margin of 50 percent or $50,000 in payment for the securities. As a result, your equity in the margin account is $50,000, and you have received a margin loan of $50,000 from the firm. Assume that on

cause disastrous results because the trader whose stock might have dropped only temporarily loses the chance to recoup the loss if the stock bounces back.[38]

3. Trading Commissions

Another factor that makes profiting from day-trading difficult is the commissions owed to the broker-dealer. Because day-traders often execute a large number of trades, they tend to rack up commissions quickly.[39] While some day-traders receive special rates from their brokers, it is still possible that all of their profits are wiped out by commissions.[40] In this situation, the only entity that benefits from the high number of trades is the broker-dealer. In fact, the broker-dealer would benefit even if the trader lost money on *all* of his[41] trades because the trader would still have to pay commissions for each

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> Day 2 the market value of the securities falls to \$60,000. Under this scenario, your margin loan from the firm would remain at \$50,000, and your account equity would fall to \$10,000 (\$60,000 market value minus \$50,000 loan amount). However, the minimum *maintenance margin* requirement for the account is 25 percent, meaning that your equity must not fall below \$15,000 (\$60,000 market value multiplied by 25 percent). Since the required equity is \$15,000, you would receive a *maintenance margin call* for \$5,000 (\$15,000 less existing equity of \$10,000). Because of the way the margin rules operate, if the firm liquidated securities in the account to meet the maintenance margin call, it would need to liquidate \$20,000 of securities.

Investing with Borrowed Funds: No "Margin" for Error, *supra* note 32.

38. *Margin: Borrowing Money to Pay for Stocks*, *supra* note 30.

39. *See* Segal, *supra* note 4.

40. *Id.*; Barber et al., *supra* note 4, at 21 (stating "the gross profits of heavy day-traders are not sufficiently large to cover reasonable estimates of transaction costs"); Interview with Leonard A., *supra* note 15.

41. The author uses the pronoun "he" because the vast majority of day-traders are male. Juhani Linnainmaa, The Anatomy of Day Traders 2 (June 2003) (unpublished manuscript), *available at* http://www.afajof.org/pdfs/2004program/UPDF/P700_Behavioral_Finance.pdf (stating "[a] typical day trader is a man in his late 30s who lives in a metropolitan area"). Furthermore, trade show statistics compiled by MoneyShow, the host of The Traders Expo, show that 86% of the attending traders are male, 80% are above the age of forty-five, and 25% are sixty-five or older. *Demographics & Statistics*, MONEYSHOW, www.exhibitorcentral.com/ec/Shows/EcStats.asp?show=lvot (last visited Nov. 7, 2011).

trade.[42] The complexity of margin rules and the effect of commissions help explain why the SEC has stated that "[d]ay-trading is extremely risky and can result in substantial financial losses in a very short period of time."[43]

B. How Does a Rookie Become a "Professional" Day-Trader?

1. A Day in the Life of a Day-Trader

Perhaps the best way to understand what day-trading looks like in practice is to sketch out a typical day in the life of a day-trader.[44] If the trader diligently follows all of the typical teachings of a day-trading training firm, he would get up well before 6 a.m. Pacific standard time to get ready for the 6:30 a.m. opening bell. Assuming that the trader is not a purist "technician,"[45] he will look at the news to determine whether any significant developments have occurred overnight, how the Asian and European markets are doing, and whether any major financial reports are coming out that day. The trader will then use specialized software to determine the overall direction and trends of the U.S. markets, employ scanning software to scan the markets for possible "trading setups,"[46] and then use charting software and technical indicators to see if any of the stocks are ready to be bought

42. Interview with Leonard A., *supra* note 15.

43. *Day Trading*, *supra* note 17.

44. The following account is based on Segal, *supra* note 4; Interview with Leonard A., *supra* note 15; Adam Grimes, *How I Prepare for the Trading Day and Find Good Set-Ups*, MONEYSHOW.COM (Jan. 6, 2011), http://www.moneyshow.com/trading/article/32/DAYTRADERS-21715/assets/js/popupFrame.asp; *How to Organize Your Schedule for Your Every Day Online Stock Trading*, SIMPLE-STOCK-TRADING.COM, http://www.simple-stock-trading.com/day-online-stock-trading.html (last visited Nov. 7, 2011).

45. For a description of a "technician," see NASSAR, *supra* note 3, at 136.

46. "Trading setups" are specific chart formations that day-trading training firms teach day-traders to recognize. *See* Interview with Leonard A., *supra* note 15. Some of the more popular setups include Breakout, Head and Shoulders, Double Top, Double Bottom, Bear Flag, and Bull Flag. For a visual overview of how these setups look on the charts, see BEDFORD & ASSOCIATES, http://www.baresearch.com/education/technical_analysis/chart_patterns/reversal/reversal.php (last visited May 21, 2011).

or sold.[47] The goal is straightforward: to be able "to make clear, concise, and emotionless decisions" as soon as the opening bell rings.[48]

After the opening bell, the trader will buy and sell, and will often be done trading by noon Pacific standard time.[49] While trading, the trader will be logged into an audio chat room hosted by his day-trading training firm.[50] The trader will use the chat room to obtain a sense of camaraderie with fellow traders; share his trading ideas, jokes, and frustrations; and ask the moderator for advice.[51]

2. *Day-Trading Training Firm Enticements to Attract New Traders*

As the preceding account might have indicated, day-traders must have a wealth of knowledge and a computer loaded with specialized software to be able to carry out all of the above-mentioned steps. A novice trader typically obtains this know-how through a day-trading training firm.[52] The path toward day-trading frequently begins with the prospective day-trader seeing an enticing advertisement offering a free introductory seminar.[53] Often, these free seminars, webinars, and video presentations are promoted on the homepages of day-trading training firms' websites.[54]

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47. Interview with Leonard A., *supra* note 15.

48. *Day Trading for a Living*, TRADE THE MARKETS, http://www.tradethemarkets.com/public/Day_Trading_for_a_Living.cfm (last visited Nov. 7, 2011).

49. Interview with Leonard A., *supra* note 15; *see also* Segal, *supra* note 4.

50. Segal, *supra* note 4. Pristine.com offers a sample audio excerpt from a day-trading chat room. *Access Trading Room*, PRISTINE.COM, http://www.pristine.com/FreeEducation/FreeTrading Room.aspx (last visited Nov. 8, 2011) (click on "Play Trading Room Tour" hyperlink).

51. Segal, *supra* note 4.

52. *See* Interview with Leonard A., *supra* note 15.

53. North American Securities Administrators Association (NASAA) lists trading seminars as one of the top ten threats to investors. *State Securities Regulators Identify Top 10 Traps Facing Investors*, NASAA (May 15, 2007), http://www.nasaa.org/7533/state-securities-regulators-identify-top-10-traps-facing-investors/.

54. *See, e.g.*, CYBER TRADING UNIV., http://www.cybertradinguniversity.com/free-stock-course-registration (last visited Nov. 8, 2011); ONLINE TRADING ACAD.,

Through seminars and video presentations, training firms proclaim it is possible to achieve financial freedom through day-trading; however, day-trading requires education, and the "best education," of course, is offered by each particular firm.[55] During live presentations, the presenters typically recount their success as proof that the firm's strategy works and present PowerPoint slides documenting some extremely successful trades.[56] During live and recorded presentations, firms also introduce several trainees who testify that they have achieved success by following the firm's teachings.[57] The trainees frequently mention flexible schedules, traveling, and exciting hobbies—all made possible by their day-trading profits.[58] Some firms also emphasize that trading is highly compatible with a harmonious family life as it takes only a few hours each day, leaving plenty of time for the family.[59] The seminars typically conclude with a call to sign up for the firm's training course, chat room, or newsletter—at a generous discount offered only to the seminar attendees.[60]

In addition to firm-specific seminars, the prospective and existing traders are also solicited at industry trade shows.[61] Currently, the most prominent day-trading shows are MoneyShow's Traders Expos.[62] These shows are staged in exciting locations, such as Las Vegas, New

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supra note 8; TRADING AUTH., http://www.thetradingauthority.com (last visited Nov. 8, 2011).

55. *See, e.g.*, Video of Customer Stories, WIZETRADE, www.wizetrade.com /lp/customerStories.html (last visited Nov. 8, 2011) (customer testimonials stating Wizetrade offers the life people dream about and allows customers to achieve "financial success" and "personal freedom"); *see also Access Trading Room*, *supra* note 50 (presenter stating that "the Pristine Method Trading Room is the best room out there for active day and swing traders").

56. *See* Interview with Leonard A., *supra* note 15.

57. *Id.*; Video of Customer Stories, *supra* note 55.

58. *See* Video of Customer Stories, *supra* note 55.

59. *Id.*

60. *See* Interview with Leonard A., *supra* note 15.

61. *Id.*

62. Traders Expos are the largest day-trading trade shows in the U.S. exclusively offered for active traders. *The Traders Expo*, EXHIBITOR CENT., http://www.exhibitorcentral.com/ec/Shows/EcTE.asp (last visited Nov. 8, 2011). MoneyShow, the expo's organizers, claim that Traders Expos attract as many as 15,000 traders annually. *Id.*

York, and San Francisco.[63] They typically last two to three days, attract several thousand traders, and feature numerous exhibitors including day-trading training firms, broker-dealers, software providers, and financial information providers.[64] Trade shows offer enticing free presentations, world-renowned celebrity traders, special events, and VIP seminars.[65] The show organizers try to create an atmosphere of excitement, exclusiveness, and success, and promise to make the individual traders "more skilled, more knowledgeable, and more confident."[66] Besides Traders Expos, other industry shows offered by MoneyShow include the Las Vegas MoneyShow, Futures & Forex Expos, and the international World MoneyShows.[67] A particularly interesting promotional tool is the investment cruise—an investment seminar at sea that offers the investor an opportunity to "[r]elax and fine-tune [his] portfolio in six-star luxury" while learning and profiting from top money experts.[68]

3. *The Realities of Day-Trading*

Once the novice traders sign up for the paid educational services,[69] they soon discover trading is a fast-moving, complex venture consisting of numerous variables. Many new traders also notice they average more losing trades than winning ones,[70] and often

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63. *Id.*; MONEYSHOW, *supra* note 5, at 8-9.

64. *See Venue At-a-Glance,* EXHIBITOR CENT., www.exhibitorcentral.com/ec/Shows/EcVenue.asp?show=lvot (last visited Nov. 8, 2011).

65. *Id.*

66. *The Traders Expo Events*, MONEYSHOW, http://www.moneyshow.com/events/Traders_Expo.asp (last visited Nov. 8, 2011).

67. *The MoneyShow Las Vegas*, MONEYSHOW, http://www.moneyshow.com/TradeShow/las_vegas/moneyshow/main.asp (last visited Jan. 14, 2012); *The Traders Expo, supra* note 62; *The World MoneyShow Events*, MONEYSHOW, http://www.moneyshow.com/events/World_MoneyShows.asp (last visited Jan. 14, 2012).

68. *Forbes: Athens to Istanbul*, MONEYSHOW, http://www.moneyshow.com/cruise/forbes/athens/main.asp?scode=013104 (last visited Nov. 8, 2011).

69. For an example of a classroom-style educational program, see *About Us*, ONLINE TRADING ACAD., www.tradingacademy.com/about-us (last visited Nov. 8, 2011).

