Wilmer, Cutler & Pickering

December 23, 1999

Securities Law Developments

ONLINE BROKERAGE: REGULATORY SCRUTINY INTENSIFIES AT BOTH FEDERAL AND STATE LEVEL

On November 22, 1999, Commissioner Laura Unger and the New York Attorney General's Office each released a report on online brokerage.[1/] We summarize the findings and recommendations of both reports below.

I. Commissioner Laura Unger's Online Brokerage Report

As Commissioner Unger recognized, the meteoric rise of online trading has raised a variety of issues for securities regulators and the securities industry. In response to these developments, Commissioner Unger studied the online brokerage industry and discussed online trading issues with industry participants in a roundtable format. The Commissioner then summarized her conclusions in the report "On-Line Brokerage: Keeping Apace of Cyberspace" ("Unger Report"), which we discuss in more detail below.

1. **Suitability.** In her report, Commissioner Unger raises the issue whether and how the suitability doctrine should apply in the context of online trading. Suitability refers to a broker-dealer's obligation to recommend only those investments that are suitable for a customer. To trigger the suitability obligation, a broker-dealer must make an investment recommendation to his or her customer. As the Unger Report points out, identifying what constitutes a "recommendation" online can be difficult, especially with the introduction of so-called "push" and "pull" data mining techniques.[2/] The

---

[1/] *See* <www.sec.gov/pdf/cybrtrnd.pdf> for an electronic version of Commissioner Unger's report and *see* <www.oag.state.ny.us/investors/1999_online_brokers/brokers.html> for an electronic version of the N.Y. Attorney General's report.

[2/] "Data mining" may include any number of computer techniques used by online broker-dealers "to personalize website content to create dynamically generated website content relevant to each user." Unger Report at 20. In general, there are two types of personalization -- push technology and pull technology. "With pull technology, the website user sets his preferences and the on-line merchant sends information tailored to these preferences. With push technology, an on-line merchant develops a user profile based on observations about the users' behavior on-line ('tracking the clickstream'), or transaction history." *Id.* at 21 (citations omitted).

Unger Report makes several recommendations regarding future regulatory action, including the following:

a. *Conversations about Data Mining with the Industry*. The Unger Report suggests that the Securities and Exchange Commission ("Commission") discuss customer relationship management products and data mining with industry participants. In particular, the Unger Report encourages the Commission to gather information on (1) how the products work; (2) what types of information would be pushed or pulled; and (3) whether the customer would recognize that the firm had specifically provided them with customized information.

b. *Firm Examinations and Data Mining.* As an alternative to (a), the Unger Report recommends that the Commission consider incorporating as a part of any future online brokerage examination program a review of what services firms provide to their customers based on information derived from data mining.

c. *Clarifying Application of Suitability Doctrine Online.* The Unger Report recommends that the Commission and the self-regulatory organizations ("SROs") consider clarifying how suitability principles apply in certain online situations and circumstances. As a starting point, the Unger Report outlines a variety of online hypotheticals and discusses the suitability issues raised by each situation. For example, the Unger Report states that an online broker that provides only order execution services to its customers should not have a suitability obligation. However, if an online broker-dealer classifies its customers into different categories based on factors such as account balance, securities holdings and frequency of trading, and the firm directs different information to customers in each category, the suitability analysis is more complex and requires more facts to make the correct determination.

2. **Best Execution**. In the wake of technological changes, the introduction of the Order Handling Rules[3/] and increased individual participation in the markets, broker-dealers have requested guidance as to how to fulfill their duty of best execution (*i.e.*, the broker-dealer's duty to seek the most advantageous terms reasonably available under the circumstances for a customer's transaction) in the changing environment.

