THE CHAIRMAN

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

March 8, 1999

The Honorable John D. Dingell
Ranking Member
Committee on Commerce

The Honorable Edolphus Towns
Ranking Member
Finance and Hazardous Materials Subcommittee

The Honorable Ron Klink
Ranking Member
Oversight and Investigations
Subcommittee

The Honorable Edward J. Markey
Ranking Member
Telecommunications, Trade, and
Consumer Protection Subcommittee

Committee on Commerce
Room 2125, Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515-6115

Gentlemen:

I am writing in response to your letter of February 4, 1999, in which you ask a number of questions regarding on-line trading. The staff has prepared the enclosed response to your questions.

As you are aware, the Commission is aggressively monitoring the technological advances in the nation's securities markets. On-line trading provides investors with many benefits, including lower costs and faster access to the securities markets. While this new trading vehicle does not alter the risks associated with investing in the stock market, it has raised some new issues that need to be brought to the attention of investors. I also believe that our regulations, as well as our examination and enforcement programs, need to adapt to the changes in the way securities business is being conducted. While the use of technology in the securities markets is not new, we recognize that the widespread and growing use of on-line trading mechanisms requires us to reexamine our programs and priorities in light of the issues raised by on-line trading.

We look forward to working with you on these issues. If you or your staff have any additional questions, please call Robert Colby, Deputy Director, Division of Market Regulation, at 942-0094.

Sincerely,

Arthur Levitt

Responses to Questions Posed By
Congressmen Dingell, Klink, Towns and Markey
in Their Letter of February 4, 1999 Regarding On-Line Trading

Question 1: *How many on-line trading systems are in operation in this country? Please provide a list of them.*

The number of broker-dealers with on-line trading systems is expanding almost daily, as investor demand for electronic access grows. While registered broker-dealers are not currently required to report to the Commission whether or not they offer on-line trading to customers, our research indicates that about 114 firms offer on-line trading services. We have attached as Exhibit A a list of those broker-dealers currently offering their customers the ability to enter orders on-line, as well as broker-dealers that plan to make on-line trading available to their customers in the next few months. Because some web sites are difficult to access and because so many new firms are entering this market, this list is by definition incomplete.

We believe it is important to distinguish between firms that provide on-line brokerage and day trading firms. The February 4, 1999 letter from Congressmen Dingell, Klink, Towns and Markey recognizes this distinction. Accordingly, the list of firms attached as Exhibit A includes only those firms providing on-line brokerage services to their customers. It does not include what have become known as day trading firms. The differences between on-line brokers and day trading firms are discussed further in the response to Question 4.

Question 2: *What is the daily trading volume on each over a representative period that includes December 1998 and January 1999?*

We do not have daily trading volumes for each of the 114 firms listed in Exhibit A. The best information we have indicates that the top 8 on-line firms have approximately the following average number of trades per day originating on-line:

Average Trades Per Day[1]

Broker-Dealer	**January 1999**	**4th Quarter 1998**	**3rd Quarter 1998**
Schwab	153,000	93,000	76,635
E*trade	73,670	39,992	27,450
Waterhouse	58,444	42,000	26,500
Fidelity	55,991	31,900	24,190
Ameritrade	53,900	25,787	17,881
Datek	47,506	33,965	21,272
DLJ Direct	21,138	12,656	10,111
Discover	12,293	11,250	9,000

It has also been reported that in the fourth quarter of 1998 the average daily trading volume of all on-line broker-dealers was approximately 340,000 trades per day. This is a marked increase from the first quarter of 1997, during which the average trading volume was approximately 95,000 trades per day.[2]

Question 3: *Press reports indicate that many of them have been experiencing significant capacity and operational problems. What information can you provide us on these system failures? What are their causes? Are any the result of these systems deliberately shutting down? What are the rules on this? How have investors been harmed? What is being done to correct these problems? What disclosures do investors receive about system capacity and access? Are on-line trading systems overselling their capacity? We also have heard unconfirmed reports that some major ECNs also are experiencing capacity problems. What information can you provide us on this? If true, what is being done about it?*

Commission staff has reviewed a number of system delays and failures experienced by on-line broker-dealers in the past several years. For example, the Commission's Office of Compliance Inspections and Examinations ("OCIE") conducted a review of the

1 The source for the third quarter and fourth quarter 1998 average daily trading numbers is Credit Suisse First Boston Corporation. The January 1999 information is based on SEC staff inquiries at each of these firms.

2 Source: Credit Suisse First Boston Corporation.

problems experienced by on-line broker-dealers during the market volatility on October 27 and 28, 1997. In these examinations, OCIE found that: (i) several of the on-line broker-dealers reviewed had insufficient trading system capacity to provide timely execution of customer orders on October 28, 1997; (ii) all on-line broker-dealers reviewed experienced limited degradation in their Internet access computers, which prevented certain customers from accessing their on-line accounts in a timely manner; (iii) a majority of the customer complaints received by on-line broker-dealers and the Commission involved delays in accessing their on-line broker-dealer accounts; and (iv) one on-line broker-dealer did not properly record e-mail complaints for books and records purposes.

OCIE and the Commission's Division of Market Regulation ("Market Regulation") also conducted a review of on-line broker-dealer system capacity during the market volatility on August 31 and September 1, 1998. The Staff found that, although all of the on-line broker-dealers reviewed recorded above-average or record trading volume during the two trading days, none of the broker-dealers experienced significant slow downs or systems outages due to volume on either day.

The recent problems with E*Trade appear to stem from the introduction of new trading software installed on the evening of February 2, 1999. Glitches in the new software appear to have disrupted trading for two hours on February 3, two and a half hours on February 4, and 29 minutes on February 5. E*Trade claims that its systems problems do not result from a lack of capacity.

