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United States General Accounting Office
Washington, DC 20548

April 27, 2001

The Honorable John D. Dingell
Committee on Energy and Commerce

The Honorable Edolphus Towns
Subcommittee on Commerce, Trade, and
Consumer Protection
Committee on Energy and Commerce

The Honorable Edward J. Markey
Subcommittee on Telecommunications and
the Internet
Committee on Energy and Commerce
House of Representatives

Subject: On-line Trading Follow-up work

This letter confirms our commitment to study key consumer protection issues in the area of on-line trading based on your November 13, 2000, letter to the Comptroller General. Based on discussions with your staff, we will complete our work and issue a written product to you by July 20, 2001. The enclosure sets forth the understanding reached with your staff on the key aspects of the study.

We look forward to working with you and your staff on this assignment. If you have questions, please contact me on (202) 512-9073 or my Assistant Director, Mathew Scire, on (202) 512-6794.

Richard J. Hillman
Director, Financial Markets
and Community Investment

Enclosure

Terms of the Work

Objectives/Key Questions

GAO's May 2000 report, On-line Trading: Better Investor Protection Information Needed on Brokers' Web Sites, concluded that consumers did not have access to information about several key areas of investor protection including margin risk, privacy considerations, trading risk, best execution of trades, and operational capabilities. In addition, it found that many firms did not—and were not required to record system outages and delays or disclose them to investors. As such, our report recommended that the SEC require broker-dealers with on-line trading systems (a) to maintain consistent records on system delays and outages and their related causes, (b) to disclose the potential for service disruptions on their sites and (c) to have adequate capacity to serve their customer. It also recommended that the SEC ensure that broker-dealers with on-line channels include accurate and complete information on their web sites in key investor protection areas of margin, privacy, trading risk and best execution of trades.

The overall objective of our work is to study the actions taken by the industry and its regulators in the areas of margin, privacy, trading risk, best execution and operational capability since GAO's May 2000 report. We intend to describe the extent to which these actions address the recommendations we made in our May report and are enforceable. In addition, we plan to update data describing the on-line trading industry, including data on market volume and complaints. The key questions in our assignment will focus on the following:

1. What actions in the form of rules, regulations, guidance and best practices have the SEC, SIA and the SROs taken to address GAO recommendations in the areas of margin, privacy, trading risk, best execution of trades and operational capabilities since our report was issued in May 2000?
2. To what extent are the actions taken by the industry and its regulators enforceable? That is, do these rules, regulations, guidance and best practices place requirements upon broker-dealers that are legally enforceable? Do the rules, regulations, guidance and best practices contain objective criteria against which compliance may be measured? Would SEC (also NASDR and NYSE, if possible) examination procedures allow examiners to identify instances where broker-dealers do not comply with/follow these rules, regulations, guidance and best practices?
3. Describe how the on-line trading market has changed since our earlier report, including changes in (a) on-line trading share of the market (b) the volume and nature of complaints and arbitration regarding on-line trading and (c) broker-dealer performance in the consumer protection areas described in our earlier report.

Scope

We will focus our analysis on the rules, regulations, guidance and best practices issued by the industry and its regulators, SEC, NYSE and NASDR based on recommendations made in GAO's May 2000 report. We intend to analyze these documents to determine whether actions they have taken address the substance and form of our recommendations and provide specific, measurable criteria that regulators can measure and enforce. In addition, we will also examine and report on both the trends in the market complaints and the change in on-line trading volume. We will rely on 1999-2000 complaints data from the SEC, NYSE and NASDR and 1999-2000 industry data on market volume and trends in the market volume of trades. We will supplement our information on conditions existing on broker-dealer web sites by using information in the SEC/OCIE Examinations of Broker-Dealer Offering On-line Trading: Summary of Findings and Recommendations report. We will also meet with a small number of broker-dealers and review a small number of broker-dealer web sites to gather additional data.

Methodology

To answer the first key question, we will review existing rules, regulations, guidance and best practices created since our May 2000 report. We will examine these documents for specific criteria and determine the extent to which we believe their actions address both the substance and form of the recommendations in our previous report. We will meet with regulators, the SEC, NYSE and NASDR and a small number of firms to discuss their perspectives on these newly issued rules, regulations, guidance and best practices. In the case where no action has been taken, we will describe reasons why there has been no action.

To answer the second question, we will conduct analysis on the newly created rules, regulations, guidance and best practices to determine the legal force behind them and the extent to which the regulators consider them in their examination procedures and modules. We will meet and discuss these issues with the regulators, the SEC, NASDR and NYSE to gain their perspectives and to understand how these issues will be considered in examinations and may be enforced.

To answer the third question, we will gather 1999-2000 data from the SEC, NYSE and NASDR on complaints made in the area of on-line trading. We will analyze those data to determine trends in the current volume and nature of complaints and to what extent those trends have changed over the 1999-2000 period (regulators did not begin to collect on-line trading complaints data until late 1998). We will meet with regulators to determine how complaints are made and categorized, determine what efforts the regulators make to deal with customer complaints and to the extent the data are available, describe the outcome of complaints, such

as arbitration or enforcement. In addition, we will gather 1999-2000 industry data on on-line trading market volume and analyze those trends for changes in the volume of on-line trading. We will use industry data on market volume and analyze the trends in the market volume of trades.

Product Type and Delivery Date

This assignment will result in a letter report that will be issued on July 20, 2001.

Reporting on Job Status

We will brief committee staff if requested, throughout the job.