

Comprehensive guide to investing with an online broker.

The Ultimate Guide to Online Investing: A Stockbroker  
Tells You Everything You Need to Know

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# ***The Ultimate Guide to Online Investing:***

***A Stockbroker Tells You  
Everything You Need to Know***

by Richard Victor, CFP<sup>®</sup>

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# Part II: Your Investment Account

## 4

### Select the Best Online Broker

*In this section, you'll learn:*

- The process and challenges of selecting an online broker
- Sources of expert opinions
- Deciding what features are important to you
- Questions you should ask
- Opening and funding an account
- Interactive resources

#### **The Early Years (around 1996)...**

The early “gold rush” years of online trading were very exciting, and I’m glad to have been part of them. Lombard Securities, I believe was the first to offer Internet investing at a time when no one knew if people would risk financial transactions over an open network. They did, and soon discount brokers both new and old started rolling out their Internet trading platforms. In 1997, when there were about sixty online investing firms, analysts were predicting consolidation in the industry. There was just too much competition, too many companies chasing too few clients to survive on such slim (and getting slimmer) profit margins. The smaller ones would have to merge or go out of business.

That didn’t happen. The number of online brokerages doubled by 1999, and not just discount and deep-discount firms either. Banks started to offer online investing as well as online banking. The traditional full-service firms who have long shunned online trading (Merrill Lynch’s chairman described it as a major threat to Americans’ financial lives), have revamped their business models and made it part of their offering. Even Merrill signed on in a big way with the critically acclaimed MLDirect.com.

The big draw was incredibly low commissions. I credit Datek with starting the “race for the bottom” with an aggressive Internet ad campaign announcing online stock trades for \$9.95.

We used to joke that once the price dropped below \$10, it wasn't a commission anymore, it was a tip.

The first Internet brokerages offered simple, convenient Web sites and cheap trades to people who pretty much knew what they were doing. By 1999, that wasn't good enough. If the firms were going to grow, they had to attract less sophisticated investors who needed more handholding. Sites had to offer features such as news, charts, free real time quotes, market updates, research reports, e-mail alerts and computerized investment tools. Firms had to distinguish themselves, either with the lowest fees, best customer service, easy to use Web sites, access to foreign markets and IPOs, extra "kid glove" services to active traders, or premium or proprietary research.

But I remember the day the rubber met the road. Ten years after the "Black Monday" crash of October 1987, the Dow Industrials dropped over 600 points on what became known as "Blue Monday" of October 1997. For the first time, the so-called "circuit breakers" kicked in and halted trading on the New York Stock Exchange.

That was bad enough. But the next day was worse for online brokers, when markets bounced off of that sharp drop and everyone wanted to jump in and catch that bounce. The New York Stock Exchange traded one billion shares for the first time ever. Brokerage firms were inundated, trying to handle four times their average daily volume, and they couldn't. Web servers, touch-tone systems and telephones were all bogged down. It was more than anyone had expected. While one executive at an online brokerage was quoted as asking "if they are expected to prepare for the 100-year flood". It soon became apparent that this was not the 100-year flood, this kind of volume was going to become commonplace. Internet trading had arrived, and it brought a lot of friends.

Many accused the online firms of spending more on advertising than they did on their systems. And they were right, they did. Honestly, they were more interested in getting clients than in being able to service them. And I'll tell you why. There are over 100 online trading firms, but the top 15 have over 90% of the market share. In the gold rush days it was either grow or die, and do whatever it took to get clients or end up as an also-ran.

But after Blue Monday, the writing was on the wall, and the Internet brokerages got the message. They spent millions on infrastructure, networks, computers and people. While no system is ever immune from crashing, they are more stable and better able to handle the demand than ever. Today, Blue Monday's volume is just another day at the office.

## **The Big Task Ahead of You**

How are you going to choose from the 100 plus financial services companies that offer Internet-based investing? You can choose from among discount brokerages, deep-discount brokerages, full-service firms, banks and mutual fund companies.

There are “online only” firms like Wall Street Electronica who conduct business solely through the Internet and phone. There are “click and mortar” firms like Schwab and Scottrade who offer both Internet trading and have a network of branch offices across the country. Some of the “online only” firms are building read-world presence; E\*Trade and Ameritrade are also opening branch offices.

The bigger online brokerages, like Schwab, Fidelity and E\*Trade, need to be everything to everybody (at least as much as is possible). Some of the smaller firms distinguish themselves by being specialists. OptionsXpress, for example, markets itself as an options specialist. Some will focus on catering to rapid-fire day traders. Some will brand themselves as cheap, some as fast, some as reliable, some as having fine customer service, some as having the best research available. Some are established and some are new. All of them are trying to compete for your business.

On the other hand, your choice has become a bit easier because the bear market of 2000 to 2002 has claimed its share of victims. Suretrade has merged with its parent company, and National Discount sold out to Ameritrade.

Your job now, is to find an online broker that best meets your needs. Give it the same consideration you would give to choosing a new business partner. You have a lot of choices, and that sometimes makes it hard to make a choice, but I’ll have a few ideas and a few tools to help you along.