Charles Schwab & Co.'s ("Schwab") most recent system shutdowns also appear to be a result of the firm's addition of new software. On February 24 and March 1, 1999, Schwab shut down for an hour and one-half hour, respectively, as a result of problems with software upgrades made to increase capacity. Schwab also shutdown for ten minutes on February 17 in order to fix database problems, and experienced system slowdowns, as well as a brief systems shutdown on January 8 as a result of record usage by customers. Schwab claims it has the systems capacity to handle current trading volume and will spend what is necessary to keep its Internet trading system from crashing again.

The causes of system failures and delays are varied. Technological choke points may slow or prevent a user's order from reaching an on-line broker-dealer. A user seeking to trade using an on-line broker-dealer may experience delays for the following reasons: (i) the user's modem or computer is slow or faulty; (ii) the user's Internet Service Provider ("ISP") is slow or delayed; (iii) traffic on the Internet is heavy, which slows down overall usage; (iv) an on-line broker-dealer's ISP is slow or delayed; or (v) the broker-dealer has inadequate computer hardware to process the user's request. A capacity problem or limitation at any one of the five choke points can cause delay or failure in a user's attempt to access an on-line broker-dealer's automated trading system.

Moreover, once an order reaches an on-line broker-dealer, various problems may occur to delay execution of an order. For example, glitches may occur in the on-line broker-dealer's order routing software. High volume or volatility in the market to which the order is routed may delay execution of the order. In addition, market makers to which orders are routed may turn off auto-execution functions during periods of high volume or volatility and process orders manually.

With regard to systems capacity and systems integrity issues, the increase in the number of on-line broker-dealers has created competitive pressures to correct systems problems. Investors who are not satisfied with the service they receive from one on-line firm will switch their accounts to other on-line broker-dealers. The Commission has no evidence that any systems failures experienced by on-line broker-dealers are the result of deliberate actions on the part of the broker-dealers. Moreover, while some market makers may turn off auto-execution functions during periods of high volume or volatility, the Commission does not have any evidence that on-line broker-dealers and market makers are colluding in this regard.

The Commission has issued a number of guidelines regarding systems capacity requirements for on-line broker-dealers. The Commission's two Automation Review Policy ("ARP") statements address the technological capacity needs of participants in the securities markets. The first policy statement discusses the importance of: (i) formally establishing capacity estimates; (ii) conducting periodic capacity stress tests; and (iii) contracting with independent reviewers to assess performance at current and future capacity levels and to assess vulnerability to physical threats.[3] The second policy statement emphasizes the importance of: (i) obtaining independent reviews of the general controls and risks in place in automated trading and information dissemination systems to determine the need for further reviews or enhancements to those controls; (ii) providing notice of significant additions, deletions, or other changes to automated systems on an annual and on an as needed basis; and (iii) providing Commission staff with real-time notifications of unusual events such as significant outages involving automated systems.[4] Although the ARP statements do not directly address the obligations of broker-dealers, the Commission has taken the position that all broker-dealers should voluntarily follow the ARP guidelines.[5]

In addition, on September 9, 1998, Market Regulation staff published Staff Legal Bulletin No. 8, which sets forth its views on how broker-dealers should handle customer orders and notify customers when marketwide circuit breakers halt trading on exchanges.[6] The bulletin also sets forth the staff's views about the need for broker-dealers to maintain enough internal systems capacity to operate properly when trading volume is extremely high. The staff emphasized the importance of broker-dealers having adequate capacity to handle high volume or high volatility trading days, and conducting capacity planning on a regular basis. While the Staff Legal Bulletin did not mandate standards for broker-dealer capacity, it encouraged broker-dealers to develop appropriate measures to minimize potential capacity problems.

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3 Securities Exchange Act Release No. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989).

4 Securities Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

5 *See* Securities Exchange Act Release No. 27445, at n.17.

6 SEC Staff Legal Bulletin No. 8 (Division of Market Regulation) (September 9, 1998).

The Commission also proposed on March 2, 1999 new rules that would specifically require registered broker-dealers to have sufficient operational capability -- taking into consideration the nature of their business -- to assure the prompt and accurate processing of securities transactions.[7] This proposal is attached as Exhibit B. The proposed rule is aimed at overall capacity and mission critical systems. Thus, isolated systems problems unrelated to a broker-dealer's core business would not violate the rule. If, however, delays occur on a regular basis due to insufficient systems capacity that result in customer orders not receiving timely executions, then such a broker-dealer could be in violation of the rule and will need to take appropriate actions before resuming its normal operation. If the rule is adopted, in addition to being able to bring enforcement actions after the fact, it would allow the Commission to take preventive measures before a broker-dealer's operational problems adversely affect its customers. For example, Commission and self-regulatory organization ("SRO") examiners would examine firms for compliance with the rule. Additionally, the Commission could bring a cease and desist proceeding to require a broker-dealer that is experiencing an operational difficulty to take remedial steps.

When on-line broker-dealers have capacity and operational problems, the primary harm to investors results from the inability to access the securities markets. Of course investors can suffer similar harm when they are unable to access the securities markets through more traditional means. In particular, there are: (i) opportunity costs to investors resulting from the inability to execute a buy order prior to an increase in a security's value; (ii) costs to investors resulting from the inability to execute a sell order prior to a decrease in a security's value; and (iii) losses to investors resulting from the inability to enter a cancellation of a pending order, potentially resulting in double execution of an order.

Efforts to correct systems problems experienced by on-line broker-dealers have been undertaken by the Commission, the SROs, and the broker-dealers themselves. As discussed above, the Commission issued the ARP statements and Staff Legal Bulletin No. 8, which encourage on-line brokers to assess the adequacy of their systems capacity. In addition, OCIE is in the process of conducting examinations of on-line broker-dealers. During the next several months, OCIE plans to conduct examinations of a number of on-line broker-dealers to review capacity, disclosures to customers regarding access and speed of execution, best execution, suitability, and other issues.