70. Interview with Leonard A., *supra* note 15.

even "sure winners turn into losers."[71] The training firms often equate the lack of success with lack of training and recommend that the trader take a more advanced class, buy more sophisticated trading software, or sign up for a private mentoring program that can cost as much as $8,000 per day.[72]

Many trading teachers also state that large losses in the beginning are perfectly normal, and in fact, the trader has to execute "a minimum of 1000 trades to become a proficient day trader."[73] To boost morale, many training firms also present stories of traders who lost it all the first time, and after several years returned with new capital and new wisdom to finally reap the fruits of their hard work.[74] While this might be true for some individuals, most day-traders eventually run out of money and are forced to confront reality—they have become part of the ninety percent who "lose everything they wager."[75] In the meantime, day-trading training firms are busy at work signing up new recruits to start the cycle all over again.[76]

C. The Future of Day-Trading: The Rise of the Machines?

The day-trading phenomenon began in the 1990s when technological advances first allowed individual investors to access the markets and quickly execute their own trades.[77] Initially, day-trading was conducted at the physical facilities of day-trading firms created by

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71. *Id.*

72. For examples of this philosophy and private mentoring offers, see *Day Trading Mentor Is a Personal Mentorship Program to Help You Learn Online Trading*, TRADE THE MARKETS, http://www.tradethemarkets.com/public/2251.cfm (last visited Nov. 8, 2011); *Online Trading Lessons by Toni Hansen*, TONI HANSEN, http://www.tonihansen.com/trading-lessons.html (last visited Nov. 8, 2011); *The Live One-on-One E-mini Trading Session*, TRADING CONCEPTS, INC., http://web.archive.org/web/20110513015920/http://www.tradingconceptsinc.com/live.cfm (last visited May 19, 2011) (accessed by searching for the website address in the Internet Archive index).

73. NASSAR, *supra* note 3, at 226.

74. For an example of such story, see *id.* at 207-08.

75. Gabaldon, *supra* note 3, at 239.

76. Interview with Leonard A., *supra* note 15.

77. *See* Bradley, *supra* note 14, at 67.

broker-dealers.[78] Because they were part of broker-dealers, these day-trading firms had to register, and were thus subject to SEC and self-regulatory organization (SRO) regulations.[79] The broker-dealer day-trading firms provided traders with physical facilities, computers, high-speed Internet, and access to Nasdaq Level II and Electronic Communication Networks (ECNs).[80] By the late 1990s, the number of ECN computer systems had increased, and ECNs became readily accessible to individual day-traders.[81] Traders could now create individual trading stations at their homes and become completely independent.[82] This type of day-trader is the focus of this Comment.[83]

Technology has not stood still since the late 1990s. Numerous advances have profoundly affected day-trading. Perhaps the most important development has been the rise of automated trading.[84] Automated trading is a type of trading that uses computer algorithms to execute trades without the need for continual human interaction.[85]

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78. Consequently, many articles on day-trading that were written in the late 1990s and early 2000s discuss this type of trading when talking about "day-trading." For example, see Gordon, *supra* note 14, at 357.

79. SEC OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, SPECIAL STUDY: REPORT OF EXAMINATIONS OF DAY-TRADING BROKER-DEALERS, at pt. III.B (2000) [hereinafter SPECIAL STUDY], *available at* http://www.sec.gov/news/studies/daytrading.htm.

80. *Id.* Nasdaq Level II is an online order book that displays live orders as they are placed. *See generally* Gordon, *supra* note 14, at 358. Access to Level II enables a knowledgeable trader to execute trades more precisely by selecting and timing the market maker, router, and ECN. *Id.* ECN is a type of automated computer system that matches customer limit orders. *Id.*

81. *See* Michael J. McGowan, Comment, *The Rise of Computerized High Frequency Trading: Use and Controversy*, 2010 DUKE L. & TECH. REV. 16, *10-11 (2010).

82. *See id.* For a photo and a description of this type of day-trading station, see Segal, *supra* note 4.

83. Also known as a "retail trader," this type of trader is different from a "proprietary trader"—a trader who trades using the trading firm's money. Ryan Garvey & Anthony Murphy, How Profitable Day Traders Trade: An Examination of Trading Profits 2 (Aug. 1, 2002) (unpublished manuscript), *available at* http://www.econ.utah.edu/~ehrbar/erc2002/pdf/P407.pdf.

84. *See* McGowan, *supra* note 81, at *1-2 (discussing high frequency trading, which is a type of automated trading).

85. *Id.*; *see also The Advantages of Automated Trading*, TRADE STATION, http://web.archive.org/web/20110109110726/http://tradestation.com/automated_trad

Depending on the program configurations, the computer makes very precise decisions regarding the timing and price of each buy and sell transaction, executing trades within a fraction of a second.[86] Many financial industry professionals note automated trading "now dominates U.S. equity markets."[87] Some analysts estimate that, in 2009, automated trading "accounted for 73% of all U.S. equity trading volume."[88]

A particularly advanced type of automated trading is high-frequency trading (HFC).[89] This trading strategy uses "supercomputers" that can execute trades at incredible speeds, down to the one-millionth of a second.[90] These programs constantly turn over large volumes of stocks, capturing even the minutest, blink-and-you-will-miss-it price moves.[91] Sophisticated hedge funds, major investment banks, and hundreds of proprietary trading firms currently use HFCs.[92] Although precise numbers are unavailable, according to several estimates, high frequency trading generated $15 to $25 billion in revenue in 2009.[93]

The rise of high frequency trading has made it more difficult for individual day-traders to reap profits from the markets. The individual traders are much slower than any computer, they cannot afford to

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ing/auto_trading.shtm (last visited Mar. 30, 2011) (accessed by searching for the website address in the Internet Archive index); *Trader68 - Automated Trading Software*, TRADING SOLUTIONS, http://www.tradingsolutions.com/products/trader68.html (last visited Nov. 11, 2011).

86. McGowan, *supra* note 81, at *1-2.

87. *E.g.*, Herbert Lash, *Analysis – SEC Panel Pits Wider Debate over Automated Trading*, REUTERS (June 22, 2010), http://blogs.reuters.com/financial-regulatory-forum/2010/06/22/analysis-sec-panel-pits-wider-debate-over-automated-trading.

88. Robert Iati, *The Real Story of Trading Software Espionage*, WALL. ST. & TECH. (July 10, 2009), http://wallstreetandtech.com/articles/218401501.

89. McGowan, *supra* note 81, at *1-2.

90. *Id.* at *1; Scott Patterson & Geoffrey Rogow, *What's Behind High-Frequency Trading*, WALL ST. J. (Aug. 1, 2009), http://online.wsj.com/article/SB124908601669298293.html.

91. McGowan, *supra* note 81, at *1-4; Patterson & Geoffrey, *supra* note 90.

92. Tyler Durden, *Goldman's $4 Billion High Frequency Trading Wildcard*, ZERO HEDGE (July 17, 2009, 2:16 PM), http://zerohedge.blogspot.com/2009/07/goldmans-4-billion-high-frequency.html; Iati, *supra* note 88.

93. *E.g.*, Durden, *supra* note 92.

trade hundreds or thousands of stocks thousands of times per day, and they are often caught off-guard when HFCs cause sudden price drops and reversals.[94] As one commentator puts it, "retail investors who lack the technological edge to keep up in this automated trading arms race may soon find themselves left behind."[95]

Responding to this situation, some day-trading firms have created automated trading software that they market to individual day-traders.[96] These programs promise to take out the "human factor"[97] and enable the trader to "harness the superior processing power of [their] computer."[98] It is unclear, however, how well these individual programs are designed, as there are no studies or test data available. Furthermore, even if these programs are based on sound principles, it is doubtful that an automated trading program developed by a small firm can be a match to an HFC supercomputer operated by an HFC giant such as Goldman Sachs.[99] In addition, the legality of auto-trading programs offered through day-trading training firms is questionable, at least in cases where the firms promote programs by promising unrealistic annual returns.[100] In fact, the SEC has issued a warning cautioning investors to thoroughly investigate any auto-trading program before they hand over their hard-earned dollars.[101]

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94. Michael W. Stocker, *Automated Trading Leaving Retail Investors in the Dust*, FORBES.COM (Nov. 19, 2010), http://www.forbes.com/2010/10/15/sec-flash-crash-report-opinions-contributors-michael-w-stocker_2.html.

95. *Id.*

96. For examples of such automated trading programs, see *The Advantages of Automated Trading*, *supra* note 85; *Trader68 - Automated Trading Software*, *supra* note 85.

97. *Trader68 - Automated Trading Software*, *supra* note 85.

98. *The Advantages of Automated Trading*, *supra* note 85.

99. *See* Patterson & Rogow, *supra* note 90 (stating that Goldman Sachs Group Inc., Citadel Investment Group LLC, and Hudson River Trading LLC use HFC heavily).

100. In 2005, the SEC filed civil charges against a day-trading training firm that signed up approximately 1,200 clients for automated trading accounts by promising annualized returns of 100% when in reality the program was producing substantial losses. Complaint at 47-49, 54, SEC v. Terry's Tips, Inc., 409 F. Supp. 2d 526 (D. Vt. 2006) (No. 2:05-CV-188), 2005 WL 1845498.

101. *All About Auto-Trading*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/pubs/autotrading.htm (last modified June 6, 2009).

The warning concludes with a time-tested axiom: "[i]f it sounds too good to be true, it usually is!"[102]

II. WHY THE SEC NEEDS TO IMPROVE THE REGULATION OF DAY-TRADING TRAINING FIRMS

A. Unavailability of Trustworthy Information About Day-Trading Training Firms

Regulation of day-trading training firms must be improved to ensure the availability of trustworthy information about the firms, their trading teachers, and strategies. Currently, day-trading training firms do not register as broker-dealers or investment advisers, and it is unclear which regulations apply to training firms.[103] Therefore, they do not file anything with the SEC, and official disclosure documents are not available to prospective clients.[104]

As a result, prospective day-traders are left to rely on information provided by the day-trading training firms themselves. This information tends to exaggerate the success of the firms' strategies, the accomplishments of their teachers, and the overall benefits of signing up with a particular firm.[105] Commonplace occurrences are trading "statistics" that show returns in excess of 100 percent,[106] slogans such as "[t]he world's most trusted name in professional trader education,"[107] and teacher biographies that claim they consistently earn "triple digit gains."[108] In the absence of active regulation, the firms are also able to use aggressive advertising

102. *Id.*

103. *See infra* Part III.A.4.

104. *See infra* Part III.A.4.

105. *See* Interview with Leonard A., *supra* note 15; *see* sources cited *supra* notes 54-55.

106. *Here's the Proof!: Daily Returns for TNT Picks*, NEWS TRADER, http://www.daytrading.nu/results.htm (last visited Nov. 12, 2011) (showing a total average return for all stocks exceeding 300% in 2010).

107. ONLINE TRADING ACAD., *supra* note 8.

108. *E.g.*, *The Velez Opportunity Report*, OLIVER VELEZ, http://www.olivervelez.com/report.php (last visited Nov. 12, 2011).

strategies to "draw[] investors in the same way that a 'system for winning blackjack brings gamblers to Vegas.'"[109]

Those firms that choose to disclose trading risks do so through small-print disclaimer links, or dense paragraphs at the very bottom of their websites which traders are unlikely to find, read, or comprehend.[110] Finally, in the absence of effective information disclosure mechanisms, even firms with dubious track records and numerous disgruntled customers are able to continue their operations with impunity.[111]

B. Day-Trading Training Firms are a Major Factor in Causing Large Losses for Day-Traders

Day-trading is a risky game where ninety-nine percent of the players ultimately lose.[112] Day-trading training firms actively contribute to this dismal statistic because they lure novice investors into day-trading by overstating the benefits and downplaying the risks of trading.[113] Specifically, training firms promote unworkable trading strategies and encourage investors to trade despite persistent losses.[114] While it appears clear that day-trading in general and the specific trading strategies taught by day-trading training firms do not work, there is scarce empirical research regarding the reasons why they fail. To date, the two most comprehensive empirical studies are a 2004 study conducted by American and Taiwanese researchers that

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109. Gordon, *supra* note 14, at 371-72 (quoting Dean Calbreath, *Day-Trade Practices Ripped by Regulators, Investor Resentment Rises Along with Losses*, SAN DIEGO UNION-TRIB., Aug. 10, 1999, at C1).

110. For examples of such disclaimers, see FOREX TRADING.COM, http://www.forextrading.com (last visited Nov. 12, 2011); ONLINE TRADING ACAD., *supra* note 8; TRADE THE MARKETS, http://www.tradethemarkets.com (last visited Nov. 12, 2011).