### ***Step One: It’s All About You***

You’ll find plenty of opinions about who are the best/worst online brokerage firms, but only one person’s opinion actually counts, and that’s yours. The way you start is by taking inventory and asking yourself what you really want to do, what you have to work with, and what do you want to get out of investing online. There’s lots of ways you can do it. Ask yourself:

- Do you intend to buy and hold, and build capital appreciation, while saving some money on the trades? Or do you intend to trade frequently, locking in small profits, holding positions for only weeks, days or even hours? Will you do some of each?
- Are you looking for one place to consolidate all your financial activity? Would you rather work with a firm that specializes in online trading?
- Will you want to be able to buy a stock then send the money later, or will you be content to have the money in the account when you place the trade?
- How important to you is access to customer service? Will you want 24/7 support, or is Monday to Friday market hours good enough? Would it be beneficial to you to have a branch office nearby? If you travel, will you prefer a firm with branches nationwide?
- How much money do you have to start with? Can you meet the minimum opening balance? If you need to start small, that will limit your choices. Some firms charge a maintenance fee for low-balance and low-activity accounts.

- On the other hand, if you've got a relatively high net worth or you trade frequently, some firms provide premium services to very active traders and high net worth investors.
- How much do you value stability and history? Would you rather go with a long established firm, or would you be willing to go with a relatively unknown and fairly new company?
- Will you use your own financial software, such as Quicken or Microsoft Money? Will your online broker support easy downloads to those programs?
- Would you also like to have multiple means of access? I don't just mean using the Internet from a PC. What about trading with a live broker, by touch-tone phone system, by wireless devices such as a PDA, or by fax? Some firms offer a trading software platform, which may have advantages over Web-based trading.

These are a few of the things to think about while selecting a broker. I'll have a list of questions you may consider asking a brokerage firm before you sign up with them. There are also several sources of expert opinion and some objective ways to measure an online brokerage's performance.

### ***And the Winner Is: Using "Best Of" Lists***

Whenever there's a difficult choice to make, there is someone who makes a living to help you make an informed choice. There are a number of consumer, financial and computer publications that regularly review online brokerage firms and offer their considered opinion as to which is best and which is not. I follow nine or ten of them.

Unfortunately that doesn't always make the choice easier. I have no problem finding well-considered opinions, but I can't find much in the way of consensus. One reviewer rates a firm as top-notch, but another puts that firm in the middle of the pack. Reviewers all analyze the same firms, study the same fee schedules and learn of each firm's policies and products, yet they come up with distinctly different opinions. Why is that?

The difference, of course, is in the methodology used to collect and interpret the data. Each reviewer puts his or her own weighting on each criterion under review. Everyone agrees that cost, speed, service, quality executions and range of products are important, but just how important each one is relative to the whole is rather subjective. For example, all reviewers rate commissions, and agree that cheaper is generally better. However, most reviewers give a rather low priority to commissions and fees, so it's a relatively small part of the overall equation. That doesn't mean fees aren't important, just that reviewers generally feel that other aspects are more important.

Of course if you're just out for the cheapest trade possible, then expert reviews may not be all that useful to you, simply because you put a greater emphasis on costs than they do. If you are just looking for the cheapest trade, I would suggest that you could use an expert review to help you sort through other criteria. Among those offering the lowest fees, you might want to see which ones are rated best for speed and execution quality – because a slow response or poor execution can cost you far more than the difference in commission.

The people who create these lists have to meet the needs of the broadest possible range of their readership. That doesn't necessarily mean that what they think is best overall is best for you. I met a reviewer for a major financial publication, and he uses a brokerage that didn't make it to his own "best of" list. Why? The firm he uses meets his individual needs just fine, and he didn't need the services of the others, even though he rated them as excellent. He said, "if you are happy with the company you work with, there is no need to change".

So don't be concerned if your brokerage firm got a bad review, as long as you're satisfied. This industry changes quickly, and so do the "best of" lists. The firm that got low marks for having a cluttered and confusing Web site gets a makeover. The one that scored high praise for a fast and responsive network now finds itself overloaded. Another that got low marks for speed six months ago invested in new hardware and doubled its capacity. And that is the magic of the marketplace.

If you change brokers every time the "top ten" list changes, you'll spend more time moving your money than investing it.

### ***What to Look For***

A "best of" list can help guide you, but you ultimately must decide for yourself. Again, only your opinion matters, and here are some of my tips for helping you create an informed opinion. Of course these tips are just my opinions, so take them for what they are. Quick note: a brokerage firm is also called a "broker-dealer", so I'll use that term also. I'll use the word "broker" to mean a person who works for a broker-dealer.

#### **Bright Blue Sky**

This is unlikely to be a problem, but you do have to know if the broker-dealer is licensed to do business in your state of residence. If not, scratch it off your list, you cannot open an account with that firm. Every state has "blue-sky" laws designed to protect the people who live in that state from securities fraud (and end up being sold "nothing but blue sky"). Every broker-dealer must be registered and licensed to do business in a state before it can solicit, invest for or take money from any resident of that state. To get licensed, a broker-dealer has to pay the state some hefty annual licensing fees. Most online brokerages are "blue-skied" in all 50 states, but a handful aren't.

#### **The Company You Keep**

Is the broker-dealer a member of the National Association of Securities Dealers (NASD) or of the New York Stock Exchange (NYSE)? NASD membership is pretty much essential. NYSE membership is highly desirable, like the Good Housekeeping Seal of Approval. In my research, I've not come across a broker-dealer that was not an NASD member, but not all are NYSE members.