[3/] *See* Securities Exchange Act Release No. 37619 (Sept. 6, 1996), 61 Fed. Reg. 48290 (1996) (adopting release for Order Handling Rules).

a. *Evaluating Execution Quality*. The Unger Report reiterates the continuing need for broker-dealers to carry out a regular and rigorous evaluation of execution quality to ensure that they are meeting their best execution obligation. In doing so, the Unger Report suggests that broker-dealers may legitimately take into account the speed and certainty of execution in addition to price. The Unger

Report recommends that the online firm demonstrate the relative importance of factors such as speed and certainty of executions in its order routing decisions.

b. *Requiring Market Centers to Release Execution Information*. In carrying out their evaluations of execution quality, brokerage firms report difficulties in obtaining comparable information from the market centers. Therefore, the Unger Report recommends that the Commission consider requiring market centers to make publicly available certain uniform information on various best execution factors, such as price improvement rates and order turn-around times.

c. *Broker-Dealer Disclosure of Execution Practices*. Because execution quality and transaction costs other than commission rates are increasingly viewed as competitive factors among broker-dealers, the Unger Report recommends that broker-dealers regularly provide their customers with plain English information about (1) execution quality available on different market centers; (2) the broker-dealer's order handling practices; and (3) the broker-dealer's receipt of inducements for routing order flow.

d. *New Order Routing Technology*. The Unger Report describes new, emerging order routing technology, including (1) algorithm-based order-by-order routing (as distinguished from the current aggregate routing of retail order flow) and (2) customer directed routing. The Unger Report recommends that the Commission evaluate how these emerging technologies may affect the duty of best execution and suggests that these issues of best execution be addressed in the Commission's upcoming concept release on market fragmentation.

3. **Market Data.** The roundtable participants generally agreed that, because of the rise in Internet-based trading, the pricing model for delivering real-time market data to individual investors should be re-evaluated. The Unger Report recognizes that any changes to the market data pricing scheme must balance various competing concerns, including (1) individual investors must have access to real-time data to make informed investment decisions; (2) currently, SROs are heavily dependent on market data fees as a source of funding for their oversight functions; and (3) in general, the industry must meet the costs of creating and maintaining an appropriate infrastructure to collect and disseminate market data. The Unger Report recommends a broad review of the current scheme for the generation, distribution and pricing of market data by way of the Commission's upcoming market data concept release.

4. **System Capacity.** The Unger Report notes that the various trading delays and outages experienced by online firms during recent periods of tremendous growth have heightened regulatory concern as to whether online firms are maintaining sufficient operational capacity. Because each firm currently addresses capacity issues in its own way -- with varying degrees of effectiveness, the Unger Report recommends various methods for ensuring adequate capacity, including the following:

    a. *Contingency/Backup Planning.* All firms should maintain contingency and backup plans that are periodically tested and re-evaluated to ensure that they continue to be adequate.

    b. *Periodic Testing.* All firms should regularly test their systems to evaluate the systems at maximum capacity.

    c. *Recordkeeping.* The Commission should consider requiring all firms to keep records of significant outages as well as records of their efforts to evaluate their systems capacity.

    d. *Operational Capability Rule.* The Unger Report recommends reproposing Rule 15b7-2,[4/] the operational capability rule, which would require registered broker-dealers to have and maintain sufficient operational capability to perform the range of services normally rendered to their clients.

    e. *Disclosure.* In new account documentation, all firms should make clear and prominent, plain English disclosures of the potential for periodic delays and outages.

5. **Investor Education.** The Internet, which provides investors with access to financial information, low commissions and self-directed trading, has shifted control from registered representatives to the individual investor. To use these tools and realize the cost savings of disintermediation effectively, the individual investor must know and understand the intricacies of investing online. The roundtable participants agreed that, despite some attempt by the Commission and members of the industry to educate investors, greater educational efforts are needed. To address the need for a better informed investor, the Unger Report recommends the following:

    a. *Additional Online Education.* The Commission should further develop the investor education section of its website. Similarly, firms should develop their own online investor education materials.

[4/] *See* Securities Exchange Act Release No. 41142 (Mar. 11, 1999), 64 Fed. Reg. 12128 (1999) (proposing release for Rule 15b7-2).

b. *Study of Best Methods for Educating Investors*. The Commission should study online activity to determine the best place and time to educate investors on the Internet.