With regard to the SROs, NASD Regulation, Inc. ("NASDR") recently issued Notice to Members 99-11, which (i) reminds member firms of the Commission staff's position set forth in Staff Legal Bulletin No. 8 regarding how broker-dealers should handle orders and maintain enough internal systems capacity to operate properly when trading volume is high; and (ii) encourages on-line broker dealers to make certain disclosures to educate retail customers about the broker-dealer's procedures for handling the execution of a securities transaction, particularly during volatile market conditions.[8] The notice specifically recommends disclosures that: (i) explain that high volumes of trading at the market opening or intraday may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was

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7 Securities Exchange Act Release No. 41142 (March 5, 1999) (File No. S7-8-99).

8 NASD Notice to Members 99-11 and 99-12 (February 1999).

entered; (ii) detail the difference between market and limit orders and the benefits and risks of each; and (iii) alert customers that they may suffer market losses during periods of volatility.

On-line broker-dealers have also taken a number of steps to respond to their own systems failures and delays in executing customers' orders because of high volume and volatility in the markets. For example, one firm has halted on-line trading in the aftermarket of hot initial public offerings ("IPOs") and other volatile stocks. Other steps include: (i) requiring customers who wish to buy hot IPOs in the aftermarket to enter a limit order specifying the highest price they will pay for these issues; (ii) raising margin requirements; (iii) prohibiting the use of margin to purchase certain volatile securities; (iv) providing investor education on issues related to market volatility on the Web; and (v) creating pop-up screens explaining that only limit orders will be accepted for certain volatile securities.

Despite these efforts, the Commission continues to have concerns regarding the disclosures and representations made by on-line broker-dealers regarding systems capacity. OCIE's research into disclosures made to both existing and prospective customers has revealed that the most common disclosure statements regarding system access and capacity are made in the form of disclaimers found in customer agreements posted on the broker-dealer's website. These disclaimers are designed more to insulate the broker-dealer from liability than to inform customers of the potential risks and hazards of using on-line trading services. OCIE's research found little substantive disclosure by on-line broker-dealers of the potential for, and the consequences of, system failure.

Finally, you asked about unconfirmed reports that some major Electronic Communications Networks ("ECNs") are experiencing capacity problems. We have not received any reports of capacity problems or related deficiencies at any ECN. While some ECNs experienced capacity problems early last year, they have since implemented systems changes that corrected the problems. There have been several ECN outages reported in the second half of 1998, but none of these outages resulted from capacity problems. The outages were caused mainly by communications and other systems problems. We are continuing to monitor these issues closely.

<u>*Question 4:*</u> *How many individuals are using these on-line trading systems? To what extent can they be identified either as retail investors or as "day traders" and what are the characteristics of each?*

Currently, there are approximately 5.6 million individual investors trading on-line.[9] This represents a substantial increase from the 1.5 million investors we estimated to be trading on-line in the October 1997 Technology Report.[10] Based on this past growth and the current reports, we believe that there is every reason to expect that the number of individuals trading on-line will continue to grow.

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9 Source: Credit Suisse First Boston Corporation.

10 SEC STAFF, *THE IMPACT OF RECENT TECHNOLOGICAL ADVANCES ON THE SECURITIES MARKETS* 105 (October 1997).

Because there is no clear definition of a "day trader," it is difficult to quantify how many "day traders" there are today. The Electronic Traders Association -- an association of firms self-identifying as day trading firms -- reports that approximately 4000 persons[11] are full time day traders.

The staff believes that these day traders work out of approximately 100 day trading firms. The Commission believes it is important to distinguish between day trading firms and on-line trading firms, such as those listed in Exhibit A. In general, day trading firms advertise for, and solicit, individuals to become full-time traders. In order to become a trader, day trading firms usually require these individuals to deposit some minimum amount of money in a trading account. In return, these firms promise to train these individuals on how to make money on small price movements. Typically, day trading firms offer their services at on-site trading facilities, rather than through an Internet Web site. Day trading firms provide their traders with access to market information not available to the average retail investor and direct entry to the firms'order processing systems, which allows direct access to market-operated order execution systems, such as Nasdaq's SelectNet and Small Order Execution System ("SOES"), and to ECNs, such as Instinet and Island. Further day trading firms provide their traders with proprietary software and systems that analyze and chart activity in particular stocks.

These day trading firms' activities raise different regulatory issues than the growing business of on-line brokerage. In particular, day trading firms raise questions regarding compliance with margin and short sale rules, broker-dealer registration requirements, and supervision, which on-line brokerage generally does not. In addition, day trading firms raise fewer concerns about the adequacy of investor education than do on-line brokers.

In addition to distinguishing between day trading firms and on-line firms, we have tried to distinguish between day traders and more typical on-line retail customers. While, the media, at times, uses the term "day trader" loosely to describe any investor who electronically buys and sells securities intraday with the goal of making short-term profits, we believe that a narrower definition is appropriate. In general, we consider a day trader to be an individual, not registered as a broker-dealer or as a registered representative, who trades stock at a firm that allow the individual "real time" access to the major stock exchanges and the Nasdaq market. These day traders buy and sell stocks during the day, often within minutes, hoping to profit from intraday swings in share prices. What particularly distinguishes a day trader from a more typical retail investor is that a day trader will:

- not, generally, carry a position overnight;[12]
- try to make money on short-term market moves;

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11 *Day-Trade Rules May Be Sought*, Los Angeles Times, February 23, 1999, at C4.

12 Day traders prefer to avoid the risk arising from not being able to sell if there is significant volatility in the after-hours markets.

- trade through direct firm links to market-operated automatic order execution systems (such as SOES), in order to obtain nearly instantaneous order execution;
- look at a stock's historical trading patterns (e.g., whether it is most active during certain hours of the day, times of the year, etc.) rather than look at a company's fundamentals or growth prospects;
- have the mind set of a "trader" rather than a long-term investor; and
- focus on trading in volatile stocks.

While it is possible for individuals to attempt to day trade through an on-line broker, such as those listed in Exhibit A, on-line brokers not only do not actively encourage this type of trading, but typically discourage it through margin restrictions. In addition, on-line brokers do not have the direct links to market-operated order execution systems that enable traders to obtain nearly instantaneous execution. Thus, it is more difficult to make money on short-term market moves through on-line brokers, than through day trading firms.