## Insurable Interest

Just like banks have FDIC insurance against failure, the securities industry has an insurance program called the Security Investor Protection Corporation (SIPC). SIPC member firms pay into an insurance pool to safeguard investors against failure and insolvency of a broker-dealer. That way, if the firm goes bankrupt, your investments don't go down along with it. SIPC protection will insure each customer up to \$500,000 and up to \$100,000 of that claim can be cash. Money market funds are not cash, so they're not affected by the \$100,000 limit.

Many firms also carry private insurance above the SIPC coverage. Insurance carriers like Aetna may offer \$1 million to \$10 million worth of protection per account. Sure, most of us won't need that kind of coverage, but it's nice to know it's there.

How likely is a broker-dealer to fail and go bankrupt? Good question. Fortunately, failure rates have been very low. A struggling firm is far more likely to merge or get bought out by a larger and more stable firm. Online brokerages have to spend a lot of money to acquire new clients, so it's cheaper to buy an existing firm and all its clients than to get new ones.

But nothing's impossible, and if it comes down to it, the SIPC will oversee the process of making the firm's clients whole again. Wherever possible, the SIPC will convert shares held with your brokerage firm (in "street name") will be converted to paper certificates and mailed to you. Otherwise, the SIPC appoints a custodial firm and transfers your assets there. You may elect to stay with that broker or transfer them to another. Most investors are made whole in one to three months.

## Take it For a Test Drive

Most of the online brokerages have demos on their sites, but some give you a better idea about what they're really like than others. While you are investigating brokerages, start by going to their home page, and look for a link marked "demo" or something like that. Spend some time here, it's worth the effort. Even if you'd have very little experience with online investing, by the time you've looked at about four to six of them, you will probably develop a sense for what you like and what you don't like. It's all a matter of personal preferences of course, but you may want to keep a few questions in mind while you are exploring some demo sites:

- Maximize your browser's viewing area so it fills the screen. Windows users click on the *maximize* button on the right side of the title bar (looks like a square within a square). You may have to select from or be able to see several items of information almost at the same time, and you'll want to avoid up and down (or even worse – side to side) scrolling wherever possible.
- Are the navigation links easy to find, and are they clearly marked? You'd like to be able to move from your account balances to news to trading quickly and easily. Can you find what you're looking for without too much difficulty? Do you find the references intuitive? Things should be easy to find. The fictional site seen in Chapter 3 uses frames to navigate to different areas. When you click on a link in the left-hand navigation frame and the appropriate Web page will be displayed in the right-hand frame. Harris Direct

uses navigational tabs across the top of the viewing area. The site is organized by topic, each topic gets its own tab. When you click on a navigation tab, Harris provides you with a list of choices under that topic. In this picture, the Trading tab was selected first, and then the “Mutual Funds” tab was clicked which brings up the mutual funds order entry screen.



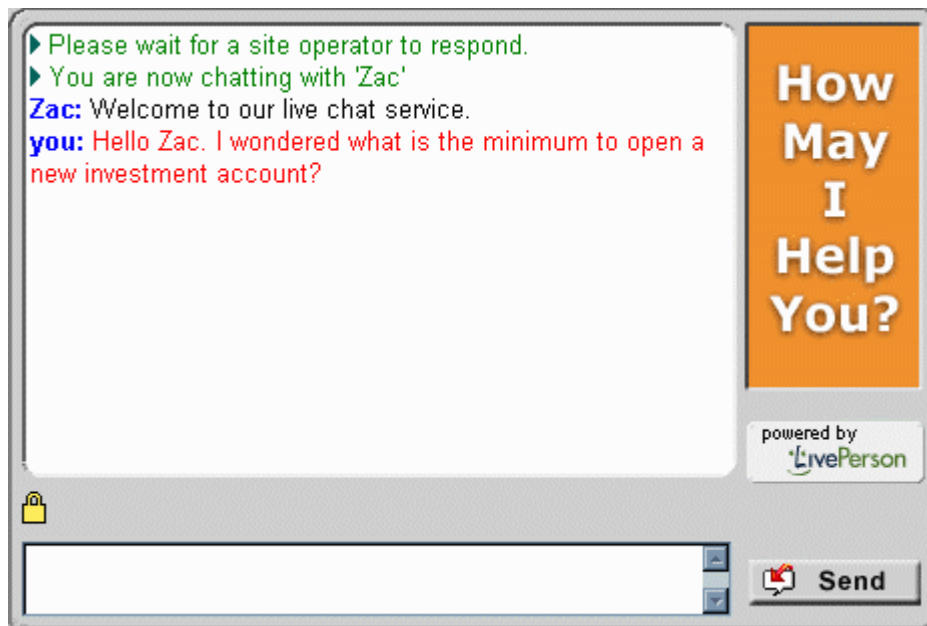
- True, a demo is just a contrived example of a fictional account, but ask yourself if what you see makes sense to you. We'll talk about things like balances and portfolio screens in upcoming chapters, but when you explore a few sites you'll see how different the sites, layouts, and information can be. The same information can be displayed in a number of different ways. None are really “right” or “wrong”, it's a matter of which Web site is the easiest for you to understand and use.

### Customer Service

Online investing is largely self-service, and I wrote this book to help you become more independent, but from time to time you will need help of a broker and customer service representative. Some firms have phone lines open round-the-clock and never close. Some will be available only during market hours and will be closed nights and weekends. How important will access hours be to you? Some people can only tend to their personal finances on nights and weekends, so a Monday to Friday firm may not be much help to them. The deeper discount firms tend to keep shorter hours (with notable exceptions like Ameritrade), so you may have to trade off between price and service hours.