111. For a partial list of potentially questionable trading firms and trading teachers, see *Become a Day Trader and Trade for a Living*, BECOME A DAY TRADER, http://www.become-day-trader.com (last visited Oct. 8, 2011) (listing, among others, Andreas Kirchberger, CommandTrade, Forex Killer, and Wizetrade as trading scams or potential scams).

112. *See supra* note 4 and accompanying text.

113. NASAA, *supra* note 53. *See generally Day Trading: Your Dollars at Risk*, *supra* note 1 (listing "facts that every investor should know").

114. *See supra* notes 70-72 and accompanying text.

analyzed trading results of more than 130,000 Taiwanese day-traders,[115] and a smaller study conducted in Finland that analyzed trading results of 7,686 traders in 2003.[116] Both studies focused on quantifying the results of day-trading, and both studies concluded that for most people, day-trading is a losing proposition.[117]

The researchers also made useful suggestions regarding the reasons why most day-traders lose money.[118] Such reasons include: the fact that many day-traders are lured by highly skewed distribution of returns (i.e., the possibility of hitting the jackpot);[119] day-traders are overconfident;[120] some day-traders find day-trading entertaining;[121] they "exhibit poor stock selection skill";[122] day-traders tend to hold on to losing stocks;[123] and they engage in heavy short-selling.[124] The first three reasons are psychological in nature, and they help explain how day-trading training firms are able to draw new customers by exploiting the unique characteristics of people who are naturally more prone to risky behavior.[125] The last three reasons have to do with day-trading strategies per se, lending empirical support to the argument that these strategies do not work.[126]

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115. Barber et al., *supra* note 4, at 2.

116. Linnainmaa, *supra* note 41, at 3.

117. Barber et al., *supra* note 4, at 20-21; Linnainmaa, *supra* note 41, at 22, 27-28.

118. Barber et al., *supra* note 4, at 18-19; Linnainmaa, *supra* note 41, at 27-28.

119. Barber et al., *supra* note 4, at 19.

120. *Id.*; Linnainmaa, *supra* note 41, at 28.

121. Barber et al., *supra* note 4, at 18.

122. Linnainmaa, *supra* note 41, at 27-28.

123. *Id.*

124. *Id.*

125. *See infra* Part II.C.

126. Additional support for this argument is provided by leading financial economists who suggest that it is impossible to predict volatile, random market movements. Schwartz, *supra* note 2, at 194-95 & n.86. Predicting volatile, random market movements is precisely what day-trading strategies are trying to do. It follows that day-trading strategies are destined to fail because they are attempting to accomplish the impossible.

C. Day-Trading Training Firms Exploit the Unique Psychology of Day-Traders: Overconfidence and Gambling Mentality

Day-trading training firms also require enhanced regulation because they capitalize on the unique psychology of day-traders. Day-trading tends to attract a particular type of person, [127] one whose major characteristic is overconfidence.[128] Overconfidence is created, in part, by an illusion of knowledge and control.[129] The "illusion of control," in turn, is partially encouraged by the fact that day-traders can trade directly through the ECNs,[130] which promotes the belief that "they [day-traders] wield more control than traders acting through intermediaries."[131] In addition, day-traders tend to embrace risk more readily than traditional investors.[132] This characteristic has caused many authors to compare day-trading to gambling.[133] As one author puts it, "the universes of investing and gambling overlap greatly."[134] Consequently, the market's fast-moving, ever-changing environment—where large gains (and losses) can be realized in minutes—tends to attract the same type of people who like to gamble in Las Vegas. Unfortunately, as is the case for a poker player with "zero knowledge" of the game, "for someone with zero knowledge of . . . stock trading, that game becomes one of chance to that player."[135]

Day-trading training firms' advertisements, seminars, and social events are specifically tailored to take advantage of this type of investor.[136] As described in Part I.B.2, day-trading training firms often

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127. *See supra* notes 125-25 and accompanying text.

128. *See* Christine Hurt, *Regulating Public Morals and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox*, 86 B.U. L. REV. 371, 412 (2006).

129. *Id.* at 410.

130. *See supra* note 80.

131. Hurt, *supra* note 128, at 410.

132. *See supra* notes 119-24.

133. *See* Bradley, *supra* note 7, at 87; Hurt, *supra* note 128, at 410; Barnett, *supra* note 14, at 1111; Gordon, *supra* note 14, at 371.

134. Hurt, *supra* note 128, at 377.

135. *Id.* at 378.

136. *See generally* Interview with Leonard A., *supra* note 15 (documenting the experience of an entrepreneur who, with no prior knowledge of trading, began to

stage their main events in Las Vegas or conduct seminars in other exciting locations (including on cruise ships in East Asia).[137] They also use glitzy promotions that highlight the success stories of traders who have achieved the life of their dreams by using the firms' trading strategies.[138] After the new traders sign up for the education programs, the firms continue to capitalize on traders' overconfidence by encouraging them to explore new, more aggressive trading strategies; trade larger volume of shares; and engage in other trading strategies that traders might not fully understand.[139] Traders' overconfidence also helps training firms convince them that their losses are not caused by the firms' faulty strategies, but by external market events, such as an "algorithm boogie" or activities of a "robo trader."[140] Training firms' simple explanations work because overconfident people tend to take credit for their successes, but blame their failures on external sources.[141] One author summarizes the situation by stating "the investors who believe in their own empowerment may, in fact, be vulnerable to being misled and cheated by those who have trained them."[142]

Although day-trading training firms take advantage of their customers' unique psychology, this Comment does not argue that day-trading should be banned altogether. Similar to losing money in Las Vegas, people should be free to lose their money in the stock market if they choose to do so. However, just as casinos are subject to

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day-trade after watching late-night infomercials and attending promotional seminars. That entrepreneur quickly advanced to very risky trading strategies and eventually lost all of his trading capital).

137. *See supra* Part I.B.2.

138. *See supra* Part I.B.2.

139. *See supra* Part I.B.2.

140. Segal, *supra* note 4 (documenting one day-trading teacher explaining a losing trade as having been "juked and jived by a robo trader" and caused by an "algorithm boogie").

141. *See* Schwartz, *supra* note 2, at 205 & n.139 (explaining that the tendency to take credit for successes and blame failures on external sources is a psychological phenomenon known as the self-attribution bias). *See generally* Interview with Leonard A., *supra* note 15 (showing one day-trader who lost all of his trading capital blaming his losses not on faulty trading strategies, but instead on "huge hedge funds and mutual funds and market makers").

142. Bradley, *supra* note 7, at 329.

regulation,[143] the main actors of the day-trading industry should likewise be regulated. Yet some of the day-trading industry's main actors, day-trading training firms, currently operate largely free of regulation.[144] For the reasons stated in Part II of this Comment, this lack of regulation must be remedied. The next Part begins with an analysis of the shortcomings of the current regulatory regime—a necessary step to finding a workable solution.

III. HOW TO IMPROVE THE REGULATION OF DAY-TRADING TRAINING FIRMS

A. Current Regulatory Regime: Are Day-Trading Training Firms Required to Register?

In the United States, individuals and entities involved in the securities industry are regulated by a set of complex regulations at both the federal and state level. The regulations are enforced by a number of entities, the most important of which are the Securities and Exchange Commission (SEC), self-regulatory organizations (SROs),[145] and state securities regulators.[146] The intertwined set of regulations and enforcement authorities has rightly been described by one author as a "crazy-quilt pattern."[147] As will be argued in this Part,

143. For an overview of gambling regulations, see Joseph Kelly, *Caught in the Intersection Between Public Policy and Practicality: A Survey of the Legal Treatment of Gambling-Related Obligations in the United States*, 5 CHAP. L. REV. 87 (2002).

144. Bradley, *supra* note 7, at 324; *see infra* Part III.A.4.

145. *See* James Koebel, *Trust and the Investment Adviser Industry: Congress' Failure to Realize FINRA'S Potential to Restore Investor Confidence*, 35 SETON HALL LEGIS. J. 61, 63-64 (2010) (SROs "set rules governing member firms in the financial industry and provide oversight, supplementing that of the SEC. . . . The largest and most well-known securities SRO today is the Financial Industry Regulatory Authority [FINRA] . . . . FINRA provides oversight of member brokerage firms, and nearly every brokerage firm in the United States is required to be a member").

146. *See* SCOT B. EHRLICH & DOUGLAS C. MICHAEL, BUSINESS PLANNING 192 (2009).

147. Howard M. Friedman, *The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers*, 53 BUS. LAW. 511, 561 (1998).

the overlaps and gaps in the regulatory quilt[148] make it possible for day-trading training firms to slip through the cracks and avoid the regulations altogether. The solution proposed by this Comment can be summarized as simplification and concentration: simplifying the regulatory quilt to make it clear that all day-trading training firms must register with the SEC, and concentrating the enforcement power into the hands of one entity—the SEC.

The regulation of securities professionals began as a response to "the excessive speculation of the 1920s and the suffering of the Great Depression."[149] In order to "curb financial fraud and other illegal and unethical activities," Congress passed four monumental statutes that continue to shape the landscape of the securities industry today: the Securities Act of 1933, the Securities Exchange Act of 1934 ("Exchange Act"), the Investment Company Act of 1940, and the Investment Advisers Act of 1940 ("Investment Advisers Act").[150] These statutes ensure that all securities professionals register and/or provide accurate information disclosures.[151] Therefore, it seems highly unlikely that day-trading training firms are somehow exempted from these requirements and instead are allowed to operate completely regulation-free. Accordingly, Sections III.A.2 and III.A.4 are devoted to determining whether day-trading training firms are required to register under the current regulatory regime; specifically analyzing whether training firms are required to register as broker-dealers, investment advisers, or both.[152]

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148. *Addressing the Need for Comprehensive Regulatory Reform: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. app. at 56-57 (2009) (statement of Timothy F. Geithner, Secretary of the United States Department of the Treasury) (arguing for the closing of regulatory gaps), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg48875/pdf/CHRG-111hhrg48875.pdf.

149. Joshua E. Broaded, *Financial Compliance, Regulation, and Risk Management: A Survey of Regulations Applicable to Investment Advisers*, 12 DUQ. BUS. L.J. 27, 28 (2009).

150. *Id.*; Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2006); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78pp (2006); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006).

151. *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml (last modified Jan. 29, 2010).

152. Section III.A.2 begins by analyzing broker-dealer regulations because many highly regarded analysts have traditionally approached the subject of day-

The Comment concludes that day-trading training firms are *not required to register as broker-dealers*. However, the firms *are required to register as investment advisers*. Unfortunately, the complexities of the current regulatory regime, coupled with lack of enforcement, have contributed to day-trading training firms' successful avoidance of such registration.[153]

1. Overview of Broker-Dealer Regulations

The Exchange Act governs broker-dealers.[154] The Exchange Act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others,"[155] while a dealer is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise."[156] The essential difference is that a broker acts as an agent who executes trades on behalf of a customer, while a dealer acts as a principal who sells or buys the securities from his own account.[157] Broker-dealers are entities and persons who perform the services of both brokers and dealers, and they generally have to register with the SEC.[158]

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trader protection by arguing for enhanced broker-dealer regulations. *E.g.*, SPECIAL STUDY, *supra* note 79. In addition, broker-dealer regulations appear pertinent in light of recent proposals to harmonize the regulation of broker-dealers and investment advisers by subjecting both groups to the same fiduciary duty rule. *See* U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, at viii, 110-29 (2011) [hereinafter INVESTMENT ADVISERS AND BROKER-DEALERS], *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf; *cf.* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 399 (2010) (exploring some of the problems of imposing fiduciary duty on broker-dealers).

153. *See infra* Part III.A.5.

154. 15 U.S.C. §§ 78a-78pp.

155. *Id.* § 78c(a)(4)(A).

156. *Id.* § 78c(a)(5)(A).