Question 5: *What is the extent and adequacy of investor education about both the benefits and the risks of on-line trading? In the absence of middlemen or brokers expert in the mechanics of trading, who is providing training to the public on the basics of successful investing or trading? What relevant disclosures or training do on-line systems provide? Is it adequate?*

On-line trading has provided many benefits to investors. Investors are enjoying lower transaction costs, faster execution and greater autonomy and control over personal investment decisions. The development and growth of on-line trading has introduced greater numbers of Americans to the benefits of investing in the country's stock markets. Nevertheless, on-line investing does have some very unique risks, and investor education is needed to increase awareness of these risks of trading on-line. For this reason, the Commission and the National Association of Securities Dealers, Inc. ("NASD") are increasing their efforts in educating investors. In most cases, the best medium to use for investor education is the Internet. Portions of both the Commission's and the NASD's web pages are dedicated to providing information to investors. Moreover, many firms are finding that it is in their interest for customers to be well educated about investing generally, and on-line investing in particular. Consequently, many on-line firms are reexamining their own web sites in an effort to organize and present information to customers in an easily accessible and understandable manner.

Chairman Levitt, in his January 27 statement, stressed the need for on-line investors to educate themselves on the risks involved with on-line trading to enable them to protect their investments.[13] The Chairman emphasized that investors need to understand basic investing theories as well as the issues and limitations of the new on-line

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13 Statement by Chairman Arthur Levitt, Securities and Exchange Commission, Concerning On-Line Trading, dated January 27, 1999. Available at http://www.sec.gov/news/press/99-9.txt.

trading technology. Investors must understand that on-line trading does not guarantee instantaneous execution and they must devise alternate trading plans when problems with timely trade executions or confirmations arise. They must understand the differences between market and limit orders so that they can protect themselves in volatile markets, and understand the rules and risks of purchasing stocks on margin to prevent over-extending themselves. The Commission is committed to protecting investors, but as the Chairman stated "investor protection -- at its most basic and effective level -- starts with the investor" and investors who have become active participants in the stock markets must also become educated participants to better protect themselves and their investments. The Commission is continuing to discuss with the industry the best ways to educate investors who use on-line brokers.

In addition, the NASD has taken an active interest in education and disclosure. As discussed above, the NASD recently released a Notice to Members stressing that firms should provide adequate and clear disclosure to customers regarding trading risks during volatile periods and any constraints on a firm's ability to process orders in a timely and orderly manner.[14] The Notice to Members also provides examples of how firms can better educate investors on-line, such as through the use of pop-up or splash screens.[15] These screens may contain current information covering such things as changes to margin requirements, the use of market versus limit orders, or entering cancellations, and may be designed to require viewing before access to customer account pages is provided.

In a letter to members dated February 4, 1999, Frank Zarb, Chairman and CEO of NASD, also stressed the importance of investor education.[16] He noted that while suitability requirements may be difficult to apply to on-line transactions, firms need to ensure that they do not encourage inexperienced investors to engage in high risk activities. He praised those firms that have responded to the recent volatility with higher margin requirements to prevent improper risk exposure and reminded members that advertising and promotional materials must not set unrealistic expectations of profits or "instantaneous" order execution. The key, he said, to reinforcing investor protection is educating investors and his letter challenges the members of the NASD to make investor education a priority.

Question 6: *How many on-line complaints did the SEC receive last year? Press reports indicate that you do not have the resources to keep up with them. Is this true? What are your current resources for (1) surveilling trading systems, (2) processing and responding to consumer complaints, and (3) bringing enforcement actions in this area?*

The ease of communicating with the Commission electronically, combined with market events in the latter half of 1998, have contributed to a surge in the total number of complaints and inquiries sent to the Commission. Complaints from investors about their

14 *See supra* note 8.

15 NASD Notice to Members 99-11 (February 1999)

16 Letter to Members from Frank Zarb, Chairman and CEO, NASD, dated February 4, 1999 (http://www.nasdr.com/trading_letter.htm).

on-line trading firms increased by 330% from fiscal year 1997 to 1998, rising from 259 to 1114 complaints. In the first four months of fiscal year 1999, we received 759 complaints concerning on-line trading firms, representing a 33% increase in complaints so far this year over fiscal year 1998. Investors most frequently complained about delays in executing orders, difficulties in accessing their accounts, and errors in processing their orders.

The Commission's Office of Investor Education and Assistance ("OIEA") reviews these complaints immediately to determine if they allege a serious fraud that should be referred to the Division of Enforcement ("Enforcement"). In most cases, these complaints deal with operational problems, so we follow our normal procedures for dealing with the complaint. We inform investors of their legal rights and send a copy of the complaint to the broker-dealer. We ask the broker-dealer to look into what happened and report back to us and the investor in writing. We also collect information from each complaint and enter it on our computerized data base so that we can track trends. Currently, OIEA, OCIE, Market Regulation and Enforcement are evaluating investor complaints to determine whether any policy initiatives are warranted.

We have not experienced problems in getting these complaints to the firms for their responses because we consider them a high priority among our contacts from the public, but we are seeing delays in getting reports back from some of firms. However, our overall volume of complaints and inquiries from the public has increased dramatically, growing by more than 45 percent since 1993 to a total of 51,311 in fiscal year 1998. This increase has been especially pronounced at OIEA in Commission headquarters where volume has doubled since 1993, rising 46% from 1997 to 1998. OIEA has 14 permanent staff members called investor specialists who answer phone calls, letters, e-mails, and faxes from the public. The Commission's regional and district offices have another 15 investor specialists who do the same type of work. The increases in complaints and inquiries from the public have strained our resources and resulted in delayed responses to investors. Staff from other Commission offices are currently lending a hand in responding to investor letters and e-mails as we assess longer term solutions.