6. **Online Discussion Forums.** Another issue explored in the roundtable discussions involved the responsibilities of issuers and broker-dealers for securities-related online discussion forums, such as chat rooms or bulletin boards. Concerns arise with these chat rooms because online participants may be unable to differentiate among accurate information, unsubstantiated opinion or rumors and fraudulent misstatements. The possible legal and reputational liability resulting from the dissemination of inaccurate or fraudulent information has made most broker-dealers reluctant to sponsor online discussions. In addition, anecdotal evidence suggests that chat room communications -- accurate or otherwise -- may cause stock price volatility. Therefore, issuers often monitor online discussions concerning their stock, but refrain from addressing rumors for fear of creating a continuing duty to correct or update.

a. *Broker-Dealer Sponsored Online Discussion Forums.* Although the roundtable participants generally disapproved of broker-dealer sponsored online discussion forums, the Unger Report does not recommend that the practice be prohibited. Instead, because broker-dealer sponsored forums may provide some benefit, the Unger Report encourages broker-dealers that do host online discussion forums to consider adopting certain best practice guidelines, including: (1) requiring participants to register; (2) encouraging participants to disclose their stock position; (3) monitoring the online discussions; (4) using notices to advise investors not to rely on online discussions as their primary source of investment information; and (5) disclosing the identity and professional experience of the event leaders.

b. *Chat Rooms and Stock Volatility*. The Unger Report encourages the Commission and/or other interested researchers to study the relationship between online postings and stock volatility to confirm or deny the anecdotal evidence and to provide a basis for any further regulatory response.

7. **Privacy.** Recent studies of Internet users suggest that consumers are concerned about the confidentiality of their financial information, even though few investors have complained to the Commission staff about perceived invasions of privacy. Such concerns have increased with the development of online data mining capabilities and the growth of financial conglomerates. As discussed further below, the Unger Report suggests that the Commission collect and analyze information about privacy practices of broker-dealers.

a. *Information Collection Practices*. A survey of the privacy policies of broker-dealers reveals that the content of the privacy disclosures vary greatly. Therefore, the Unger Report recommends that the Commission obtain and evaluate the information collection practices of online firms.

b. *Gramm-Leach-Bliley Act.* In adopting the Gramm-Leach-Bliley Act, the recent financial modernization legislation, Congress strongly debated the Act's privacy provisions regarding the use and disclosure of customers' financial information. In addition to requiring the Commission and other regulators to adopt specific privacy rules, the Act also requires the regulators to issue jointly a report on the state of privacy regulation in the United States. In preparing that study, the Unger Report recommends that the Commission consider (1) data gathering practices of online firms; (2) any burdens that firms would incur by letting customers opt out of information sharing; and (3) any customer complaints regarding firms' collection practices.

8. **Portals.** The roundtable discussions also focused on how broker-dealers currently compensate Internet portals, like AOL and Yahoo, for directing traffic to the broker-dealers' web sites and how broker-dealers would prefer to compensate them. Under the current regulatory scheme, if a portal is deemed to receive transaction-based compensation (*e.g.,* a fee for every completed securities transaction generated by the portal's site), the portal would have to register as a broker-dealer. To avoid the registration requirements, broker-dealers currently compensate portals by paying a flat, up-front fee or nominal fee per order transmitted through the portal. However, broker-dealer participants would prefer to compensate portals based on the success of their advertising, measured in accounts opened or transactions completed. Because technology allows portals and online firms to measure the success of Internet advertising with a high degree of specificity, the Unger Report recommends that the Commission reconsider the types of permissible compensation arrangements between broker-dealers and unregistered entities.

II. The New York Attorney General's Online Trading Report

In response to complaints received by its office related to online trading and general public concern about the online brokerage firms' outages, the New York Attorney General's Office initiated an extensive nine month inquiry into the practices of online brokerage firms and set forth its findings in its report "From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry" ("Trading Report"). As described in more detail below, the Trading Report identifies several factors that contribute to online brokerage performance problems and investor dissatisfaction and makes recommendations to the industry and investors on how to address these issues.

