



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

November 3, 2000

The Honorable John D. Dingell
Ranking Member
House Committee on Commerce
Room 2322, Rayburn House Office Building
Washington, DC 20515-6115

Dear Congressman Dingell:

In a letter dated June 8, 2000, you asked how the Securities and Exchange Commission is responding to the recommendations made by the General Accounting Office in its report On-line Trading: Better Investor Protection Needed on Brokers' Web Sites ("GAO Report"). As the GAO Report notes, on-line trading is a rapidly growing and evolving segment of the securities industry. The receptiveness of investors to on-line trading is transforming the relationship between broker-dealers and their customers.

It is important that regulators ensure that investor protection standards are maintained as the industry evolves. The GAO has made a number of thoughtful recommendations for achieving this goal, and I have asked my staff to respond to them in the attached memorandum.

If you have any questions, please contact me or Annette L. Nazareth, Director of the Division of Market Regulation, at 202-942-0090.

Sincerely,

A handwritten signature in black ink, appearing to read "ALV", written over the printed name "Arthur Levitt".

Arthur Levitt

Attachment

Similar letters sent to:
The Honorable Edward J. Markey
The Honorable Ron Klink
The Honorable Edolphus Towns

MEMORANDUM

TO: Chairman Levitt

FROM: Annette L. Nazareth *AN*
Director, Division of Market Regulation

DATE: November 2, 2000

RE: On-line Trading

This memorandum responds to the request made by Representatives Dingell, Klink, Markey, and Towns that the Securities and Exchange Commission ("SEC" or "Commission") provide a status report on the recommendations made by the General Accounting Office in its report On-line Trading: Better Investor Protection Needed on Brokers' Web Sites, May 9, 2000 ("GAO Report"). The GAO Report recommended that the SEC require broker-dealers with on-line trading systems to maintain consistent records on systems delays and outages and their related causes, and to disclose the potential for service disruptions on their web sites. The GAO Report also recommended that the SEC monitor these records to ensure that firms have adequate capacity to serve their customers. The GAO Report further recommended that the SEC ensure that broker-dealers with on-line trading systems include accurate and complete information on their web sites in the key investor protection areas of risk disclosure, margin requirements, privacy protections, and trade executions. Each of these recommendations is discussed below.

1. Maintaining records of systems disruptions and disclosing the potential for systems disruptions

The GAO recommended that the SEC "require broker-dealers with on-line trading systems to maintain consistent records on systems delays and outages and their related causes and to disclose the potential for service disruptions on their [w]eb sites." As the GAO noted, the SEC does not have a specific rule requiring broker-dealers to maintain records of systems disruptions or disclose the potential for systems disruptions.¹

¹ In Staff Legal Bulletin No. 8, SEC staff reiterated the Commission's position that it is a violation of the antifraud provisions of the federal securities laws for a broker-dealer to accept or execute any order for the purchase or sale of a security or to induce or attempt to induce such purchase or sale without adequate personnel and facilities to enable prompt execution and consummation of securities transactions. See Staff Legal Bulletin No. 8 (December 9, 1998), citing Securities Exchange Act Rel. No. 8363 (July 29, 1968). Also, in the first Automation Review Policy Statement, the Commission stated that "[w]hile this Policy Statement does not directly discuss the obligations of broker dealers . . . the Commission believes all should engage in systems testing, and this Policy Statement should be used as a guideline." Securities Exchange Act Rel. No. 27445 (November 16, 1989).

As you are aware, we have been working toward implementing operational capability standards for all broker-dealers for some time. In March 1999, the Commission proposed for comment a rule requiring broker-dealers to have sufficient operational capability to assure prompt and accurate order entry, execution, and clearance and settlement of securities transactions as a condition to conducting a securities business.² In response to nearly unanimous comment that the proposed rule was overly vague and unnecessary, however, the Commission deferred the proposal pending further consideration until after the Year 2000 transition.

Currently, the staff in both the Division of Market Regulation and the Office of Compliance Inspections and Examinations ("OCIE") have been monitoring developments in the on-line brokerage industry with a view toward recommending that the Commission adopt a more narrowly tailored approach than that originally proposed. In particular, the Division of Market Regulation acknowledges the need for baseline standards in this area and is currently evaluating the form that any recordkeeping and disclosure requirements should take.

As the GAO acknowledged, any approach the Commission ultimately decides to take should not be targeted exclusively at on-line broker-dealers and must take into consideration the nature of the brokerage industry as a whole.³ As technology continues to redefine the nature of the brokerage business, it becomes increasingly clear that outages and systems delays pose problems for investors wherever they may originate. For example, the failure of back office technology will affect both investors that typically trade through the web site as well as investors that trade through a registered representative. Of course, business incentives will typically cause broker-dealers to develop adequate systems and capacity; but as new technologies for investor trading are embraced by the industry, some firms may underinvest in systems technology to lower costs. With this in mind, we anticipate making specific recommendations early next year.

2. Monitoring system disruption records

The GAO also recommended that the SEC monitor the system disruption records of on-line broker-dealers to ensure that firms have adequate capacity to serve their customers. Broker-dealers are currently required to have adequate capacity to serve their customers.⁴ OCIE recently requested information from some of the largest on-line broker-dealers in order to evaluate whether they are meeting this requirement. OCIE found that most firms retain at least some information about service disruptions even though not specifically required to do so. Although the quality of such information

² See Securities Exchange Act Rel. No. 41142 (March 5, 1999).