Enforcement receives e-mail referrals from OIEA, as well as e-mail complaints sent directly to the Enforcement Complaint Center and regional office e-mail boxes. Every communication that is directed to Enforcement is reviewed for allegations of securities law violations that should be investigated. More than 50 percent of the complaints sent to the Enforcement Complaint Center and regional office e-mail boxes relate to existing investigations and many result in a new investigation. Those communications involving conduct by registered entities, but that do not contain allegations sufficient to commence an investigation, are forwarded to OCIE for possible review during an on-site broker-dealer or investment adviser inspection.

The enormous volume of messages sent to the Commission about potential frauds conducted through the Internet, added to the growing number of frauds that come to light through the Commission's own Internet surveillance, have clearly placed a new burden on existing enforcement resources. The increased number and complexity of investigations that result from surveillance of activity on the Internet could soon tax resources.

To provide a coordinated approach to uncovering Internet-related frauds, Enforcement has established a dedicated Office of Internet Enforcement in headquarters and a CyberForce of 125 enforcement staff professionals throughout the country. The Office of Internet Enforcement and CyberForce provide regular surveillance of the Internet, searching for illegal offerings of securities and fraudulent touting of stocks. Moreover, to maximize efficiency in investigating Internet-related frauds, Enforcement has developed relationships with other federal regulators and the SROs. Through these relationships, investigations are coordinated and information and expertise are shared.

Finally, OCIE has directed its resources to focus on ways to effectively examine both alternative trading systems (including ECNs) and broker-dealers that provide the public with the ability to trade on-line. Through special examinations and inspections of these systems, OCIE has developed examination procedures tailored to trading systems and broker-dealers that provide on-line trading capability.

Question 7: *Internet investing "chat rooms" and electronic stock market newsletters on Web pages appear to be a significant source of market information for those engaging in on-line trading. There also appears to be a significant risk of false or misleading information about publicly traded companies being electronically disseminated to the on-line investing public. What is being done to protect investors from market manipulation involving dissemination of false or misleading data or other information over the Internet, and to require appropriate disclosure of any financial or business relationship between companies and the authors of Internet investment newsletters or Web pages?*

The frauds of disseminating false or misleading information and failing to disclose conflicts of interest in connection with the offer or sale of securities are as old as the securities markets themselves. The Internet has merely made it cheaper, easier, faster, and more efficient to communicate with large numbers of unsuspecting potential investors. Although the communications media is new and evolving, the Commission's authority to investigate violations of, and to enforce compliance with, the federal securities laws remains the same.

Six areas of potential fraud and regulatory concern are: (i) the offer and sale of bogus securities; (ii) market manipulations and microcap fraud; (iii) on-line investment newsletters and fraudulent touting; (iv) unregistered off-shore investment advisers and broker-dealers; (v) fraudulent spamming and junk e-mailing about investment opportunities; and (vi) the circulation of negative information to benefit shortsellers. The Commission has an aggressive program in Enforcement to detect, investigate, and bring enforcement actions against those that are using the Internet to commit securities fraud, buttressed by continuing investor education and investor self-policing.

Enforcement Actions:

A dedicated Office of Internet Enforcement in the Commission's headquarters office and a CyberForce of 125 enforcement staff professionals throughout the country have been specially trained in Internet surveillance. In addition to their other duties, the

CyberForce members regularly devote time to searching the Internet for conduct that appears to violate securities laws. The focus and methodology of the CyberForce's surveillance of the Internet changes constantly in order to keep up with the latest scams.

Since the Commission filed its first Internet-related case back in 1995, over 60 Internet-related fraud cases have been brought. Thirty-eight of these actions were brought in 1998, indicating the Commission's commitment to a strong response to the increased use of the Internet to conduct securities fraud.

To raise the public's awareness of the illegal tactics used by fraudsters on the Internet, the Commission conducted an Internet fraud sweep. The sweep began with the collection of leads by the CyberForce, continued with a carefully coordinated follow-up and investigation of those leads, and culminated in a large Internet roundup. On October 28, 1998, 44 individuals and companies across the country were charged in 23 actions with committing fraud over the Internet and deceiving investors around the world. The sweep involved actions filed by Commission offices in Atlanta, Boston, Chicago, Denver, Fort Worth, Los Angeles, Miami, New York, Philadelphia, Salt Lake City, and Washington, D.C.

These cases primarily concerned unlawful and fraudulent touting about microcap companies through a range of fraudulent Internet communications, fraudulent spams, on-line newsletters, message board postings and Web sites, in violation of Section 17(b) of the Securities Act of 1933 ("Securities Act").[17] The Commission alleged that the authors of the communications unlawfully touted more than 235 microcap companies by: (1) making misrepresentations about the companies; (2) making misrepresentations about their own "independence"; or (3) failing to disclose adequately the nature, source, and amount of compensation paid to the authors by the touted microcap company. The creators of the Internet touts received in total almost $7 million and almost 2 million shares of cheap insider stocks and options for their touting services.

Continuing our sweep targeting Internet fraud, on February 25, 1999, we filed an additional four actions against 13 individuals and companies for Internet fraud (primarily illegal touting). In total, the promoters received more than $450,000 in cash and approximately 2.7 million shares of stock and options.

In addition, 17 trading suspensions were filed in fiscal year 1998 and 10 in fiscal year 1999. Increasingly, the Commission has sought trading suspensions in stocks where a dramatic run-up in price is accompanied by unsubstantiated reports and anonymous hype on the Internet.

The CyberForce works extremely closely with over ten federal agencies, North American Securities Administrators Association, Inc. ("NASAA"), and the SROs to coordinate referrals and investigations and to share information and expertise. As an example, the Commission filed 4 injunctive actions on August 11, 1998, that resulted from

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[17] 15 U.S.C. 77q(b), Securities Act of 1933 § 17(b).

a coordinated sweep with the Federal Trade Commission and NASAA of fraudulent investments offered on the Internet by entertainment companies.