157. Laby, *supra* note 152, at 400.

158. *See* DIV. OF TRADING & MKTS, U.S. SEC. & EXCH. COMM'N, GUIDE TO BROKER-DEALER REGISTRATION, at pt. II (2008) [hereinafter GUIDE TO BROKER-DEALER REGISTRATION], *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm.

Registration imposes a number of duties, including a duty to comply with all of the anti-fraud provisions of the Exchange Act,[159] such as a duty of fair dealing and best execution, restrictions on short sales and insider trading, and restrictions on private securities transactions.[160] Registration also imposes a requirement that any reports circulated by broker-dealers accurately reflect the analyst's personal views,[161] a series of penny stock rules,[162] and a duty to protect the privacy of customer information.[163] Finally, the Investment Advisers Act also requires some broker-dealers to register as investment advisers.[164]

A major difference between investment advisers and broker-dealers is that the latter do not owe a fiduciary duty to their clients. However, the SEC has recently proposed changing this rule to subject broker-dealers to the same fiduciary duty rule as investment advisers.[165]

To start working, most broker-dealers must also register with a self-regulatory organization (SRO), the most important of which is the Financial Industry Regulatory Authority (FINRA).[166] FINRA requires broker-dealers to pass an examination and satisfy certain character

159. The main anti-fraud provisions of the Exchange Act are sections 9(a), 10(b) and 15(c)(1)-(2) (codified at 15 U.S.C. §§ 78j, 78o-5).

160. 15 U.S.C. §§ 78j, 78o-10.

161. 17 C.F.R. § 242.501 (2011).

162. *Id.* §§ 240.15g-2 to -9. Penny stocks are "low-priced (below $5), speculative securities of very small companies." *Microcap Stock: A Guide for Investors*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/pubs/microcapstock.htm (last modified June 27, 2011).

163. 17 C.F.R. §§ 248.1 to .18.

164. GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 158, at pt. V(j); *see also* U.S. SEC. & EXCH. COMM'N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 6 n.15 (2011) [hereinafter INVESTMENT ADVISER EXAMINATIONS], *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf (stating that as of October 1, 2010, about five percent of registered investment advisers were also registered as broker-dealers).

165. INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 152.

166. *See* GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 158, at pt. III.B; Koebel, *supra* note 145, at 64.

fitness requirements.[167] In addition, FINRA imposes a series of rules and regulations, many of which parallel the Exchange Act requirements.[168] FINRA has also been active in developing its own rules, such as the requirement to behave according to "high standards of commercial honor"[169] and the suitability rule.[170]

Suitability means that a broker-dealer can recommend to a customer only those securities that match the customer's financial circumstances, needs, and goals.[171] This rule imposes an affirmative duty to inquire about the investor's financial circumstances.[172] For example, a broker-dealer cannot simply recommend high-risk stock to an elderly widow of modest means looking for steady income without making sure that this investment will suit her financial circumstances and needs.[173] If a broker-dealer recommends unsuitable stock, the elderly widow could notify FINRA, which would investigate the broker-dealer and, if necessary, impose sanctions ranging from a short suspension and fines to a complete bar from FINRA.[174] The bar would

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167. *FINRA Registration and Examination Requirements*, FINRA, http://www.finra.org/industry/compliance/registration/qualificationsexams/registeredreps/p011051 (last updated Nov. 9, 2011); *see also* Bradley, *supra* note 7, at 320.

168. *FINRA Registration and Examination Requirements, supra* note 167.

169. Fin. Indus. Regulatory Auth., Proposed Rule Change to Adopt Rules 2010, 2020, and 5150 (Form 19b-4), at 5 (June 13, 2008), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p038731.pdf; *see also* Order Approving FINRA Proposed Rule Changes as Part of the Process of Developing the Consolidated FINRA Rulebook, Exchange Act Release No. 58643 (Sept. 25, 2008), *available at* http://www.sec.gov/rules/sro/finra/2008/34-58643.pdf.

170. Fin. Indus. Regulatory Auth., Proposed Rule Change to Adopt Rules 2090 and 2011 (Form 19b-4), at 5 (July 30, 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p121835.pdf; *see also* Greenberg, Exchange Act Release No. 6320, 1960 WL 56279, at *3 (discussing expulsion of a NASD member, in part, due to unsuitable recommendations to customers). For an excellent overview of the suitability doctrine and suitability rules, see Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999).

171. *See* Gedicks, *supra* note 13, at 547.

172. *See FINRA Registration and Examination Requirements, supra* note 167.

173. *See* Gedicks, *supra* note 13, at 547-48; Lowenfels & Bromberg, *supra* note 170 at, 1575-76.

174. Lowenfels & Bromberg, *supra* note 170, at 1575, 1580. Although the article analyzes NASD and NYSE sanction decisions, they offer useful guidance

effectively prevent the violator from working as a broker-dealer.[175] In addition, in certain cases the SEC could initiate prosecution for securities fraud[176]—a scenario that could result in both civil and criminal consequences.[177]

2. *Are Day-Trading Training Firms Required to Register as Broker-Dealers?*

Most day-trading training firms claim explicitly or implicitly that the broker-dealer definition and regulations do not apply to them.[178] Most often, this claim is made by using small-print disclaimers at the very bottom of the firms' websites and print materials.[179] Although the relationship between training firms and their affiliated brokerages is often a close one,[180] training firms are correct when they claim they are *not* broker-dealers under the Exchange Act. The Exchange Act's

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about FINRA sanction processes because NASD and NYSE merged in 2007 to form FINRA. *See* Koebel, *supra* note 145, at 64.

175. This is because registration with FINRA is a requirement to be able to do business as a broker-dealer. *See* GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 158, at pt. III.B.

176. The SEC prosecutes violations of the suitability doctrine under the Exchange Act's anti-fraud provisions found in sections 10(b) and 15(c)(1) (codified at 15 U.S.C. §§ 78j(b), 78o(c)(1)); Lowenfels & Bromberg, *supra* note 170, at 1581-82.

177. Ronald W. Breaux & Daniel H. Gold, *Criminal Enforcement of the U.S. Securities Laws*, HAYNESBOONE 3 (May 5, 2008), http://www.haynesboone.com/files/Publication/ed770586-b5e6-4af7-83d7-3e45f44886b1/Presentation/PublicationAttachment/5b204bc3-e71a-41f7-8e6b-3f851b2eb010/Criminal%20Enforcement%20of%20the%20US%20Securities%20Laws.pdf.

178. *See, e.g.*, DAY TRADING UNIV., *supra* note 8 (disclaimer stating that "[n]othing in our website shall be deemed a solicitation or an offer to Buy/Sell stocks, currencies, or futures"); PRISTINE.COM, *supra* note 8 (disclaimer stating that "[p]ristine.com is not a registered broker-dealer but does provide customized links to its affiliated brokerage company for your convenience only. The brokerage company you select is solely responsible for its services to you, the user").

179. *E.g.*, PRISTINE.COM, *supra* note 8.

180. Because day-trading training firms currently do not register, it is impossible to tell exactly how many training firms have closely affiliated brokerages. *See infra* Part II.A.4. In contrast, data collected from registered (traditional) investment adviser firms show that, in 2010, about twenty-two percent of all registered investment adviser firms had an affiliated broker-dealer. INVESTMENT ADVISER EXAMINATIONS, *supra* note 164.

definition of a broker as "any person engaged in the business of effecting transactions in securities for the account of others,"[181] on its face, does not apply to training firms. These firms technically never "effect" any transactions but only "recommend" them.[182] Thus, training firms might suggest which stock to buy, exactly when, at what price, and through which broker, but ultimately it is the investor who carries out the transaction.[183] Similarly, the Exchange Act's definition of a dealer as "any person engaged in the business of buying and selling securities for such person's own account"[184] does not fit training firms because the firms do not trade for their own account. Hence, training firms are *not* broker-dealers.

The SEC acknowledged this reality and its consequences in a special report based on examinations of forty-seven brokerages involved in day-trading by stating:

> [M]any day-trading firms [i.e., brokerages] refer potential customers to firms that offer day-trading training. The Staff identified significant links (e.g., common personnel or managers, or monetary or other forms of compensation) between the day-trading firms reviewed and these training entities. *Because these entities [training firms] are not registered broker-dealers*, the Staff was unable to review the content of training programs conducted by these entities.[185]

As this excerpt indicates, the divide between the broker-dealer and investment adviser regulations complicates oversight of day-trading training firms. Entities labeled only as broker-dealers will be investigated only as broker-dealers, while entities labeled only as investment advisers will be investigated only as investment advisers.[186] Entities not labeled as either of the two might go

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181. 15 U.S.C. § 78c.

182. Even a day-trading training firm with an affiliated brokerage, such as Pristine.com, takes pains to point out that the training firm provides information for "informational purposes only," and is not responsible for any transactions effected through the brokerage. *See* PRISTINE.COM, *supra* note 8.

183. *See* Interview with Leonard A., *supra* note 15.

184. 15 U.S.C. § 78c.

185. SPECIAL STUDY, *supra* note 79, at pt. II (emphasis added).

186. See Koebel, *supra* note 145, at 79-81, for an example of how this division works in practice and a discussion of the problems that arose by investigating the

uninvestigated altogether.[187] An example of the latter problem is the SEC's above-mentioned investigation, which left many day-trading training firms unexamined. An example of the former problem is the Bernard Madoff investment scheme.[188] Different divisions of Madoff's business were registered as broker-dealer and investment adviser departments.[189] Over a period of sixteen years, the SEC investigated Madoff as an investment adviser several times; meanwhile, FINRA investigated Madoff as a broker-dealer.[190] Yet, the agencies somehow "missed a $50 billion Ponzi scheme."[191] One reason for this oversight was that the investigations were conducted separately and the results were not shared as each agency focused only on that part of Madoff's business that fit its mandate.[192] In the day-trading training firm context, FINRA currently cannot inspect training firms because they are not labeled broker-dealers. SEC inspection is also lacking, giving free rein to the training firms.

It should be noted that the broker-dealer/investment adviser divide is not a hard-and-fast rule worldwide. Some countries regulate broker-dealers and investment advisers under a single license, making comprehensive regulation of online investing businesses easier.[193] Because the U.S. observes the regulatory divide[194] and training firms do not fit the broker-dealer part of it, attention will now turn to investment adviser regulations.

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investment adviser and broker-dealer divisions of Bernard Madoff's companies separately.

187. *Id.*

188. Diana B. Henriques, *Madoff Scheme Kept Rippling Outward, Across Borders*, N.Y. TIMES (Dec. 19, 2008), http://www.nytimes.com/2008/12/20/business/20madoff.html?pagewanted=1 (explaining Bernard Madoff's Ponzi scheme).

189. *See* Koebel, *supra* note 145, at 79-80.

190. *Id.*

191. *Id.* at 81.

192. *Id.*

193. One example is Australia. For a discussion of Australia's "more or less universal regulatory scheme" see Dimity Kingsford Smith, *The Same Yet Different: Australian and United States Online Investing Regulation*, 37 U. TOL. L. REV. 461, 465 (2006).

194. For a suggestion to lessen the divide and harmonize broker-dealer and investment adviser regulations, see INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 152, at ii.

3. *Overview of Investment Adviser Regulations*

Currently, the regulation and oversight of investment advisers is a hotly debated topic, in part due to the Bernard Madoff and Stanford Financial Group's securities fraud scandals that came to light in 2008 and 2009.[195] In response to these scandals and the financial crisis of 2008-2009, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010.[196] The Dodd-Frank Act made several important changes to the existing investment adviser regulations,[197] the most important of which is the Investment Advisers Act of 1940 (Investment Advisers Act).[198]

The Investment Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications and writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[199] Thus, if a client wants to purchase or sell securities, the investment adviser will provide analysis and advice; however, the adviser will not execute the transaction for the client but will instead refer the client to a broker-dealer.[200]

As a general rule, investment advisers are required to pass two exams and register with the SEC, the states where they work, or both.[201] Investment advisers are required to disclose relevant background information (including any violations of the securities laws) and their business practices on Form ADV.[202] After registration,

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195. *See* Koebel, *supra* note 145, at 81; Henriques, *supra* note 188 (explaining Bernard Madoff's Ponzi scheme).

196. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

197. *Id.*

198. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006).

199. *Id.* § 80b-2(a)(11).

200. *Id.* §§ 80b-1 to -21.

201. *How to Register as an Investment Adviser*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/divisions/investment/iaregulation/regia.htm (last modified June 23, 2005).

202. U.S. SEC. & EXCH. COMM'N, FORM ADV-PART 1A (2011), *available at* http://www.sec.gov/about/forms/formadv-part1a.pdf; *see also Form ADV*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/ answers/formadv.htm (last modified Mar. 11, 2011) (stating that "Form ADV is the uniform form used by investment advisers

investment advisers have a duty to regularly update this information.[203] In addition, federally registered investment advisers must adopt and annually review a written compliance policy;[204] provide their clients with information about the adviser's business practices and background; maintain accurate books and records; submit financial statements to the SEC; and remain subject to inspection and examination by the SEC.[205] The SEC also requires registered investment advisers to adopt a code of ethics.[206]

Perhaps even more importantly, all registered investment advisers are subject to the fiduciary duty rule.[207] As explained by the Director of the SEC's Office of Compliance Inspections and Examinations, Lori A. Richards, "fiduciary duty is the *first principle* of the investment adviser."[208] While fiduciary duty can be analyzed at length, its essence is simple—it is "doing what's right by the client"[209]

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to register with both the Securities and Exchange Commission (SEC) and state securities authorities").

203. *Form ADV*, *supra* note 202.

204. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74714, 74720 (Feb. 5, 2004) [hereinafter Compliance Programs].

205. *See How to Register as an Investment Adviser*, *supra* note 201.

206. "[SEC] Rule 204A-1, requir[es] each registered investment adviser to adopt a written code of ethics that sets forth standards of conduct expected of advisory personnel and addresses conflicts that arise from personal trading by them." Mary Ann Gadziala, Assoc. Dir., SEC Office of Compliance Inspections & Examinations, Rebuilding Ethics and Compliance in the Securities Industry, Remarks before the NYSE Regulation First Annual Securities Conference (June 23, 2005), *available at* http://www.sec.gov/news/speech/spch062305mag.htm.

207. The Investment Advisers Act does not explicitly state that investment advisers owe a fiduciary duty to their clients. However, the Supreme Court has held that investment advisers are fiduciaries with "an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' . . . clients." SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963) (quoting WILLIAM L. PROSSER, LAW OF TORTS 534-35 (1955) and FOWLER V. HARPER & FLEMING JAMES, JR., THE LAW OF TORTS 541 (1956) respectively).

208. Lori A. Richards, Dir., SEC Office of Compliance Inspections & Examinations, Fiduciary Duty: Return to First Principles, Address at the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), *available at* http://www.sec.gov/news/speech/spch022706lar.htm.

209. *Id.*

by acting in the client's best interests and avoiding conflicts of interest.[210]

Unlike broker-dealers, investment advisers are not regulated by SROs such as FINRA.[211] Instead, the regulatory authority over investment advisers is split between the SEC and the states in a complex manner laced with numerous exceptions and exemptions. The National Securities Markets Improvement Act of 1996 (NSMIA) created the division between the SEC and states.[212] NSMIA's goal was to alleviate the SEC's burden of policing all registered investment advisers by essentially splitting the responsibility.[213] Thus, the SEC would oversee larger advisers, and the sates would oversee smaller ones.[214] While theoretically a great idea, the split created numerous complexities and "cracks" in the regulatory pattern that can be exploited by day-trading training firms.[215]

The division between the SEC and the state oversight responsibilities is mainly based on the "assets under management" test.[216] The assets requirements were changed substantially by the Dodd-Frank Act. Prior to the Dodd-Frank Act, all investment advisers with "assets under management" exceeding $25 million would register with the SEC;[217] after the Dodd-Frank Act, this threshold is now $100 million.[218] The Dodd-Frank Act also changed another provision of the Investment Advisers Act that is important to day-trader training firms: the national investment advisers (multi-state advisers) exemption.[219] This exemption generally applies to investment advisers who operate

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210. *See* Koebel, *supra* note 145, at 89-90.

211. *Id.* at 64-65. Some authors refer to the lack of SRO oversight as "somewhat of an anomaly." *Id.* at 71 ("Because all brokerage firms belong to at least one SRO, and most belong to several, regulators have the opportunity to oversee broker-dealers with a fine-tooth comb, which stands in stark contrast to the SEC's relatively limited oversight of registered investment advisers.").

212. 15 U.S.C. § 80b-3a (2006); *see also id.* §§ 77z-3, 78mm.

213. *See* Friedman, *supra* note 147.

214. *Id.* at 532-34.

215. *See infra* Part III.A.5.

216. 15 U.S.C. § 80b-3a.

217. *Id.*

218. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 410(2)(B)(ii), 124 Stat. 1376, 1577 (2010) (codified at 15 U.S.C. § 80b–3a).

219. 17 C.F.R. § 275.203A-2(d) (2011).

nationally but have few assets under management.[220] Without an exemption, these firms would be required to register in every state where they do business.[221] The exemption, however, generally allows them to register with the SEC.[222]

4. *Are Day-Trading Training Firms Required to Register as Investment Advisers?*

As of 2010, there were 11,888 investment advisers registered with the SEC.[223] However, a search of the SEC investment adviser registry[224] indicates that none of the most prominent day-trading training firms are registered as investment advisers. After searching for the names of more than fifty keynote training firms and individual teachers listed in the promotional materials for the largest day-trading trade shows in the United States (Traders Expos)[225] against the SEC registry of investment advisers, no such names were registered as investment advisers.[226]

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220. *Id.*; *see also* 15 U.S.C. § 80b-3a.

221. *Investment Adviser Guide*, NASAA, http://www.nasaa.org/industry-resources/investment-advisers/investment-adviser-guide (last visited Oct. 4, 2011).

222. 17 C.F.R. § 275.203A-2(d).

223. INVESTMENT ADVISER EXAMINATIONS, *supra* note 164, at 8 & chart 1. As of January 1, 2011, there were approximately 14,600 state-registered investment advisers. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-3221, 76 Fed. Reg. No. 42950, 43005 & n.828 (July 19, 2011) [hereinafter Rules Implementing Amendments].

224. *Investment Adviser Search*, U.S. SEC. & EXCH. COMM'N, http://www.adviserinfo.sec.gov/%28S%28uy5rbi45nuio1p45m5mn2q45%29%29/IAPD/Content/Search/iapd_Search.aspx (last visited Nov. 14, 2011).

225. *See* MONEYSHOW, *supra* note 5.

226. Two of the keynote speakers had been previously registered as investment advisers but did not have current registrations. The date of search was Mar. 5, 2011. The SEC Investment Adviser Registry can be accessed at *Investment Adviser Public Disclosure*, U.S. SEC. & EXCH. COMM'N, www.adviserinfo.sec.gov/%28S%28gc5csizxe0urqjayhgvlp0a3%29%29/IAPD/Content/Search/iapd_Search.aspx (last accessed Jan. 15, 2012). The promotional materials for Traders Expos can be accessed at *Investor, Trader, Forex, Advisor & Cruise Events*, MONEYSHOW, www.moneyshow.com/events/MoneyShow_Events.asp (last accessed Jan. 15, 2012).

Despite their lack of registration,[227] this Comment proposes that day-trading training firms *are* required to register as investment advisers because they fit the statutory definition of an investment adviser.[228] The firms provide advice about buying and selling various securities through their websites, webinars, and live seminars;[229] and firms are paid for this service in the form of website subscription and seminar fees.[230] Therefore, it appears day-trading training firms are required to register.

Ending the analysis here, however, would be an incomplete assessment of the applicable regulations. Because the Investment Advisers Act is laced with numerous exceptions and exemptions, a question that must be explored is whether day-trading training firms are lawfully excused from registration through disclaimers or exemptions.

a. Disclaimers

Many day-trading training firms use disclaimers to state that they are not investment advisers. The disclaimer of E-Mini Ticks, Inc., is representative of such statements:

> Neither the EminiTicks, Inc., nor its principals, officers or employees are registered investment advisers, or brokers/dealers. By engaging in any material produced by the EminiTicks, Inc., you agree that the information contained within is for educational and/or informational purposes only and is to be never construed as trading or investment advice.[231]

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227. For a discussion of the reasons why the day-trading training firms currently do not register, see *infra* Part III.A.5.

228. The Investment Advisers Act defines an Investment Adviser as "anyone who, for compensation, engages in the business of advising others, either directly or through publications and writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2006).

229. *See* discussion *supra* Part I.B.1-2.

230. *See* discussion *supra* Part I.B.1-2.

231. *Risk Disclosures and Disclaimers*, E-MINITICKS, http://2011eminiticks.artisteer.net/risk-disclosures/ (last visited Jan. 16, 2012). For additional disclaimer examples, see DAY TRADING UNIV., *supra* note 8; *Disclosure*, TRADING ACAD.,

However, at the same time, many websites state traders should always follow the firms' "rules-based trading strategies" that help "eliminate the guessing and confusion."[232] Essentially, training firms tell traders to always do what the firms' methods tell them to do: scan the market for stocks fitting certain criteria, and always "take the set-up" (i.e., enter the trade) when it presents itself.[233] While the firms might not be saying "buy/sell" every time the trader pushes the button, by making the traders follow a set of strict rules, the firms accomplish the same effect. Since training firms are paid for teaching the rules, they fit both prongs of the investment adviser definition: they provide advice regarding investment transactions, and they receive compensation for it.[234] The investment adviser nature of day-trading training firms is even more obvious in respect to the paid live chat rooms where moderators call out trades and entry prices as they occur.[235]

As this analysis demonstrates, the economic reality is that the day-trading training firms act as investment advisers. According to established precedent, the economic reality governs over disclaimers.[236] Therefore, simply putting up a disclaimer does not save day-trading training firms from Investment Advisers Act registration requirements.

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http://www.tradingacademy.com/Disclosure.aspx (last visited Nov. 14, 2011); *Terms of Use*, TRADING AUTHORITY, http://www.thetradingauthority.com/products.php?page=Terms (last visited Nov. 14, 2011).

232. *See, e.g.*, E-MINI ACAD., http://www.eminiacademy.com (last visited Oct. 4, 2011).

233. *See* Interview with Leonard A., *supra* note 15.

234. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2006).

235. *See generally* Segal, *supra* note 4; Interview with Leonard A., *supra* note 15.

236. *See, e.g.*, SEC v. Wall St. Transcript Corp., 454 F. Supp. 559, 565-66 (S.D.N.Y. 1978) (stating that simply "disavowing any intention to influence investors" does not exempt a newspaper providing investment advice from the registration requirements; therefore, the newspaper must register, unless it can show that it fits the newspaper exemption). For a discussion of the newspaper exemption, see *infra* Part III.A.4.b.ii.

b. Registration Exemptions

i. Teacher Exemption

Many day-trading training firm websites feature statements claiming the firms are simply educators, not investment advisers.[237] Such statements implicate the teacher exemption to the Investment Advisers Act. Thus, the Act explicitly excludes from the investment adviser definition "any . . . teacher whose performance of such [investment advice] services is solely incidental to the practice of his profession."[238] However, in 2009, a federal appellate court noted that the teacher exemption might not apply to day-trading training firms.[239] In *S & D Trading Academy v. AAFIS, Inc.*, the U.S. Court of Appeals for the Fifth Circuit held that a company that was hired to train an investment company's Chinese investors on day-trading could not recover for breach of contract because the trading firm was not registered as an investment adviser.[240] In reaching its decision, the court rejected the argument that the teacher exemption could save the firm from registration.