Of course you won't do all of your business over the phone. When you trade online, you will often use e-mail reach customer service. Try to find out your firm's stated e-mail turnaround policy. 24 to 48 hours for a personalized response is pretty standard. Some firms have an auto-reply system, so when you send them an e-mail, their computer sends you an e-mail to tell you it was received and someone will reply within the usual time. A few firms have added artificial intelligence to their e-mail system, so the computer tries to “read” your email with certain key words. Then it sends you a reply based on what the program thinks is the most likely answer to your question. Of course that doesn't always work, but sometimes it does and you'll certainly get a faster (if less accurate) answer.

You might also be able to use an instant messenger system with a broker, too. There is a program called Live Person, and it lets you type messages to a representative in real time, and the representative will type in an answer. You type a question, he or she types an answer, and you can “chat” back and forth. This is a good alternative to look for if you only have one phone line.



**Techies:** Ask if they have a separate technical support department. Some of the people who work at your online brokerage firm will be trained as technical support and some will be trained as brokers, and some can do both. But not everybody can be good at everything. All else being equal, I'd give the nod to a firm with a separate technical support division to help you with your computer needs.

**Parlez vous?** If English is not your first language, a broker with multi-lingual capabilities might be what you need. Some firms, like Schwab, have Web sites written in – and representatives who speak – Spanish, Mandarin, Cantonese and Korean. E\*Trade has Web sites in Chinese and German.



### Branching in All Directions

The original concept of online investing was that the broker would have little to no real-world “brick and mortar” presence. You’d work with them electronically, computers would do most of the work and you’d never have to step into an office. Because of their low overhead, you’d get really cheap commissions.

Shortly thereafter, established discount brokers with brick and mortar offices also offered a “best of both worlds” service, both online and off. More recently, the traditional full-service (and full-commission) brokers now offer an Internet alternative, along with their research and expertise.

Why might you be interested in an online brokerage with branch offices? It is a very convenient place to pick up and drop off a check or forms. People have told me that they are more comfortable knowing that there is someone they can go see and talk to (and yell at if necessary).

## Getting Down to Business: Opening the Account

Once you've selected an online brokerage to work with, you get started by opening an account with that firm. Although I once got a call from a man who wanted to buy some stock for the first time, but he didn't want to open an account – he just wanted to buy stock. I told him we can help him, but to become a client of our firm it takes opening an account and he buys and sells stock through his account. He said, “Why should I? I don't open an account to buy hamburgers!” and hung up.

He should stick to buying hamburgers. I might have explained that if each and every hamburger that came off a grill had to be registered with state and federal hamburger authorities, that every hamburger restaurant had to keep very precise records as to who bought what hamburger, when and at what price, whether you held the pickles or held the lettuce, etc., and had to report your hamburger activity to the IRS, then yes one would have to open an account to buy hamburgers.

All financial transactions require you to open an account, even if you do not hold your assets at a brokerage firm. But there are many different types of accounts, for different people and different purposes. Here are the various account types.

### ***Investment Accounts***

**An account owned by one person:** is called an *individual account*. Like the name implies, one person is the sole owner of the assets in this account.

**An account owned by more than one person:** is called a *joint account* because the assets are owned jointly. Each person who has an ownership interest in the account is called a *tenant*. One tenant can buy and sell, and make deposits or withdrawals, without the consent of the other. Here are some ways of handling joint ownership; you'll have to specify which one you want on the new account form.

- **Joint Tenants with Rights of Survivorship** is an account type that means the two (or more) people who own this account have (almost always) equal ownership in the assets, and when one of them dies the other gets the decedent's interest automatically. This is usually used between a husband and wife.
- **Tenants in Common** means each person owns a certain percentage of the assets (it's equal unless otherwise specified), and when one person on the account dies, his or her interest goes to the estate, to be settled according to will.
- **Community Property** only applies to married couples of community property states (Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington and Wisconsin) where each tenant has an undivided 50% interest in all assets acquired during marriage, except for gifts and inheritances. When one spouse dies, half the assets transfer to the estate.

**Custodial accounts** are set up for minor children under the Uniform Gift to Minors Act (UGMA) or the Uniform Transfer to Minors Act (UTMA). Since one has to be of legal age to make investments (old enough to enter into a contract), assets are held in a custodial account where one adult (the custodian) invests and acts on behalf of one minor. Any assets deposited to or invested within a custodial account are permanently and irrevocably the minor's property. Taxes are reported under the minor's social security number, and are taxed at the minor's rate. Children under age 14 can earn up to \$1,400 of investment income tax free, and any amount over that is taxed at the parent's rate. After age 14 years, all income is taxed at the minor's rate. Only one adult can serve as the custodian. Once the minor is of legal age (varies from state to state) the account can be converted to a regular individual investment account.

**Trust accounts** hold the assets that have been set up for a legally created trust. A trust is a separate legal entity, almost like a person or a business. A trust is created for assets or property given by one person (a trustor) for the benefit of another person (a beneficiary), to be managed and watched over by a third person (a trustee) who has the responsibility to follow the trustor's wishes. Those assets have to be held somewhere, and if they are to be invested in stocks, bonds or mutual funds, then they will be held in a trust account.

**Partnership and corporate accounts** are for established businesses and companies. There is usually a little more paperwork involved, especially when it comes to determining who gets to act on behalf of the partnership or corporation. Investment clubs are technically partnerships, but many firms have a separate investment club account application.