Continuing Education:

The Commission has a "Cyber Alert" on its Web page, warning the public about frauds that occur on the Internet and to exercise caution when presented with an investment opportunity. Enforcement has posted public information on Internet forums, such as with commercial on-line providers, Internet discussion forums, and newsgroups, where such information might help investors in a specific security. For instance, in several recent trading suspensions of public companies, the Commission posted press releases concerning the trading suspensions and a copy of the suspension order in discussion forums dedicated to discussing those particular stocks.

Self-Policing:

The Commission has been encouraged by the culture of vigilance and self-policing evident among Internet users. Enforcement is currently receiving 300 e-mail messages daily, many containing highly specific information about suspicious web pages, spams, and chat room conversations. Users take time to provide painstaking details of potential violations and tips on parties behind Internet hype about companies.

Question 8: *Does federal law provide adequate tools for the SEC and protections for investors? If not, what changes are needed?*

The federal securities laws provide a basic framework for regulating broker-dealers, with more specific requirements and prohibitions put in place through Commission and SRO rules. Because Internet trading has only recently become a significant component of the securities industry, both the Commission and the SROs are studying the need for new, or modifications to existing, rules. This process may include determining that the current rules are adequate as applied to all broker-dealers, adopting Commission rules to address issues unique to on-line brokers, and working with the SROs to ensure that they are adequately meeting their obligations to enforce their members' compliance with the federal securities laws. As described below, the Commission is actively engaged in this process, and we believe that the existing statutory framework is sufficiently broad and flexible to address any concerns raised by on-line trading.

Some currently existing Commission rules are equally applicable to on-line broker-dealers as to traditional broker-dealers. For example, the margin requirements were designed to ensure that investors do not jeopardize their own, or the broker-dealer's, financial stability through excessive borrowing. As discussed in the response to Question 10 below, many firms have also increased the margin that customers must provide initially and maintain in highly volatile stocks, and the NASD has suggested that other firms follow suit. Moreover, the broker-dealer capital requirements ensure that firms are well capitalized and able to withstand sharp downward price movements. Similarly, the requirements that broker-dealers segregate customer assets protects on-line investors in the same way as more traditional investors. In addition, on-line brokers must be members of a SRO and must comply with the SRO's rules governing sales practices, trading and business practices, member financial responsibility, and advertising.

The Commission has also begun to enhance its regulations to address the unique issues involved in on-line trading. For example, although the statutory requirement to have adequate operational capability has been around since 1975,[18] only recently have customer expectations for instantaneous executions focused attention on the importance of capacity. Accordingly, on March 2nd, the Commission proposed a rule that would specifically require broker-dealers to have sufficient operational capability to assure the prompt and accurate processing of securities transactions.[19] It is important to note, however, that there is no current requirement, nor would this proposed rule impose one, that broker-dealers instantaneously execute customer orders.

In addition, a great deal of attention is now focusing on what firms disclose to customers about their execution capabilities. NASD rules have always prohibited a firm from exaggerating its capabilities or omitting material information about the risks of trading and the possibilities of delayed execution in the firm's advertisements and sales literature.[20] On-line brokers' compliance with this rule, however, has been brought into question. In response, the NASD's recent Notices to Members urged firms to disclose to customers potential risks associated with trading during volatile time periods and any other constraints that impact firms' ability to process orders in a timely and orderly manner. In addition, the NASD stated that members should also disclose to investors any altered procedures implemented during volatile market conditions.[21] The NASD is examining on-line firms for the adequacy of their disclosure and considering whether any additional measures are needed.

Finally, the anti-fraud and anti-manipulation provisions of the federal securities laws, as well as common law agency duties, provide important protections for investors. These basic requirements are the underpinnings of many, more specific, duties brokers have to their customers, including best execution and suitability obligations. Regardless of how the securities business changes, we believe that these basic standards about how brokers should treat their customers do not change, and that existing law provides the essential elements needed to address the current changes in how securities are traded.

Questions 9: On-line stock underwriting is also becoming more prevalent. What regulatory issues does this raise? How are you addressing them?

On-line stock underwriting appears to be the latest trend in the rapidly evolving world of Internet securities trading, and the Commission has been monitoring this development closely. Generally, we think on-line underwritings are a positive development because they provide individual investors greater opportunities to participate

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18 15 U.S.C. 78o(b)(7), Securities Exchange Act § 15(b)(7).

19 *See supra* note 7.

20 *See* NASD Rule 2210(d). This rule defines the general standards to be applied to all communications with the public by broker-dealers. Broker-dealer communications must be based on principles of good faith and fair dealing. The rule also prohibits the omission of material facts if the omission would cause the communication to be misleading.

21 *See supra* note 8.

in hot IPOs (traditionally only available to institutional investors). The typical on-line underwriting that we have seen involves on-line broker-dealers who either participate in underwriting syndicates or receive offering shares directly from issuers. These broker-dealers then offer those shares at the offering price to their on-line customers, who are usually individual investors. In this manner, individual investors have the opportunity to participate in offerings at the initial stage, rather than in hot aftermarkets where they may pay a premium for the shares.

Despite these clear benefits, we do have concerns that investor protections may be inadequate. These offerings also raise issues concerning the capital rules, adequate disclosure, and required registration under Section 5 of the Securities Act.[22] As reported in the press, the Commission and NASDR have been working with several firms to ensure that their on-line underwritings comply with the federal securities laws.

The on-line underwriting structure originally contemplated by Wit Capital Corporation ("Wit Capital") required investors to submit electronic indications of interest to buy offering shares on a first-come, first-served basis, so long as they promptly placed sufficient funds in their on-line brokerage accounts to cover the purchase. These offers to buy the securities could not be accepted until the registration statement for the securities was declared effective by, and the securities were registered with, the Commission. Wit Capital proposed to accept customers' offers to buy immediately upon effectiveness of the registration statement, without any further action or consent from the customers.

The Wit Capital structure posed a regulatory issue because Wit Capital was effectively accepting payment for securities that were not yet subject to an effective registration statement, which violates Section 5 of the Securities Act.[23] After extensive discussions with Commission staff, Wit Capital agreed to obtain reaffirmations from each investor who submitted an electronic indication of interest in an on-line offering after the registration statement for the offering was declared effective, which removed the staff's Section 5 concern.