1. **Causes of Slowdowns and Outages in the Online Brokerage Industry.** As the Trading Report describes, online trading activity over the past year has skyrocketed. This explosive growth, paired with the tremendous volatility associated with Internet stocks, resulted in a rash of slowdowns and outages at the online trading firms. The Trading Report describes the following developments as significant contributing factors to the problems experienced by the

online firms:

a. *Advertising.* Online brokerage advertising budgets have ballooned over the past two years, generating a significant increase in trading volume and the number of customer accounts. The online firms were unprepared for the surge in demand created by the ad campaigns.

b. *Technological Deficiencies.* The Attorney General's review of the online trading firms' information systems and technology identified potential deficiencies in each major component of their systems. Each trading system comprises numerous complex components, any one of which can become a bottleneck that constrains the firm's overall ability to accommodate customer demand. Specifically, the Trading Report notes

- Deficiencies in the "front end" component that provides the web interface used by online customers;
- Deficiencies in the "middleware" component that routes messages back and forth between the front and back ends of the system;
- Deficiencies in the "back end" component that controls order routing, the vetting of trade orders and maintenance and updating of customer accounts;
- Limitations in the back-up systems that could adversely affect the firms' ability to function in the event of system failures; and
- Inadequate access to customer support that is critical when the systems are delayed or down.

c. *Constraints on Firm Capacity.* The Trading Report recognizes that online firms may solve many of their current problems by increasing capacity. However, the Trading Report identifies a number of structural constraints on increasing firm capacity, including the following:

- Use of mainframe computer systems originally designed for use by the brokers -- not high speed use by the customers themselves on the basis of 24 hours, 7 days a week;
- Limitations on scalability (*i.e.*, the ability to grow as customer demand increases);
- Physical limitations, including adequate space, power and cooling needs; and

- Difficulty in hiring and training technical staff.

d. *Actions Taken by Firms in Response to Technological Deficiencies.* In addition to technological deficiencies, certain actions taken by online firms in response to capacity issues -- which often were not adequately disclosed to customers -- exacerbated the slowdowns and outages. Some of these actions discovered in the course of the inquiry include the following:

- One firm blocked online orders for certain high volume securities and required those orders to be placed by telephone in order to slow the order flow;

- One firm believed that some investors were inappropriately using order modifications and cancellations during periods of heavy trading. Therefore, the firm disabled the on-screen buttons, thereby preventing all online customers from canceling or modifying their orders;

- Many firms do not update customer account information to reflect the day's transactions until market close. Because the account's buying power, portfolio value and other information is outdated, investors at times made purchases that exceeded their margin buying power or other account limitations;

- Some firms utilize touch-tone telephone trades as an alternative means for submitting orders when the firm's website is down. However, because the touch-tone orders often follow the same technological route as online orders, the touch-tone order may not be executed for the same reasons as the online order; and

- During periods of heavy trading, one firm would reduce the number of "ports" available for the order entry process, thereby slowing the flow of orders by preventing some customers from completing the order entry process in a timely manner.

2. **Recommendations to the Online Brokerage Industry.** The Trading Report recommends that the following actions be taken to facilitate the responsible growth of online investing:

a. *Technology Disclosure Requirements.* The Trading Report suggests the implementation of new technology disclosure standards for online broker-dealers, which would allow for "apples-to-apples" comparisons of technology performance, customer services and technology development processes, preferably through a combination of standardized self-reporting and independent third party reviews.

b. *Quality Assurance Processes.* The Trading Report also recommends that firms assess and improve their quality assurance processes, perhaps using models widely recognized in the computer industry, such as CMM or ISO 9000.

c. *Improved Disclosure of Certain Events.* The Attorney General believes that online broker-dealers should improve the disclosure of the risks and limitations of online trading, thus allowing investors to make educated decisions in choosing a brokerage firm and to trade successfully online. In particular, the Trading Report states that firms should

- Promptly inform online investors of any outages, delays and other downtimes in a clear and prominent fashion on the firm's website;

- Remind customers of heightened margin requirements of certain stocks at the time of order entry;

- Describe order cancellation procedures at the time of order entry to avoid order entry errors;