## **Retirement Accounts**

Investment accounts, like those mentioned above, have no special tax benefit. Your brokerage sends you and the IRS a 1099 form every year for your earned interest, dividends and capital gains. Retirement accounts, though, have some very significant tax benefits, which I'll explain. The only catch is you can't touch the money without suffering a penalty until you are of retirement age (59 ½).

**Individual Retirement Accounts (IRAs)** allow you to deposit up to \$4,000 a year. Anyone with earned income (wages, salaries, etc.) can deposit money to an IRA. If you are not covered by any employer-sponsored retirement plan (like a 401k), your contribution is tax deductible. If you do have an employer-sponsored plan, your IRA contribution may be fully, partly, or non-deductible depending on your income. In all cases you get tax-deferred growth. You can invest your contributions in things like stocks, bonds and mutual funds, and let the money grow tax deferred, so you don't have to pay taxes on the earnings until after you take the money out, some time after age 59 ½. You don't pay capital gains taxes on your trades in your IRA (but you can't write off your losses, either). IRA distributions, assuming you take them after age 59 ½, are taxed as ordinary income.

Only one person can be the owner of an IRA account. The "I" stands for "individual", and there is no such thing as a joint IRA. There is such a thing as a *spousal IRA*, where a

working spouse can make retirement contributions for a non-working spouse. They can contribute up to \$8,000 a year between them, but no one can contribute more than \$4,000 to a single account per year.

You can open and fund an IRA as late as April 15 and still get your deduction for the previous year.

**Roth IRA accounts** were created by the 1997 Taxpayer Relief Act. They allow you to put up to \$4,000 into a retirement account a year, but you cannot deduct it from your taxes. However, instead of paying taxes on the growth later, the Roth IRA lets you withdraw what you've put in *plus* what you've earned *tax free*. This is sometimes called a back-end IRA because the real tax benefits come later. A regular or "traditional" IRA gives you a deduction now and you pay tax later, while a Roth IRA gives you no deduction now but gives you a tax break later. However, the amount you can contribute to a Roth IRA is reduced if your gross income is over \$95,000 (\$150,000 if married filing jointly) and eliminated if you make more than \$110,000 (\$160,000 if married filing jointly).

**SEP, SARSEP, SIMPLE and Keogh** accounts are retirement plans set up for self-employed people or as a retirement plan for employees of small companies. Like a traditional IRA, they provide a current tax deduction, and offer tax deferred growth until withdrawn from the account. No new SARSEP plans can be implemented; they have been replaced by SIMPLE plans.

### ***Opening the Account***

We're ready to get this show started. Once you've selected the type of account you need the first step in establishing your investment or retirement account is to fill out the *new account application*. In the Internet era, "paperwork" may not actually involve a piece of paper. Some firms will require your signature on a piece of paper, while others will accept your application by phone or by filling out a form on their Web site with your name, address, social security number, etc. Some may allow you to fill out the online form, then mail you the paperwork all filled in for your signature.

Some firms will allow you to open a cash investment account or an IRA or Roth IRA online or over the phone. However, if you want to open an account with a margin trading feature, you will have to sign on the dotted line. Margin accounts have their own rules, and you'll have to sign a margin account application saying that you've read and understand the rules and specifically want to open a margin account.

**Minimum Requirement:** Just like the sign at the amusement park that says you have to be this tall to ride the roller coaster, you may have to fund the account with a minimum deposit in order to trade with this firm. Ameritrade, for example, requires a \$2,000 minimum deposit. Schwab requires \$5,000 and Brown & Co. requires \$15,000. However, other firms like Harris Direct require no minimum deposit.

**Fund the Account:** This part is pretty simple. Brokerage firms are quite accommodating when it comes to taking money. You can deposit a check, money order or cashier's check. You will not be able to fund the account with cash, either by mail or in person. That's just asking for trouble. Sorry, you will not be able to fund the account by credit card, either. There are certain specific rules that govern borrowing funds to make investments, and running a credit card is one way of borrowing money. Yes, I know we could all build up our frequent flyer miles, but alas no.

While all brokerage firms will accept a personal check, they may require that the check clears (typically within five business days) before you can invest the money, especially in high-risk securities like penny stocks or options. Money orders and cashiers checks are cleared on deposit. You can also fund the account with a wire transfer from your bank. Wire transfers usually cost a few dollars, but they're bank guaranteed so they are also considered cleared on deposit.

**Depositing Stock Certificates.** If you hold a paper stock certificate, you can deposit the stock instead of, or in addition to, cash in order to fund the account. To deposit a stock certificate, you have to endorse it on the back, much like you'd sign over a check.

If you have a certificate, flip it over on its back. There's a paragraph that starts with the words "For value received..." Jump down a few lines and a sentence says "I hereby irrevocably constitute and appoint \_\_\_\_\_ attorney". Write the formal name of your broker/dealer in the blank line. At the bottom of the paragraph, you must sign your name exactly the way your name appears on the front. So if it's first name, middle initial, last name on the front, then it must be first name, middle initial, last name on the back. If your name is spelled wrong on the front, spell it wrong on the back. Do not write the date.

**Transferring Accounts.** When people get tired of paying a broker high fees to mishandle their money, and decided that they'd rather mishandle it themselves. They decide to transfer their account to a new brokerage firm.

To transfer accounts, go to the firm you will transfer assets to and fill out one of their account transfer forms. Return it along with a photocopy of your last statement of the account you want to transfer.