> [The training firm] provided the traders with market research, stock recommendations, and trading strategies for a particular day or particular stock. . . . Applying the teacher exception under these circumstances would allow almost any investment adviser to qualify for the exception so long as they accompanied their advice with a justifying explanation.[241]

Unfortunately, this case did not definitively decide the fate of day-trading training firms because the decision was based on the Texas Securities Act. Although the court used the Federal Investment Advisers Act and several SEC no-action letters in reaching its decision, the holding was nonetheless an interpretation of the Texas

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237. For an example of this type of statement see *supra* note 231 and accompanying text.

238. 15 U.S.C. § 80b-2(a)(11)(B).

239. S & D Trading Acad., LLC v. AAFIS, Inc., 336 F. App'x 443, 450 (5th Cir. 2009).

240. *Id.*

241. *Id.* at 449-50.

statute.[242] In addition, the court issued its opinion as an unpublished opinion,[243] thus lessening its precedential weight.

However, even in the absence of a groundbreaking federal appellate court decision, several SEC no-action letters show that the teacher exemption does not apply to day-trading training firms. Thus, the SEC letters demonstrate that individuals who plan to start a "stock market school" are not covered by the teacher exemption, even if the school would only teach how to find and evaluate information, and leave the final decision to buy or sell in the hands of the investor.[244] Similarly, the SEC has stated that an individual offering general advice about the securities markets and not issuing any newsletters has to register as an investment adviser.[245] Finally, even one-day investment seminars taught by a Wharton School finance professor were deemed to be an activity requiring investment adviser registration.[246]

If the SEC found that a Wharton School professor offering live presentations in a traditional lecture hall did not meet the teacher exemption, it is almost certain that the SEC would find that a day-trading training firm's website offering stock tips and strategies by non-credentialed teachers also does not fit the teacher exemption. Therefore, the teacher exemption does not excuse training firms from registration.

ii. Newspaper Exemption

Another exemption that seemingly applies to day-trading training firms is the newspaper exemption. This exemption excludes "the

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242. *Id.*

243. *Id.* at 443.

244. J.H. Rodgas, Jr., SEC No-Action Letter, 1974 WL 10941, at *1, *4-5 (Sept. 7, 1974).

245. Joseph P. Canouse, Esq., SEC No-Action Letter, 1977 WL 10657, at *1 (July 15, 1977). This letter also provides a factors test for determining whether an individual qualifies for the teacher exception. *Id.* Some of the factors are: whether the compensation is paid by an educational institution, whether the course is part of a program regularly offered by the educational institution, whether the school or institution is accredited, and the manner in which the course is offered to the public. *Id.*

246. David A. Umstead, SEC No-Action Letter, 1976 WL 12176, at *1-2 (Aug. 13, 1976).

publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation,"[247] and it is based on the First Amendment free speech protections awarded to newspapers in the U.S.[248] However, a closer analysis reveals that this exemption most likely does not protect day-trading firms' subscription websites and online bulletins.

The leading case interpreting the newspaper exemption is *Lowe v. Securities Exchange Commission*.[249] In *Lowe*, the Supreme Court ruled the newspaper exemption applies if the publication provides completely disinterested information, and it is distributed to the general public on a regular schedule.[250] In addition, the publication cannot "offer individualized advice attuned to any specific portfolio or to any client's particular needs."[251] The publication in *Lowe* satisfied these requirements because it provided disinterested, general information about market indicators, and it was distributed regularly to up to 19,000 subscribers.[252]

It is unlikely that the online advice columns, chat rooms, and bulletins provided by day-trading training firms are protected under the newspaper exemption because they do not fit the requirements of *Lowe*.[253] Many online bulletins are not "completely disinterested"[254] because they contain advertisements for and links to affiliated brokerages. If the investor reads the online publication, clicks through and executes the trade, the brokerage benefits from the commissions, and the newsletter publisher benefits from selling the advertisement.[255] In addition, the newsletters of various day-trading

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247. 15 U.S.C. § 80b-2(a)(11)(D) (2006).

248. *See* Bradley, *supra* note 7, at 317.

249. 472 U.S. 181 (1985).

250. *Id.* at 206.

251. *Id.* at 208.

252. *See id.* at 185.

253. The SEC has argued at least in one case that *Lowe* does not protect an investment newsletter that provides non bona-fide advice. *See* Constance Z. Wagner, *Securities Fraud in Cyberspace: Reaching the Outer Limits of the Federal Securities Laws*, 80 NEB. L. REV. 920, 938 (2001) (discussing SEC's arguments in *SEC v. Wall St. Publ'g Inst., Inc.*, 851 F.2d 365 (D.C. Cir. 1987)).

254. *Lowe*, 472 U.S. at 182.

255. Bradley, *supra* note 7, at 316. For an example of such arrangement, see Pristine.com's online newsletters, which provide links to its affiliated brokerage

training firms are usually distributed to a limited number of subscribers. Thus, such newsletters fail *Lowe*'s "offered to the general public" requirement.[256]

Furthermore, many of these publications might also fail the "no individualized advice" requirement.[257] Some training firms provide specialized newsletters catering to investors interested in particular trading styles and market segments. For example, Pristine offers the "Pristine Swing & Position Trader" for customers interested in holding equity positions for up to five days; "Pristine Swing Trader Lite" for customers looking for a single stock pick to be held for a few days; and "Pristine Day Trader" for customers interested in intra-day positions and gap trading.[258] The specificity of the advice offered in each newsletter suggests that the firm has crossed the line and is offering "individualized advice attuned to any specific portfolio or to any client's particular needs."[259]

Based on these reasons, day-trading training firms' websites and publications likely do not satisfy the requirements of the newspaper exemption. In the absence of any applicable exemption, the firms must register as investment advisers.

5. *Why Day-Trading Training Firms Do Not Register as Investment Advisers*

The reasons why day-trading training firms do not register might be numerous, and exploring all of them is beyond the scope of this Comment. Therefore, this Comment focuses on two reasons. First, the sheer complexity of the current investment adviser regulations creates ambiguity regarding which regulations apply to the training firms and with which entity (the SEC or the states) they must register. Simply put, the current investment adviser regulations do not fit the fluid online nature of day-trading training firms. Second, this regulatory

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Mastertrader. *Pristine Newsletters*, PRISTINE.COM, http://www.pristine.com/ToolsServices/newsletters.aspx (last visited Nov. 13, 2011).

256. *Lowe*, 472 U.S. at 206.

257. *Id.* at 208.

258. *See Pristine Newsletters*, *supra* note 255.

259. *Lowe*, 472 U.S. at 182, 208.

complexity leads to lack of enforcement from both the SEC and the states.

The complexity is created, in part, because of the split of the regulatory authority between the SEC and the individual states.[260] Although well-intended, the division is based on traditional notions of investment advisers that do not fit day-trading training firms. Two such notions are the "assets under management" [261] and the "principal office and place of business"[262] tests. Generally, firms with assets exceeding $100 million must register with the SEC, while smaller firms must register with the states.[263] The day-trading training firms do not fit this traditional mold because they typically do not have any "assets under management" as they do not "provide continuous and regular supervisory or management services" in respect to their clients' accounts.[264] In addition, it is often difficult to determine in which state(s) a particular day-trading training firm is located because these firms operate largely online, they rent seminar facilities in various cities, and their moderators and teachers operate from various locales across the United States and abroad.[265]

The complexity becomes obvious when one attempts to apply the current investment adviser regulations to day-trading training firms. Initially it appears that training firms must register with the states because training firms fail the "assets under management" threshold

260. NSMIA created this split. *See supra* note 212 and accompanying text.

261. *See supra* note 212 and accompanying text; *see also* Investment Advisers Act of 1940 § 203A(a)(1), 15 U.S.C. § 80b-3a (2006).

262. 15 U.S.C. § 80b-3a.

263. Dodd-Frank Act, Pub. L. No. 111-203, § 410(2)(B)(ii), 124 Stat. 1376, 1577 (2010) (codified at 15 U.S.C. § 80b–3a). The Dodd-Frank Act increased the registration asset threshold requirements established by the Investment Advisers Act. *See* 15 U.S.C. § 80b-3a. For an explanation of how the SEC changed its rules in response to the Dodd-Frank monetary threshold requirements, see Rules Implementing Amendments, *supra* note 223, at 42950-51.

264. Rules Implementing Amendments, *supra* note 223, at 42955; Interview with Leonard A., *supra* note 15.

265. For an example, see the seminar, trade show, and webinar schedule of Money Show, one of the largest day-trading training entities in the U.S. MONEYSHOW, *supra* note 5.

required for the SEC registration.[266] It further appears that training firms might have to register in every state. This is because investment advisers are "generally . . . required to register in each of those states [where they do business]."[267] The online advice of day-trading training firms reaches customers in all fifty states, thus potentially necessitating registration in each one of them.

However, the analysis does not end here. A special exemption to the Investment Advisers Act (the multi-state exemption) provides that investment advisers that would be required to register in more than fifteen states may instead register with the SEC.[268] This exemption was affected by the Dodd-Frank Act, and in the immediate aftermath of the Dodd-Frank Act, it was unclear whether the multi-state

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266. *See* Dodd-Frank Act § 410; Rules Implementing Amendments, *supra* note 223, at 43005 (defining "small advisers" and stating that they are prohibited from the SEC registration and must instead register with the states).

267. *See* Friedman, *supra* note 147, at 554.

268. SEC Rule 203A-2 (titled "Exemptions from Prohibition on Commission Registration") explains this exemption. The SEC's authority to adopt Rule 203A-2 is based on the Investment Advisers Act section 203(A)(c). Thus, SEC Rule 203A-2 creates five categories of investment advisers that are allowed to register with the SEC even though they do not satisfy the Investment Act's requirements for federal registration. The Rule's five exemptions are: (a) pension consultants; (b) certain investment advisers affiliated with investment advisers registered with the SEC; (c) investment advisers expecting to be eligible for the SEC registration within 120 days; (d) *multi-state investment advisers* who are "required by the laws of 15 or more States to register as an investment adviser with the state securities authority in the respective States"; and (e) Internet investment advisers. 17 C.F.R. § 275.203A-2 (2011) (emphasis added); *see also* Rules Implementing Amendments, *supra* note 223, at 42959. Even though category (e) of Rule 203A-2 (Internet investment advisers) might seem applicable to day-trading training firms, it is not. It does not apply because the definition "internet investment adviser" covers only advisers who "provide investment advice . . . *exclusively* through an interactive website." 17. C.F.R. § 275.203A-2(e) (emphasis added). In contrast, many day-trading training firms also offer live seminars, lectures, and training classes that are conducted in person. Therefore, they do not provide investment advice *exclusively* through their websites. In addition, most day-trading training firm websites do not fit the definition of an "interactive website" as provided in Rule 203A-2(e) because they do not use "computer software-based models or applications [to] provide investment advice to clients based on personal information each client supplies." 17 C.F.R. § 275.203A-2(e); *see also* Exemption for Certain Investment Advisers Operating Through the Internet, Investment Advisers Act Release No. 2091, 67 Fed. Reg. 77620, 77621, 77625 (Jan. 20, 2003).

exemption will apply to small advisers, mid-sized advisers, or both.[269] This issue was important for day-trading training firms because they typically do not have any client assets under management, and therefore they fall into the small adviser category.[270] The SEC resolved this issue in a July 19, 2011, release that established that the multi-state exemption will apply to both small and mid-sized investment advisers.[271]

Unfortunately, this SEC decision will not provide the desired certainty nor close the SEC/state enforcement gap. Instead, the current status quo will continue because the post Dodd-Frank multi-state exemption, as applied to day-trading training firms, is as complex as it was before the amendments. A particular problem is the provision that allows investment advisers who satisfy the exemption (and thus could register with the SEC) to nonetheless register with the states.[272] This choice creates a registration loophole and an enforcement disaster because day-trading training firms are essentially required to police themselves by voluntarily registering with a proper entity(ies). There is no neutral third party overseeing this process to ensure that the firms pick an entity and register at all.[273] As a result, day-trading training firms are free to continue their current "strategy": to not register with anyone and hope that the SEC will not do the fifteen-state calculation and catch them. To avoid this scenario, the SEC rules should be amended to make it clear that all online day-trading training firms must register exclusively with the SEC.