The on-line underwriting structure proposed by W. R. Hambrecht, Inc. ("W.R. Hambrecht") is different from that of Wit Capital. W.R. Hambrecht proposes to incorporate a "Dutch auction" process both to set the price for securities in an on-line offering and to determine how the shares are to be allocated among potential investors. After the registration statement for an offering is declared effective, the firm would conduct a Dutch auction for approximately one month during which they would solicit bids from investors for the number of shares they want to purchase and the price they are willing to pay for them within a predetermined price range set by the firm. Investors would be committed to purchase shares at their bid, contingent on the firm setting a clearing price for the offering that would accept the bids at or above that price and entering into a firm commitment underwriting agreement with the issuer. Investors could modify their bids at any time before the close of the auction.

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22 15 U.S.C. 77e.

23 Id.

If there are insufficient bids within the price range for all of the securities, the offering is either abandoned or the price range is modified and a post-effective amendment would be filed. If there are sufficient bids, the auction would close, the firm would sign an underwriting agreement, apply a net capital haircut to the securities purchased by the firm, and allocate them to the investors. Bids at or above the clearing price would be accepted, and the firm would prorate the securities among investors if necessary.

This structure raises issues because it is unclear whether the on-line offerings are firm commitment underwritings or conditional ones. The firm is viewing them as firm commitment underwritings, but they appear to have some characteristics of conditional offerings. The Commission and NASDR have been working with W.R. Hambrecht and its counsel to resolve this and other issues.

In an arrangement that raised some of the same issues raised by on-line underwritings, an issuer proposed to give securities free of charge to anyone who visited its web site and completed a registration form. The company did not intend to register the securities until it gave enough away to trigger the mandatory registration provisions of the Securities Act. The Commission staff issued this company a letter advising that its structure would violate the federal securities laws.[24] The issuance of securities in exchange for visiting a web site would be considered an event of sale within the meaning of Section 2(a)(3) of the Securities Act.[25] Because the company did not intend to register the securities or qualify for an exemption from registration, such an issuance would violate Section 5 of the Securities Act.[26] Two other companies have contemplated similar on-line stock giveaways, and the Commission staff has promptly advised them that they also would be violating the federal securities laws.[27]

The Commission has also been working with the SROs on issues arising from on-line underwritings. For example, on January 22, 1999, the Commission approved a proposal by the Nasdaq Stock Market ("Nasdaq") to extend the pre-trading quotation period for IPO securities from five to fifteen minutes.[28] Nasdaq sought to extend the pre-trading quotation period to fifteen minutes because it observed increased volatility in the opening of IPO securities for trading on Nasdaq. Nasdaq believes the extended time period will allow market participants to better digest and respond to market price indications before an IPO security is released for trading and thus provide better information upon which to make trading decisions. The pre-trading quotation period permits Nasdaq market makers to adjust their initial quotes for IPO securities before trading begins. The change was intended to help curb excessive volatility in Nasdaq IPOs

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24 Letter from Michael Hyatte, Special Counsel, Division of Corporation Finance, SEC, re: Vanderkam & Sanders (January 27, 1999).

25 15 U.S.C. 77b(a)(3).

26 15 U.S.C. 77e.

27 Letter from Michael Hyatte, Special Counsel, Division of Corporation Finance, SEC, re: Simplystocks.com (February 4, 1999).

28 Securities Exchange Act Release No. 40968 (January 22, 1999), 64 FR 4729 (January 29, 1999).

by providing Nasdaq market makers with sufficient time to gauge market interest in IPO securities and to set initial prices that more accurately reflect such demand.

The approved rule change also authorizes Nasdaq to make available an additional fifteen minute period if the market for an IPO security is locked or crossed to such an extent that releasing the IPO security for trading would be detrimental to the market or investors. Nasdaq's MarketWatch Department is charged with monitoring the pre-trading quotation period and is responsible for determining whether an additional fifteen minute period is necessary.

In the first two weeks after the proposal became effective, Nasdaq's MarketWatch Department extended the pre-trading quotation period to thirty minutes for six IPO securities: (1) Pacific Internet; (2) Modem Media; (3) Tut Systems; (4) Smith-Gardner & Associates; (5) Med E America Corp.; and (6) Corinthian Colleges.

Finally, Nasdaq represented that its proposal was an initial response to the volatility it had observed in the trading of Nasdaq securities and that its efforts to address market volatility would continue. The Commission has encouraged Nasdaq to develop additional proposals as part of its review of trading activity and Nasdaq market practices.

Question 10: *Federal Reserve Chairman Greenspan recently opined about Internet stocks that "you wouldn't get hype working if there weren't something fundamentally sound under it." Alan Abelson rejoined in this week's Barrons Up & Down Wall Street column "Is Alan Greenspan in urgent need of rest and relaxation? That brilliant insight means the tulip mania was really based on sound fundamentals, or else the world wouldn't have gone bananas over tulips. Nor would Mr. Ponzi have been able to spark such phenomenal excitement if his scheme hadn't been based on sound fundamentals." The January 30th - February 5th 1999 The Economist cover story, "Why Internet shares will fall to the earth," notes: "Once normal valuations fly out of the window, there are no reference points. Nor does anyone know how the day traders will cope with sustained downward pressure. Internet shares are not liquid and on-line brokerages may not be able to handle large volumes. In any other market, it would be a recipe for panic selling." What is driving the speculative bubble in Internet stocks? What is being done to address the serious volatility in these stocks? What is being done to address the issues raised in The Economist quote?*

There are many theories about what is driving the market for Internet stocks. Some analysts believe it is being caused by a demand for Internet shares that far exceeds the actual supply. The bulk of the shares of many high tech companies are held by company insiders (who received the shares as compensation), leaving a small float for public trading. Internet shares are being chased not only by individual investors but also by institutional investors. It has been reported, however, that institutions have had a hard time buying large blocks of Internet stocks without significantly moving share prices. The limited supply of Internet stocks has also led investors to attempt to find other Internet-related opportunities including companies with minimal Internet connections.