The Depository Trust Corporation oversees the transfer of investments from one brokerage firm to another. If you do a full account transfer, that is all the assets of one account move to a different firm, the firms' transfer departments will use an electronic system called Automated Customer Account Transfer (ACAT). ACAT transfers take seven business days to complete, starting from the time the brokerage receiving the transfer form acknowledges the transfer.

**Power of Attorney:** Let me clear this up...adding a power of attorney to you account does not mean hiring a lawyer. Sometimes I just say the word "attorney" and people just jump. Power of attorney means giving someone else authority to act on your behalf. Someone with

a power of attorney can do things for you like call your broker, get account information, or place a trade. A stockbroker is only allowed to give specific account information to either the account owner, or to someone to whom the owner has granted power of attorney. Very commonly, a husband and wife grant each other power of attorney of their IRAs. Like most things, the account owner fills out a form to grant someone else power of attorney.

There are two levels of authority. *Limited Power of Attorney* lets the person who is granted the power the ability to get account information and place trades on behalf of the account owner. *Full Power of Attorney* allows the grantee to withdraw money from the account as well, and is usually granted because the account owner is incapacitated in some way. A full power is more restrictive and harder to get than a limited power, so ask your brokerage's firm reps what it takes to get one, or if you really need one.

### **Breadth of Products:**

When we think of online trading we think of buying and selling stocks. But there's a whole lot more to the financial world than stocks, and there could very well be something in it for you. Bonds, mutual funds, options, limited partnerships, commodities and futures are financial instruments that you can invest in, each have their own characteristics, risks and opportunities.

It all depends what you want to do, of course. Plenty of people are only interested in trading shares of stock. That's fine. Some people may want to consolidate all their financial activity under one roof, even under one account. Anyone interested in options trading and complex strategies will want to use a brokerage that can accommodate their needs. If you want the broadest array of financial products, or think you might use them one day, you'll look for an online brokerage that offers as much as possible.

Here's a list of some of the products offered by many online firms, along with some questions you might ask of a prospective brokerage. Don't worry if you're not sure what these things are. I'll cover them in later chapters.

**Stocks:** Represent equity ownership in a company. When you own a share of stock, you own a piece (maybe one hundred-millionth) of the company. That's why stocks and things that impart ownership are called *equity securities*. All the online brokerages handle stocks, of course, or they'd be pretty much useless.

- Find out if they offer dividend reinvestment programs. This allows you take the dividend that you'd normally get in cash and use it to buy additional fractional shares of stock. Now, fractional shares don't really exist, they're just a bookkeeping entry. Still, half of a \$50 stock is worth \$25, and if you liquidate your position you will get cash for the fraction of a share. See if there is a fee for this service (it might be something like 5%).
- Not all stocks are the same. There are certain stocks that trade in a market called the *Bulletin Board* or the *Pink Sheets*. Again, I'll cover these in more detail in Chapter 11, but these markets are for thinly traded stocks that don't qualify to be listed on a major



exchange. Not all brokers will trade these stocks, and some won't do it online and want you to phone the orders in.

- The world is your oyster, and you may also find opportunities in foreign markets. For those brokerages that offer access to foreign stocks, inquire whether they trade on the foreign exchanges directly, or do so through a market maker. A market maker may take a cut for his trouble and you may not get as favorable an execution.

**Bonds:** Bonds are debt instruments issued by a corporation or a government, which means that's how they borrow money. A bond is an IOU. Online bond trading has just started to reach its potential, especially because more investors sought the relative safety of bonds during the bear market of 2000-2002. Not all firms that offer bond investments offer online bond trading, so you may have to phone orders in to a broker. Some corporate bonds can be converted into common stock, and are called *convertible bonds* or *convertible debentures*.

**Options:** Briefly, exchange listed options are tradable rights to buy or sell a stock at a certain price within a certain time. It's a little more complicated than that, of course, but if you use options strategies, here are some things to keep in mind:

- You need to open an options account to go with your brokerage account, and that means filling out a form. Options offer many strategies with levels of risk ranging from quite conservative to extremely risky. On your application, you will indicate what options strategies you intend to use. Select the strategy with the largest level of risk and complexity you are likely to implement. The risk department at your online brokerage will review your application to see if you have the knowledge, experience and the means to withstand riskier strategies based on their own criteria. If you do not meet their requirements, they will not grant you the risk level of options strategies you're looking for, and may only grant you a lower risk level.
- If you use options strategies, naturally you'll look for a firm that handles options trades. If you intend to use complex options orders (where you enter an order to buy/sell stocks and options at the same time, or to buy/sell two or more options at the same time), then naturally you might prefer to use a broker that supports them online. This is not a concern, obviously, if you don't use options strategies at all.

**Mutual Funds:** You pool your money with a bunch of other investors to have it professionally managed by someone who will invest all that money into stocks and bonds, depending on the fund manager's stated objectives and methods. There are now more mutual funds than there are stocks listed on the New York Stock Exchange.

- Many online brokerage firms are mutual fund supermarkets, offering hundreds of funds from many fund families. This gives you the convenience of consolidating all your investments under a single account number, with a single monthly statement and a single 1099 form at the end of the year. You could transfer your mutual fund shares to a brokerage firm, if that firm has an arrangement with the fund managers.
- Many of these mutual fund supermarkets let you buy and sell third party mutual funds without paying a transaction fee. The brokerage firm gets a small piece of the management fee instead. To prevent people from churning mutual funds (which is

detrimental to that fund's buy and hold investors) many firms impose a transaction fee if you sell within a short period of time, perhaps three to six months.