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269. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, 75 Fed. Reg. 77052, 77060 (Dec. 10, 2010) (stating that the SEC was soliciting comments on whether the fifteen state threshold should be applied to small advisers as well as mid-sized advisers).

270. *See supra* note 264 and the accompanying text; *see also* Rules Implementing Amendments, *supra* note 223, at 43005 (explaining when an investment adviser is considered a "small entity").

271. *See* Rules Implementing Amendments, *supra* note 223, at 42959.

272. *Id.* at 42960.

273. The Investment Advisers Act does not create a neutral third party who would oversee the registration process. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006).

B. Proposed Changes to the Current Regulatory Regime

As the previous Subsection demonstrated, day-trading training firms are subject to the Investment Advisers Act's registration requirements, but ambiguity exists regarding *with whom* they must register. The proposed solution to this problem is twofold: simplification and concentration. Simplification would entail amending SEC Rule 203A-2[274] to require all day-trading training firms to register with the SEC. Concentration would place all enforcement authority in the hands of the SEC. Simplification and concentration would eliminate any ambiguity regarding who must inspect and sanction a particular day-trading training firm for Investment Advisers Act violations, and thus lead to better investor protection. To further improve investor protection, the SEC should also require day-trading teachers to pass basic securities exams, provide easy access to information they would file with the SEC, make the information filed with the SEC easier to understand, and disclose their trading statistics. In addition, the SEC should create a register of serious offenders.[275]

274. 17 C.F.R. § 275.203A-2.

275. The proposed solution is not the only possible response to the problem of protecting day-traders. Perhaps the most successful solution would be prohibiting day-trading altogether. However, implementation of this solution is highly unlikely as it would go against some core American values: privacy, individual freedom (that includes a right to lose money by making bad decisions), the "nothing ventured, nothing gained" mentality, and the desire to realize the American dream by taking control of one's own financial destiny. *See* Hurt, *supra* note 128, at 372; Gordon, *supra* note 14 at 376-77.

Another interesting proposal is to regulate day-traders themselves. Thus, Professor Choi argues that all investors should be licensed and divided into four groups. Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 284 (2000). Depending on their sophistication, each group would be allowed to invest in a particular type of stock and work with a particular type of broker-dealer/investment adviser. *Id.* at 283-84. This solution has been widely criticized. Some of the criticisms of Choi's theory include allegations that it is based on incorrect assumptions about investor behavior; requires impossible policing of the intermediaries; and that it is impractical because it would add more complexity to the regulatory regime—severely restricting the freedom of investors. Iris H-Y Chiu, *Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from European Union Securities Regulation*, 2 VA. L. & BUS. REV. 307, 350-51 (2007). Additionally,

1. *Simplification: Amending SEC Rule 203A-2*

SEC Rule 203A-2 should be amended by adding a section stating that all day-trading training firms must register exclusively with the SEC, irrespective of the size of their assets or location(s). SEC Rule 203A-2 lists exemptions that allow some investment advisers who would normally be required to register with the states (and thus prohibited from registering with the SEC) to register with the SEC instead.[276] The SEC's power to create such exemptions comes from section 203A(c) of the Investment Advisers Act.[277] The SEC has created five exemptions as part of Rule 203A-2.[278]

This Comment proposes adding another exemption for day-trading training firms. Adding such an exemption would require adding a short, straightforward section modeled on the existing exemptions.[279] The new exemption should consist of two parts. Part one would contain a concise statement that all day-trading training firms are required to register with the SEC. Part two would define a day-trading training firm. A proposed definition might read:

> A day-trading training firm is any entity (whether formally registered as a business or not) consisting of one or more individuals who teach other persons how to profit from intra-day or multi-day price movements of various securities, allow other persons to observe their trades (live or paper), or comment on intra-day or multi-day market movements using any medium of

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investors could "circumvent the rules by using agents to conduct trades where they are prohibited from doing so themselves." *Id.* at 350.

276. 17 C.F.R. § 275.203A-2.

277. Investment Advisers Act of 1940 § 203A(c), 15 U.S.C. § 80b-3a (2006). Significantly, the Dodd-Frank Act did not eliminate the SEC's power to use section 203(A) to add or remove exemptions, which means that the SEC can use this section to create the proposed exemption for day-trading training firms. *See* Rules Implementing Amendments, *supra* note 223, at 42959 (explaining how the SEC used its section 203(A) authority post Dodd-Frank to eliminate one exemption and amend two other exemptions).

278. For the full text of the five exemptions, see 17 C.F.R. § 275.203A-2. Until recently, the rule contained six exemptions. However, on July 19, 2011, the SEC amended the rule by eliminating the exemption for nationally recognized statistical rating organizations. Rules Implementing Amendments, *supra* note 223, at 42959.

279. *See* 17 C.F.R. § 275.203A-2.

communication, if such firm receives or expects to receive direct or indirect compensation for its trading-related activities.

The SEC should take this definition as a starting point and use its regular process of soliciting public comments to fine-tune it.

The registration requirement would oblige all day-trading training firms to fill out Form ADV[280] in order to continue their operations. Once the Form ADV is approved, the firms would become subject to the full force of the Investment Advisers Act requirements, including its anti-fraud and fiduciary duty provisions.[281] In addition, the information filed with the SEC would become publicly available through the SEC website[282] and the day-trading training firm websites.[283]

Filing Form ADV with the SEC would allow every potential day-trader to see its contents. Part 1 of Form ADV discloses information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees.[284] Part 2 of this form is often referred to as the "brochure."[285] The brochure requires investment advisers to describe in plain English the types of advisory services they offer, disciplinary information, financial information, conflicts of interest, the educational and business background of management, and key personnel of the adviser.[286] The registered advisers must provide the brochure to their clients, and it is also available on the SEC's Investment Adviser Public Disclosure website.[287] In addition, every year registered investment advisers are required to deliver to clients a

280. *Id.* § 279.1; *see also Form ADV*, *supra* note 202 (stating that "Form ADV is the uniform form used by investment advisers to register with both the Securities and Exchange Commission (SEC) and state securities authorities").

281. *See supra* note 207 and accompanying text.

282. *Investment Adviser Search*, *supra* note 224.

283. *See infra* Part III.B.3.b.

284. FORM ADV-PART 1A, *supra* note 202.

285. *See Form ADV*, *supra* note 202.

286. *Id.*; *see also* U.S. SEC. & EXCH. COMM'N, FORM ADV-PART 2 (2011), *available at* http://www.sec.gov/about/forms/formadv-part2.pdf.

287. *Form ADV*, *supra* note 202.

summary of material changes to the brochure.[288] They are also required to deliver a brochure supplement whenever there is a new disciplinary event.[289] The goal of all these requirements is to provide investors with easily accessible, accurate, and up-to-date information about their investment advisers.

In addition, registration as an investment adviser means that the registrant has a duty to maintain accurate books and records, adopt and annually review a written Investment Advisers Act compliance policy,[290] adopt a written code of ethics,[291] and remain subject to the SEC inspection.[292] The Investment Advisers Act also prohibits false and misleading advertising,[293] as well as prohibits advisers from engaging in fraudulent, deceptive, or manipulative activities.[294]

Finally, the Investment Advisers Act registration would impose on all day-trading training firms a fiduciary duty toward their clients.[295] This means the firms would have an affirmative duty to make sure they act in the client's best interests.[296] In certain situations, the firm would be obligated to tell a client that the firm's strategy is not suitable for him or her. For example, if an elderly woman with no trading experience and only $25,000 in her trading account wished to try her hand at scalping,[297] the firm would be required to explain in straightforward terms that it is highly likely that she will lose all of her money (or even more) in commissions and losing trades. Day-trading training firms who violate the fiduciary duty rule could be investigated

288. *See* INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 152, at 20 (stating that some of this information can be delivered electronically).

289. *Form ADV*, *supra* note 202.

290. *See* Compliance Programs, *supra* note 204, at 74715, 74720.

291. Gadziala, *supra* note 206.

292. *See How to Register as an Investment Adviser*, *supra* note 201.

293. Investment Advisers Act, § 206(4)(1)-(2), 15 U.S.C § 80b-6 (2006). For a discussion of the advertising-related provisions, see INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 152, at 29-32.

294. 15 U.S.C § 80b-6.

295. *See supra* note 207.

296. *See* Richards, *supra* note 208; Koebel, *supra* note 145, at 89-90.

297. Scalping is an aggressive trading strategy that envisions numerous trades throughout the day, completed in mere minutes or "even a few seconds." *See* Interview with Leonard A., *supra* note 15. The theory behind this method is that consistently making a little profit on each trade will add up to significant profit. *Id.*

and sanctioned by the SEC, including a prohibition to work as an investment adviser,[298] as well as exposed to SEC-initiated civil and criminal proceedings.[299] The ultimate result would be enhanced protection for day-traders from unscrupulous operators, and a warning to other advisers not to engage in questionable practices.

2. Concentration: Placing All Enforcement Authority in the Hands of the SEC

In addition to requiring all day-trading training firms to register with the SEC, the SEC should also be placed in charge of enforcing registration requirements and other Investment Advisers Act provisions.[300] By placing all enforcement authority in the hands of the SEC (as opposed to sharing it with the states), the current ambiguity about who should regulate a particular day-trading training firm will

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298. *See, e.g.*, Dawson, Investment Advisers Act Release No. 3057, 2010 WL 2886183 (July 23, 2010) (enjoining an investment adviser who violated fiduciary duty and anti-fraud provisions of the Investment Advisers Act from working as an investment adviser or associating with any investment adviser).

299. *See* INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 152, at apps.17-18.

300. One criticism of this approach could be the argument that the SEC does not have adequate resources to take on any additional regulatory responsibility. To remedy this situation, Congress could take several steps. First, Congress could ease the SEC's burden by providing help in the form of a new self-regulatory organization (SRO). Congress could authorize the new SRO to examine, subject to the SEC oversight, all SEC-registered investment advisers, including day-trading training firms. *See* INVESTMENT ADVISER EXAMINATIONS, *supra* note 164, at 4. To ensure proper inspections, the new SRO should not be an organization ran by day-traders themselves, but instead an independent, reliable SRO consisting of reputable investment advisers.

Second, Congress could expand FINRA's authority instead of creating a new SRO. *Id.* Under this approach, FINRA would double with the SEC in overseeing all investment advisers (including day-trading training firms), much like they double now with respect to overseeing broker-dealers. The result under both approaches would be the same—more frequent inspections and improved protection of investors' interests.

This approach is in line with the argument that a major problem with the overall U.S. financial regulatory regime is its "highly fragmented and arguably Balkanized structure," and that (as part of the changes to the global U.S. regulatory system), all authority for consumer protection and oversight of business practices should be concentrated within the SEC. John C. Coffee, Jr., & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?* 95 VA. L. REV. 707, 716-17 (2009).

be eliminated. If a firm fits the amended SEC Rule 203A-2 "day-trading training firm" definition,[301] it will have to register with the SEC, and the SEC will be the only entity responsible for inspecting and sanctioning the firm.

3. *Additional Provisions for Enhanced Investor Protection*

Besides simplification and concentration, the SEC should consider additional provisions to better protect prospective day-traders from falling prey to dubious firms and teachers. Some of the more important provisions to consider are: basic investment adviser examinations, improved disclosure of the information filed with the SEC, simplification of disclosed information, disclosure of trading statistics, and a register of serious offenders.

a. *Basic Investment Adviser Examinations*

Day-trading training firms' teachers and authors of their trading strategies should be required to pass basic investment adviser examinations, such as Series 66 and Series 7, or Series 65.[302] Adding this requirement is necessary because currently those investment advisers who register only with the SEC do not need to show proof of any examinations, although such examinations are required for those investment advisers who register with the states.[303] The new requirement would spell out explicitly that the SEC registration does not excuse operators of day-trading training firms from showing that they have basic knowledge about securities and investments. In practice, this would mean the person the firm touts as the "superstar trader" and the inventor of the firm's "15-minutes-a-day" strategy that

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301. 17 C.F.R. 275.203A-2 (2011); *see also supra* Part III.B.1.