- Inform customers of unusual market conditions, like extreme volatility, which may affect how the customer trades;

- Warn the investor that a particular trade will exceed the buying power of the investor's account; and

- Seek to dispel investor misconceptions, by clarifying that (1) online trades are not sent directly to markets, but rather must pass through the brokerage firm procedures first; (2) account updates are not instantaneous; and (3) market orders, as opposed to limit orders, may expose investors to significantly greater liability in fast moving markets.

d. *Proposed Regulatory Requirements.* The Trading Report recommends that the Commission and SROs consider adopting requirements regarding the documentation and retention of system outage information, system performance standards and customer service data. Furthermore, the regulators may want to consider (1) requiring an effective and accountable process for online brokerage capacity and planning; (2) providing further guidance regarding the disclosure of online capacity and reliability; and (3) mandating disclosure of online brokerage spending on information systems technology.

3. **Recommendations to Investors.** The Trading Report identifies a significant gap between the expectations of online trading customers and the services the firms provide and suggests that the misconceptions are fueled, in part, by the aggressive advertising campaigns of online

firms. The Attorney General believes that the answer to the expectation gap is consumer education and suggests educating investors regarding the following misconceptions in particular:

- C Investments are not sound merely because they are easy to make online;

- C Making a trade with a click of the mouse is not the same as executing a trade because investors are not directly connected to the markets. An online investor merely places a trade in the firm's trading system, and then the order must navigate several market layers before it is executed;

- C Day trading may be a good strategy for some investors. However, making long-term, sound investments is still the best course for most investors;

- C Speed, access and reliability of online services are dependent on system availability; and

- C Trading fees may be more complicated and expensive than they appear. Investors should carefully investigate the costs associated with online trading.

4. **Attorney General's Plan of Action.** The Attorney General plans to pursue certain additional industry and educational initiatives, including the following:

   a. *Investor Education and Industry Initiatives*. Working with the Securities Industry Association ("SIA"), the Attorney General plans to

      - C Form an Online Brokers Committee composed of senior legal counsel of the top online firms and dedicated to discussing and addressing the particular issues confronting online brokers;

      - C Post SIA educational materials on its website and encourage online firms to do the same;

      - C Disseminate advertisements for educating investors in major newspapers.

   b. *Assessing Investors' Attitudes and Needs.* In an effort to assess the knowledge of online investors and the effect of existing advertising and educational materials, the Attorney General may consult with a research group to study the present state of investor understanding of the processes and technology risks of online trading.

   c. *E-Commerce Roundtables.* The Attorney General proposes a series of roundtables on the e-commerce issues raised in the Trading Report. The roundtables will include representatives from the Commission, SROs and other regulators as well as the online brokerage industry, relevant experts and other interested parties. Possible topics include

- The content, preparation and independent review of periodic information services reports for technology dependent firms;
- The value of an independent assessment of a firm's quality assurance profiles;
- A common framework of performance metrics for e-commerce firms; and
- Investor knowledge of various online trading issues.

******

If you would like a copy of the reports or have any questions, please call Brandon Becker (202-663-6979), Soo Yim (202-663-6958) or Cherie Macauley (202-663-6855).

WILMER, CUTLER & PICKERING

2445 M Street, N.W.
Washington, D.C. 20037-1420
Telephone: (202) 663-6000
Facsimile: (202) 663-6363

Securities Practice Group

Philip D. Anker
Brandon Becker
Stephen F. Black
Joseph K. Brenner
Mark D. Cahn
Richard W. Cass
Bruce E. Coolidge
Meredith Cross
Charles E. Davidow
Robert F. Hoyt
Michael R. Klein
Yoon-Young Lee
Lewis Liman
Eric R. Markus
Robert B. McCaw
William McLucas
Eric J. Mogilnicki
Thomas Mueller
Jeremy N. Rubenstein
Stephen H. Sachs
Marianne K. Smythe
Andrew N. Vollmer
Harry J. Weiss
Andrew B. Weissman

Robert G. Bagnall
Matthew Chambers
Leon B. Greenfield
Jeffrey E. McFadden