### **Account and Trading Practices**

Every firm has its own policies, and if you are seriously looking at doing business with them, you'll need to know their policies ahead of time. Don't make assumptions. Find the answers by going to their Web sites and asking customer service reps. Here are some suggested questions.

- How are uninvested funds handled? Here you're asking how your cash balances are put to work for you. Will it earn interest, or will the money be swept into a money market fund? A money market fund is a special type of mutual fund that invests only in things like short-term bonds and CDs, and is managed to maintain \$1 a share. They work like cash, and are called *cash equivalents*. You may need a minimum deposit to open a money fund feature (perhaps \$1,000) and keep a certain minimum to maintain it (maybe \$100), otherwise your deposits don't earn anything. Also find out how often they sweep cash into the money fund, whether daily or weekly (more often is better). If you have a fairly large deposit that you don't plan to invest at the moment, ask if they offer a higher-yielding money fund with a high minimum. Do they offer government, treasury or tax exempt money funds? How do their rates compare? Deep discount online brokers charge low commissions but may offer lower money market yields.
- Does your brokerage have a cash-up-front requirement on new orders? If so, that means you will have to have the money in the account at the time of the order, or else they will not allow the trade to go through. Even though the Federal Reserve allows you to pay for your stocks up to three business days after you buy them (known as T+3, where T stands for Trade Date), your broker is allowed to insist that you have the money on deposit ahead of time. If your online broker requires cash up front, there are a few considerations you will have to understand...
  - When you place a new buy order, you must have sufficient cash or margin cash available to cover the minimum required deposit (see the chapter on margin trading). If there is not enough funds to cover the purchase, the firm will reject and cancel the order.
  - There has to be enough money or cash available to cover all your new open buy orders as they come in. Each new buy order will be evaluated as to whether there is enough money to cover the new order *and* all existing open buy orders. So if you send three buy orders, and there is enough money to cover the first two but not all three, the third order will be rejected. Someone called me on this once; his order was rejected because he had forgotten he had an open buy order in the pending queue.
  - It's called a "cash-up-front" requirement on buy order, but it is also a "shares-up-front" requirement on your sell orders. You must have the shares on deposit in your account before your brokerage will accept a sell order. Without that restriction, you would be able to sell the shares and then deliver the stock certificate within three business days.

- Why do some firms have this restriction? Usually the deep discount firms have a cash-up-front requirement, because they have to work on very slim profit margins. It's inefficient and expensive to chase after people who are late on making deposits.
- Does a broker review orders before they are sent to the exchange? Here's the order review process in a nutshell, with the details varying from firm to firm. You place and submit a new order.
  - A computer reviews that order and that computer can be programmed to look for certain "red flags". If the order triggers a flag (such as selling something that's not in your account), then the order can be passed to a broker for review. He or she will check the order for accuracy and validity.
  - This can prevent you from selling something you don't have, a trap into which even your humble author has fallen, and something you don't want to fall into. It can also prevent you from overspending your account, or placing the wrong kind of order.
  - This review process may also mean a delay in the time it takes for an order to be queued, reviewed, then sent to the exchange. Stock markets move pretty fast sometimes, and an extra thirty seconds can mean hundreds of dollars. Very active traders can sometimes be very challenged, because it takes a broker more time to review a new order when there are a bunch of orders already filled or pending. Ask your online broker what is generally considered an acceptable review time. Please be aware that certain specific circumstances may lengthen an acceptable review time.
  - Some firms allow you to submit a new order that will bypass any manual review by a person. Yes, that will get your orders in faster – both the good ones and the bad ones. This does increase your power, but also increases your responsibility.
  - When markets heat up, orders start piling up. The computer that reviews new orders can be reprogrammed so that fewer circumstances throw up red flags. Otherwise it would take fifteen minutes or more to review orders. Bottom line, even if there is an order review process, not all orders will be reviewed. You are responsible for all orders received by your broker. You must not assume that all bad orders are going to be caught like a safety net. That means if you mismanage your account (say by spending more money than you have, or selling something you don't own) you are responsible for making your account right again.
- On what exchanges do they trade? Many stocks listed on the New York and American stock exchanges are *dually listed* on the Boston, Philadelphia, Chicago, Cincinnati, and the Pacific Stock Exchanges. Frequently, online brokerages route orders to the *regional stock exchanges*. This, in my opinion, is a good thing. More exchanges mean greater liquidity, more competition, and more rapid handling and better execution of your orders. I'll talk about the regional exchanges in Chapter 11.
- Does your broker accept stop orders on all securities? We'll discuss different types of orders in Chapter 10, but a stop order is usually used to sell your stock if it falls down to a certain price (sometimes called a stop loss order). Strictly speaking, the stock exchanges handle stop orders, but the over-the-counter markets do not. However, your brokerage or its affiliate market maker may still accept those orders. Not all will accept stop orders on Nasdaq or OTCBB stocks. Not all will accept stop orders on exchange listed stocks. You have to ask.
- Individual investors now have the ability to trade while the stock exchanges are closed. For many years, institutional investors were able to trade with outside standard market

hours (9:30 to 4:00, Eastern), sometimes taking advantage of news releases that came out after the close. Now, you and I have the ability to trade in *extended market hours* after the market is closed and before it opens. Computer systems called Electronic Communication Networks (or ECNs for short) match your buy and sell orders with someone else that placed orders in that system. Right now there are nine ECNs. Usually, your online brokerage will offer access to at least one of them, and some have access to more than one (it's a good thing if they do).