302. The vast majority of states require Investment Advisers/Investment Adviser Representatives registering with them to pass several examinations. The exact exams required depend on each state. Series 66 (Uniform Combined State Law Examination), Series 7 (General Securities Representative Examination), and Series 65 (Uniform Investment Adviser Law Examination) are among the most often required exams. *See Sample Rule*, NASAA, http://www.nasaa.org/industry-resources/exams/sample-rule/ (last visited Oct. 8, 2011).

303. *See* INVESTMENT ADVISER EXAMINATIONS, *supra* note 164, at 10, 38 (suggesting that perhaps this situation should be changed and federal licensing requirements should be imposed on all federally-registered Investment Adviser Representatives).

guarantees "jaw-dropping results"[304] would have to prove that he or she has at least a basic understanding of the markets. In the absence of such proof, the SEC would be able to stop the firm and its leaders from cashing in on questionable investment advice.

b. Easy Access to SEC Filings via Website Banner

The SEC should also require all day-trading training firms to provide their clients with information about how to access the firms' SEC filings. This requirement is vital because registration and information disclosures will do nothing to protect investors unless they know that this information exists and how to access it. Since most day-trading training firms operate mainly through their websites, the SEC should require firms to place a prominent banner on the firm's home page stating: "This firm is registered with the SEC. Information about the firm, including teacher education and violations of laws (if any) can be found *here*. You can file and view complaints about the firm *here*."[305] The firms would be required to hyperlink the first "*here*" to the search page of the SEC's Investment Adviser Registry[306] and the second "*here*" to the SEC's Investor Complaint Homepage.[307]

The purpose of the banner and hyperlinks is fourfold: (1) to provide investors with easy access to the information the firm would file with the SEC; (2) to educate investors about their right to complain about the training firms and their teachers; (3) to provide investors with easy access to complaints filed by other investors;[308]

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304. *See, e.g.*, *Signals for the Professional Trader*, FINANCIAL PICKS, http://www.financialpicks.com/ (last visited Oct. 8, 2011).

305. The idea of a banner is based on the "red herring" disclosure statement that must be prominently featured on the cover page of all preliminary prospectuses (used in connection with a public offering). 17 C.F.R. § 229.501 (2011). The suggested banner to be placed on the home pages of day-trading training firm websites should similarly be very prominent.

306. *Investment Adviser Search*, *supra* note 224.

307. *Tips, Complaints and Referrals Portal*, U.S. SEC. & EXCH. COMM'N, https://denebleo.sec.gov/TCRExternal/disclaimer.xhtml (last visited Nov. 15, 2011).

308. Implementing this suggestion would require modifications to the SEC's Investor Tips, Complaints and Referrals portal to allow investors to see other complaints (with private information redacted) filed against a particular firm. Currently, the SEC website only allows filing a complaint but does not allow for viewing of complaints filed by other people. *Id.*

and (4) to provide the SEC with timely information about possible violations of the Investment Advisers Act committed by day-trading training firms. In practice, this would mean that a prospective client of a day-trading training firm would first see a prominent banner when visiting the firm's website. The banner would remind the investor to take a minute to check out the firm's background. Since the banner would also provide an easy means of doing this (the investor would only have to click on the two hyperlinks), perhaps a substantial number of investors would take a moment to look at their firm's credentials.

As a result, investors would immediately see critical information about the firm necessary to make an informed decision about whether to trust it. The banner would also provide a convenient and fast way to lodge a complaint if the day-trader runs in to trouble with the firm. Consequently, the SEC would have up-to-date information about possible Investment Advisers Act violations, which would foster swift enforcement.

c. Simplified SEC Information

In addition, the SEC should ensure that the registration information is provided to potential day-traders in an easy-to-understand format. Under the proposed rules, day-trading training firms would disclose information about their operations and key personnel on Form ADV.[309] However, reading and comprehending Form ADV takes effort and patience. To make this process easier for investors, the SEC should insert a short summary page at the beginning of Form ADV containing statements such as "Past Violations of Securities Laws – Yes/No," "Past Criminal Sanctions – Yes/No," "Past Disciplinary Action – Yes/No," "Currently Under Investigation – Yes/No."[310] Such disclosures would help the

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309. *Form ADV*, *supra* note 202.

310. The idea about short front-page disclosures is based on the front page of Form ADV used by the Investment Adviser Representatives. *Investment Adviser Search*, *supra* note 224. This form states on the first page: "Is this Investment Adviser Representative currently suspended with any jurisdiction? Yes/No" and "Are there events [formal investigations, criminal and civil actions/convictions etc.] disclosed about this Investment Adviser Representative? Yes / No." If the answer to the latter question is "Yes," the form also lists the type of events disclosed, such as "regulatory event" or "civil event." For an example of such disclosures, see *id.*

prospective investors obtain the most vital information at a glance and motivate them to read a problematic firm's Form ADV very carefully. The ultimate result would be the dissuasion of at least some investors from entrusting their financial futures to dubious day-trading training firms.

d. Accurate Trading Statistics

The SEC should also require all day-trading training firms to keep accurate statistics about the success of their trading strategies and techniques.[311] These statistics should be included in the annual Form ADV brochure, which must be provided to all clients.[312] The disclosure of such data might be the single most effective mechanism of protection for day-traders. Seeing the true success/failure rate of the firms' trading strategies might dissuade at least some prospective day-traders from engaging in this risky game. Ideally, the firms would also make available the personal training records of the firms' teachers.[313] Presumably, many of them would not be able to back up statements like earnings of "300K+ a year"[314] and that the firm's strategy ensures that profits outweigh losses by "at least a 3:1 ratio."[315] Seeing that the teachers themselves are unable to realize the fortunes promised by their strategies would make many investors think twice before following their lead.

(select "Investment Adviser Representative" and type in "Louis Navellier"). These front-page disclosures cue the readers to look at the form more closely, and read about the Representative's legal problems.

311. This could be achieved by developing a software program that automatically executes each of the firm's trading strategies and accurately records the gains/losses produced. Currently, some firms widely publicize their trading statistics, but the accuracy of their tracking methods is highly questionable. *See* Interview with Leonard A., *supra* note 15.

312. *Form ADV*, *supra* note 202.

313. This could be done by disclosing (perhaps quarterly) day-trading teachers' trading account balances obtained from their brokers.

314. DAY TRADERS COACH, http://daytraderscoach.com/default.aspx (last visited Nov. 15, 2011).

315. STOCK BANDIT, http://www.thestockbandit.com/stock-trading-strategy (last visited Nov. 15, 2011).

e. Register of Serious Offenders

Finally, the SEC should create a register of the most serious Investment Advisers Act offenders.[316] This register could be modeled after those already in effect with respect to sexual predators.[317] The register would feature day-trading training firms and individual teachers whom the SEC considers especially unethical and dangerous. The register would have to be widely publicized so that the investors know of its existence and how to use it. In addition, day-trading training firms should be required to disclose on their website banners[318] whether they or their teachers are on the register. The goal of this proposal is to empower prospective day-traders with knowledge regarding which day-trading training firms and teachers to take with a grain of salt, and which to take with a bucket full.

CONCLUSION

Day-trading allows investors to take charge of their own financial affairs by actively trading their investment accounts.[319] When viewed from the best possible angle, day-trading is "the American Dream at work."[320] However, this dream is usually over in a few months.[321] By this time, most day-traders have lost their entire investments and are forced to face the cold reality: the failure rate of day-trading is ninety-nine percent.[322]

Given the dismal prospects, a rational observer would expect that the day-trading frenzy would have ended in a few years. However, since day-trading first began in the 1990s,[323] this activity has remained a staple of the individual investing landscape as evidenced by the

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316. This suggestion is based on the idea of an offender register offered in Jayne W. Barnard, *Creative Sanctions for Online Investment Fraud*, 76 MISS. L.J. 949, 971-72 (2007).

317. For an example of such register, see *Dru Sjodin National Sex Offender Public Website*, U.S. DEP'T OF JUSTICE, http://www.nsopw.gov/Core/Portal.aspx?AspxAutoDetectCookieSupport=1 (last visited Oct. 8, 2011).

318. *See supra* Part III.B.3.b.

319. *See supra* Part I.A.1.

320. Bradley, *supra* note 14, at 63.

321. *See supra* text accompanying note 3.

322. *See* Segal, *supra* note 4.

323. *See supra* text accompanying note 77.

scores of day-trading training firms doing business on a daily basis.[324] The marketing and teaching practices of day-trading training firms help explain why investors continue to fall into the day-trading trap. These firms profit from teaching novice day-traders what and how to trade.[325] Their business model largely depends on constantly attracting new customers to replace traders who run out of money.[326] This reality is the driving force behind the firms' constant advertising campaigns, enticing promotions, and special events, such as Las Vegas seminars and exotic investment cruises.[327]

Even though training firms play a major role in the day-trading scene, these firms currently operate largely unregulated.[328] They do not register with the SEC or the states, and they are not actively inspected and sanctioned by anyone.[329] This Comment contends the current regulatory regime requires day-trading training firms to register as investment advisers. However, the sheer complexity of the investment adviser regulations (exacerbated by the changes underway in response to the Dodd-Frank Act)[330] creates ambiguity regarding whether a particular firm must register with the SEC or one or more states. As a result, the firms do not register with anyone.[331] Coupled with lack of enforcement, this situation leads to day-trading training firms having free rein of a market that is otherwise heavily regulated.

This Comment proposes a twofold remedy.[332] First, SEC Rule 203A-2 should be amended to state that all day-trading training firms must register exclusively with the SEC. Second, all enforcement authority should be placed in the hands of the SEC. In addition, the SEC should require day-trading training firms to provide clients with easy access to information the firms would file with the SEC. The

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324. *See supra* note 5.

325. *See* Interview with Leonard A., *supra* note 15.

326. *See supra* Part I.B.3.

327. *See supra* Part I.B.2.

328. *See supra* text accompanying note 7.

329. *See supra* Part III.A.4.

330. *See supra* text accompanying notes 268-69. *See generally* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (relevant sections codified at 15 U.S.C. § 78).

331. *See supra* Part III.A.4.

332. *See supra* Part III.B.

firms should also disclose their trading statistics so prospective day-traders can judge for themselves the profitability of the firms' trading strategies. To improve the quality of training, the SEC should require the firms' teachers to pass basic securities examinations. Finally, the SEC should create a register of particularly egregious Investment Advisers Act violators so that prospective day-traders can quickly check the people they are about to trust with their financial futures.

Implementation of these investor protections is crucial in the light of the recent investment fraud scandals, financial recession, and calls to overhaul U.S. investment adviser and broker-dealer regulations.[333] Furthermore, the proposed changes will help protect the finances of millions of retirees who soon might be required to self-direct their investments due to social security reform and a phase-out of defined benefit plans.[334] This vulnerable population might become a ready target for day-trading advertisements promising financial wellbeing.

In the end, the proposed changes will benefit both investors and legitimate day-trading training firms. Investors will benefit because they will be able to make wiser investment decisions based on more accessible, more reliable information.[335] The legitimate day-trading training firms will also benefit because the prestige of their industry will increase once all the firms are registered and the disreputable players are weeded out.

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333. *See, e.g.*, Koebel, *supra* note 145, at 62-66.

334. *See supra* note 13 and accompanying text.

335. No solution is perfect, and in the end it is only day-traders who can educate themselves and protect their own interests. Day-traders cannot do so, however, until they have access to reliable information about their teachers and the strategies they promote.

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