Another theory simply posits that investors' enthusiasm over the tremendous recent growth of on-line technology is driving the increase in the market. The rise in popularity of technology stocks may be traced to the increased use by investors of technology generally, and their use of technology in managing their investments in particular. Investors are noticing, and are in fact a part of, the trend of increased participation in on-line commerce and are making their investment decisions based on their own personal experiences. In addition, the dramatic rise in the price of shares of Internet companies, such as Amazon and Ebay, have motivated investors to look for the next big success story.

Regardless of the underlying reasons, it is impossible to ignore the almost daily news reports about the extreme volatility of Internet stocks. While we appreciate your concern about volatility, we believe it is important to recognize that the fundamentals of the stock market are sound. Moreover, the extreme volatility only relates to a discrete segment of the market -- technology and Internet-related issues.

Even if Internet stock prices fall, we believe the current regulatory structure will adequately ensure the integrity of the market. Broker-dealers are well capitalized and many firms have taken steps to protect themselves and investors from volatility by increasing both initial and maintenance margin requirements for highly volatile stocks. Further, we are talking to the SROs about the appropriateness of responding to this volatility with, for example, changes to their trading halt rules, margin requirements, and suitability obligations.

In its Notice to Members, the NASD suggested that firms increase margin requirements for volatile stocks to help ensure that the equity in a customer's account is sufficient to cover large changes in the price of a stock.[29] For example, the NASD noted that some firms have raised the amount of equity customers are required to maintain in their account from the 25% maintenance margin required by the NASD and the exchanges, or the 30-35% maintenance required by many firms, to between 40% and 100%. This reduces the incidence of margin deficits and the likelihood that a firm will have to liquidate assets in a customer's account to meet a margin call. The NASD also noted that some firms have prohibited the use of margin to purchase certain securities, requiring customers to purchase designated stocks with 100 percent initial margin.

Trading halts are another method some have suggested as a way to reduce volatility. Proponents of trading halts contend that they reduce sharp price movements. Opponents, however, argue that trading halts increase volatility by causing investors to rush to make trades before trading is halted. The NASD is currently considering whether to allow trading halts in Nasdaq stocks because of volatility. While in general the NASD does not believe in halting trading, given the "potential of total disconnect between stock prices on the screen and the ability for investors to access those prices in the marketplace,"

[29] *See supra* note 15.

trading interruptions may be necessary.[30] Any decision to halt trading would be based on several factors, including the inability to handle orders and achieve execution.

In addition to volatility of Internet stocks in the secondary market, IPOs in Internet stocks have also been subject to extreme volatility. It has been reported that the number of IPOs is down, with only 348 new issues in 1998 compared to 592 in 1997.[31] In 1998, these new issues on average rose 9% from their offering price after issuance.[32] The 36 IPOs in Internet-related stocks, however, rose on average 112% from their offering price after issuance.[33] This volatility has led some firms to cease offering IPOs of Internet and Internet-related companies to their customers. In addition, as noted above, to help curb excessive volatility in Nasdaq IPOs, the Commission recently approved a Nasdaq proposal to extend the pre-trading quotation period for IPO securities.[34]

Finally, investor education is key to ensuring that investors do not ignore time honored rules of investing. As Chairman Levitt stated in his January 27, 1999 statement,[35] investors should be aware of the risks involved in on-line trading and educate themselves about the dynamics of the nation's stock markets before implementing aggressive investment strategies. During volatile periods, investors must be aware of the differences between market and limit orders to enable them to protect themselves against extreme pricing swings. Investors must also be aware of margin requirements. The Commission is working with the SROs and the industry to continue to improve investor' understanding about these issues.

<u>Question 11</u>: *A recent report by the Federal Trade Commission raised significant concerns about on-line privacy, indicating that many Web sites collect, compile, and utilize vast amounts of data regarding those who surf the site -- often without the user's knowledge or informed consent. What privacy policies do on-line brokerages have? What data do they collect about those who visit their Web sites? How do they use this information? Do on-line brokers provide meaningful opportunity for the public to say "NO" to the collection or dissemination of personal information?*

On-line brokers' approaches to privacy issues vary. A number of on-line brokers post their privacy policies directly on their web home pages, while others do not appear to have any privacy policies at all. Some of the on-line brokers that do have privacy policies state that their policy is not to keep information about persons who browse the public areas of their sites, but that they will retain -- for legal, regulatory, and marketing purposes

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30 *Inability to Handle Orders Key to Trade Interruption, NASD Official Says*, 31 SECURITIES REGULATION & LAW 241 (1999) (quoting Richard G. Ketchum, President, NASD).

31 "Bubble.com," The Economist (December 19, 1998).

32 <u>Id.</u>

33 <u>Id.</u>

34 *See supra* note 28 and accompanying text.

35 *See supra* note 13.

-- information provided by account holders. On-line brokers may also provide customers the option of refusing to receive unsolicited marketing communications.

To become a customer through a brokers' web site, a prospective customer typically must complete and mail in an account application available on the web site. An application requests information such as name, birthdate, social security number or tax identification number, driver's license number, home address, mother's maiden name, home and business phone numbers, employment information and information regarding investment objectives, investing knowledge and experience, and financial resources. We understand that generally on-line brokers do not provide their customers a way to prevent the information they provide on their applications from being used by the broker for internal marketing purposes, or being sold to others.

The issue of privacy in general, and specifically as it relates to financial institutions, has been the subject of much debate recently. Congress appears to be considering, in various pieces of legislation, some of the larger questions raised. We do not have detailed information about on-line brokers' use of the information provided by persons who visit their web site. It is our understanding, however, that on-line brokers rarely, if ever, sell this information to others. Portions of this information is also used by on-line broker-dealers to meet their regulatory obligations.