### **Margin Policies**

We'll go into the use of margin in Chapter 12, but for those of you who trade on margin, or think you may, you'll want to pay very close attention to your brokerage firm's margin policies.

Every brokerage firm must adhere to certain minimum requirements as to how much they can lend you against the value of your portfolio. However, a firm is allowed to implement policies that are stricter than the requirements mandated by Federal and stock exchange rules. The rules specify how much equity you have to have to start with, what percent of the value of your portfolio you can borrow, and how far your account can fall in value before you'll have to deposit more money or sell off shares.

For example, the Federal regulation says you must maintain \$2,000 in equity before you can borrow anything against it. Charles Schwab requires that you maintain at least \$5,000 equity. That means, if you want to buy \$3,000 in stock, the Feds say you have to put up \$2,000, but Schwab says you have to put up all \$3,000 (assuming you have no other assets in your account).

Ask a prospective brokerage firm what their minimum margin account maintenance policy is. Regulations say an account must maintain 25% equity, but it's very common for an individual firm to require a minimum of 30-35% equity. Many firms will not lend anything against stocks trading under \$5 a share, and many will limit the amount they will lend against what they consider highly volatile stocks.

Of course there is a matter how what kind of interest rate you'll pay if you borrow on margin. Margin interest rates are based on a figure published in the Wall Street Journal called the *broker call rate*, and each firm tacks a percentage onto that rate as to what they charge you. Of course that added percentage varies among firms, and the rate is often tiered so you pay a lower rate if you borrow more money.

### **Trading and Account Fees**

Online trading has brought about super low commissions. One thing about such deep-discount trading fees, however, may mean that additional services that once were free may

now cost a little something extra. I don't care much for surprises, especially when they cost money, so again we want to be aware of any additional costs ahead of time.

First, there may be a different fee schedule for the type of security that you are trading. Stocks, bonds, mutual funds and options can all be traded online, but might not cost the same. Many options traders called me because they thought they'd pay the same rate for options trades as they would for stock trades. That was not the case, and my firm's published commission schedule showed different rates for stocks and for options.

You can place orders by different mechanisms, but there may be a different fee depending what channel you use. Ameritrade currently charges \$11 for orders placed on the Internet, \$15 placed by touch-tone phone, and \$25 for broker-assisted market orders. Also, the fee may be different based on the type of order. Ameritrade charges an extra \$5 for broker-assisted limit orders.

Some firms charge annual or quarterly account maintenance fees, but they will waive the fees if you keep a minimum balance or do a minimum amount of trading.

Ask if there are fees for certain extra services. There may be charges for more time or labor intensive services. Things like:

- Ordering out stock certificates
- Picking up checks from a branch office
- Real time quotes
- Mandatory or involuntary reorganizations.
- Holding non-standard assets, like limited partnerships
- Exit fees for transferring out your account

### ***Resources and High-End Services***

Research services should not be overlooked. I'd give higher marks to those firms that offer proprietary or premium third-party research to its customers with no extra fee. Also look for tax planning, retirement planning and asset allocation tools. Some of the low-cost firms, like Brown, don't really offer research, just links to sites like zachs.com (which is information you can get anyway).

Are you a high roller? See if you qualify for the high roller treatment. There's a saying in business that 20% of your customers are 80% of your business, and that's certainly true for the online brokerage industry. Many firms compete for the very active and wealthy investors by offering premium services. E\*Trade offers Power E\*Trade, Schwab offers Signature Services, and Harris Direct offers Select Client Services. You have to do a certain amount of trading or have a certain amount on deposit with the firm in order to qualify for high-end services.

Some of the perks include a special toll-free number to reach an investment specialist faster, free premium research, extra discounts or rebates on commissions, free level II quotes, and they might even buy you a computer. The premium perks are reserved for people who are the heavy hitters, not for wannabe's or people who say they are but aren't. So the guy who told me "I'd be more active if I had some incentive" is not going to get it. His incentive is his ability to profit by trading actively. The people who get the perks are the ones who have already stepped up. If you're a new client, the firm will ask for copies of your last statements to demonstrate how actively and consistently you've been trading.

**OFX:** Really want to save some time? Users of Quicken, MS Money or the Microsoft Investor Web site may want to consider using a broker that supports Open Financial Exchange, or OFX for short. OFX is a standard by which you can download your account activity directly into any one of these three programs. Quicken and Money are personal finance programs produced by Intuit and Microsoft, respectively. Microsoft Investor is a free online service that provides many of the same features. OFX allows you to securely download your account activity directly into your computer, and save you a lot of time over entering transactions manually. OFX uses dedicated SSL-enabled servers, so your account information is always encrypted.

All in all, no one brokerage firm can be all things to all people. Many people have accounts at several firms, each for their own reasons. I once read about a man who had an account with Schwab because he had over a million dollars with them and got very good executions on large positions. He also had an account with Ameritrade for its very low commissions, and he had an account with Datek when he wanted rapid-fire execution. I think it comes down to priorities. If you're clear about what you want in a brokerage firm, and what's most important to you, your decisions will be easier.

Comprehensive guide to investing with an online broker.

The Ultimate Guide to Online Investing: A Stockbroker  
Tells You Everything You Need to Know

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