³ In a letter dated October 13, 2000 from the GAO to Representatives Dingell, Klink, Markey, and Towns regarding the GAO Report, the GAO stated that "although our report's recommendations are focused on the on-line trading industry, this does not preclude SEC from addressing these problems industrywide or from considering industry actions, such as implementing appropriate and effective best practices to resolve the problems."

⁴ See footnote 1, above.

varied among firms, most firms were making efforts to increase the amount of information retained regarding technological problems. Upon conclusion of OCIE's review, we will determine whether additional recordkeeping requirements would meaningfully enhance the Commission's examination and enforcement authority in this area.

3. Providing information on web sites regarding trading risks, margin requirements, privacy considerations, and trade executions

The GAO Report recommended that the SEC ensure that broker-dealers with on-line trading systems include accurate and complete information on their web sites in the key investor protection areas of risk disclosure, margin requirements, privacy protections, and trade executions. Currently, there are several initiatives in progress to address these issues with respect to on-line broker-dealers, as well as traditional broker-dealers.

a. Trading risks

To date, the SEC has not required on-line broker-dealers to post information regarding trading risks on their web sites. However, we have urged on-line broker-dealers to create links from their web sites to the SEC's investor education site that provides information about the risks of on-line trading; and when OCIE conducted a survey of the web sites of on-line broker-dealers, it found that many voluntarily linked to our investor education site. Accordingly, OCIE has developed a summary of findings and recommendations based on its examination of on-line firms that it expects to recommend to the Commission for publication shortly. This summary provides additional risk disclosures that broker-dealers should consider providing to customers, including disclosures regarding some common risks of trading.

With respect to the risks of after-hours trading, which may be conducted over the Internet or via traditional channels, on January 10, 2000, the National Association of Securities Dealers ("NASD") issued Notice to Members 00-07 to remind broker-dealers of their obligation to disclose the material risks of after-hours trading to retail customers before permitting them to engage in after-hours trading.⁵ The Notice was accompanied by a model disclosure statement.

b. Margin requirements

On September 5, 2000, the NASD filed with the SEC a rule proposal that would require NASD members to deliver to non-institutional customers a new margin disclosure statement.⁶ This proposal was prompted in part by the findings made in the GAO Report.

⁵ The NASD filed this Notice to Members with the Commission as a proposed rule change. See Securities Exchange Act Rel. No. 42363 (January 28, 2000), 65 FR 5715 (February 4, 2000).

⁶ See Securities Exchange Act Rel. No. 43441 (October 12, 2000).

Under the proposed rule, all broker-dealers would be required to deliver to their customers a disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin. The NASD has developed a sample margin disclosure statement that some firms already have begun to distribute to their customers. A broker-dealer would be permitted to develop its own disclosure statement, provided the alternative statement is substantially similar to the sample and incorporates all of the relevant concepts.

This statement would have to be delivered, in writing or electronically, to customers prior to or at the opening of a margin account. The proposed rule also would require broker-dealers to deliver the disclosure statement annually to all non-institutional customers with margin accounts.

The SEC published notice of the proposed rule change in the *Federal Register* on October 23, 2000. The comment period closes on November 13, 2000.

c. Privacy

With respect to privacy issues raised by the GAO, we note that the SEC recently adopted comprehensive privacy rules in the form of Regulation S-P. Pursuant to Section 504 of the Gramm-Leach-Bliley Act (GLBA), the Commission and other federal agencies adopted rules implementing notice requirements and restrictions on a financial institution's ability to disclose nonpublic personal information about consumers. Specifically, Regulation S-P requires investment advisers, brokers, dealers, and investment companies to provide customers with a notice of their privacy policies and practices. Annual updates of the privacy notice are also required. In addition, these parties may not disclose nonpublic personal information about a consumer to nonaffiliated third parties unless the consumer has been provided information regarding the proposed disclosure and has not elected to opt out of the disclosure.

Regulation S-P also requires these entities to adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. These policies and procedures must be reasonably designed to (a) ensure the security and confidentiality of customer records and information; (b) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (c) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer. OCIE's summary of findings and recommendations discusses possible methods of promoting the security and confidentiality of customer information.

Regulation S-P is effective November 13, 2000. The Commission and the other federal agencies that adopted privacy regulations pursuant to GLBA have agreed to begin enforcing Regulation S-P on July 1, 2001. In light of the adoption of Regulation S-P, the NASD withdrew its proposed rule addressing privacy of customer information.

d. Trade executions

The SEC has stressed on numerous occasions the importance of best execution. Most recently, in July 2000, the SEC proposed new Rule 11Ac1-6 that would require every broker-dealer to make publicly available each calendar quarter a report discussing and analyzing its order routing practices.⁷ That report would include, among other things, a discussion and analysis of the objectives the broker-dealer considered in determining where to route orders, the extent to which order executions achieved those objectives, a comparison of the quality of executions actually obtained with those produced by other venues for comparable orders during the relevant time period, and whether the broker-dealer has made or intends to make any material changes in its order routing practices in the succeeding quarter. To satisfy the public availability requirement, a broker-dealer must post the report on a free Internet web site and furnish a written copy on request and notify customers at least annually that a written copy will be furnished on request. The SEC stated in the proposing release that the purpose of requiring an Internet posting to satisfy the public availability requirement would be to assure ready access to the reports by interested parties, without placing an undue paperwork and cost burden on broker-dealers. The SEC has received over 40 comments on this proposal, which we are currently studying.

⁷ See Securities Exchange Act Rel. No. 43084 (July 28, 2000).