

Securities Sites and Online Trading Become Regulatory Priorities

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Issues faced by regulators include the validity of electronic signatures, disclosures required in online trading, whether hyperlinks are regulated with the documents in which they are embedded, what obligations online sites have to day traders, when offers to buy can be accepted in IPOs, what capacity must be provided for online trading given the high volumes that occur in times of volatility, and who may receive what information about customers. Inconsistencies between the U.S. and other national and regional regulators will also have to be addressed in the coming years.

Though regulation of electronic transactions must begin with an analysis of regulation of paper transactions, the pace and invisibility of the electronic environment has created conceptual challenges for the drafters in the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). In addition, the self-regulatory organizations and the industry associations have vied in providing frameworks that will allow participants to function without unnecessary interference.

Customer Agreements, Consents and Account Opening Disclosures

As to futures transactions, electronic signatures are permitted for customer agreements, required disclosure consents, and other documents where signatures were previously required.¹ Neither the CFTC nor the National Futures Association (NFA) specifically mandate customer agreements. They do, however, mandate customer acknowledgment of margin disclosures and agreements to certain practices, such as fund transfers. All of these consents and acknowledgments may be effected electronically.

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¹ CFTC Rule 1.4, 17 C.F.R. 1.4.

The CFTC permits electronic delivery of monthly statements, confirmations, and purchase and sale statements, but only if the customer first consents, electronically or in writing, to receive the documents electronically. Certain institutional customers—"eligible customers"—may also orally consent to electronic receipt of documents in lieu of consenting electronically or in writing. The required disclosures include:

1. Electronic medium or source for delivery.
2. Period of the consent's effectiveness.
3. Information to be delivered.
4. Cost for electronic delivery.
5. Customer's right to revoke.

These disclosures may be in either a customer agreement or by a separate consent. The consent may be by electronic means.²

Customer contracts executed in the U.S. are controlled by state law. In the past, execution of contracts by electronic signature in lieu of handwritten signature was permitted in some states, but its legal status was unclear in many states. For example, it was unclear whether a choice of law provision in a customer agreement specifying a state where electronic execution of a contract is permitted would bind a customer residing in another state. For this reason, most Futures Commission Merchants ("FCMs") have required handwritten signatures to customer agreements. To open an account, the customer agreement, consents and disclosures are usually displayed at the FCM's website where the customer may download, print out, execute manually the customer agreement and mail it to the FCM before commencement of trading. However, with the recent enactment of the Electronic Signatures in Global and National Commerce Act ("Electronic Signatures Act"), signed by President Clinton on June 30, 2000, it is likely that, in the future, more and more FCMs will permit the on-line execution by electronic signature of the customer agreement and other documents necessary to open customer accounts.

The SEC permits electronic consent and disclosures provided that the consent is informed, meaning that certain disclosures must be first made, which include:

1. Electronic medium or source by which the information is to be delivered.
2. Period during which the consent will be effective.

² See Distribution of Risk Disclosure Statement by Futures Commission Brokers and Introducing Brokers, 63 F.R. 8566 (February 20, 1998); CFTC Advisory: Alternative Method of Compliance with Written Record Requests, 62 F.R. 7675 (February 26, 1997), corrected 62 F.R. 34165 (June 25, 1997).

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3. Information to be delivered.
4. Potential cost associated with electronic delivery, such as online charges.

All of these disclosures may be made on the broker-dealer's website or other electronic medium. The SEC has provided specifically that the following consents or disclosures may be made electronically:

1. Consent to hypothecation (Rule 3c-1 and Rule 15c2-1).
2. Option disclosure (Rule 9b-1).
3. Order flow and order routing (Rule 11Ac1-3).
4. Certain municipal securities activities (Rules 15c1-5, 15c1-6 and 15c2-12).
5. Confirmations (Rule 10b-10).
6. Margin disclosures (Rule 10b-16).
7. Financial and other information (Rule 15c2-1).
8. Insurance premium funding (Rule 15c2-5).
9. Notification of free credit balance (Rule 15c3-2).
11. Repurchase agreement consents and confirmations (Rule 15c3-3).
12. Broker-dealer financial positions (Rule 17a-5).
13. Penny stock (though penny stock disclosures can be delivered electronically, a written consent is required) (Rules 15g-3 through 15g-8).³

Recently the SEC released an interpretive statement permitting broker-dealers to obtain consent to electronic delivery on a "global multiple issuer basis." This new release also clarifies that a PDF format is acceptable as long as investors are provided instructions on the use of PDF and the necessary software without cost. The SEC also confirmed that telephone consent was a form of permitted electronic consent so long as an "appropriate" record of the same was retained.

The SEC's recent release emphasized that *a consent provision buried in a customer agreement* would not be an informed consent. The SEC release suggested either a separate disclosure or a highlighted separate section in a customer agreement with a separate signature line. The release takes the position that if a global consent is a condition of opening an account, the consent would not be an "informed" consent. This position

³ See Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisors for Delivery of Information, Release No. 33-7288, 61 F.R. 24646 (May 15, 1996); SEC Final Rules: Use of Electronic Media for Delivery Purposes, Release No. 33-7289, 61 F.R. 24652 (May 15, 1996); SEC Interpretation: Use of Electronic Media for Delivery Purposes, Release No. 33-7233, 60 F.R. 53457 (October 13, 1995). See also NASD Notice to Members 98-3 (January, 1998).

seems to be at odds with another statement in the release that an issuer can require a consent to electronic transactions as a condition to doing business if the consent was revocable. The SEC again makes clear that a customer may revoke a consent to receive documents electronically at any time.⁴

Although the SEC permits electronic signatures, most broker-dealers have required a handwritten signature for account and other agreements. Currently, many broker-dealers have their agreements on their websites with instructions for printout, completion and return by mail. As discussed above, with the recent passage of the federal Electronic Signatures Act, it is likely that at least some of these broker-dealers will permit the on-line execution by electronic signature of their customer agreement and other documents necessary to open customer accounts.

Confirmation and Account Statement Delivery

As to futures, the CFTC and the NFA permit electronic delivery of monthly account statements, confirmations and purchase and sale statements, provided a customer has consented electronically or in writing (orally if an institution) and various disclosures have been made as described in above.⁵

As discussed above, for securities, the SEC permits use of electronic means to deliver customer confirmations and account statements and other documents. The SEC requires customers to consent electronically or otherwise on a revocable basis, subject to the disclosures discussed above.

Online Disclosures

The CFTC has extensive risk disclosure and other disclosure documents that are required in connection with the opening of accounts and a variety of transactions. These same disclosures must be made to online customers. Further, many futures firms that have online trading available through a website provide additional disclosures involving the potential for system failure, capacity limitation, execution risk, quotation delays and price reporting delays. A uniform disclosure for online trading has been developed by the Futures Industry Association (FIA). The uniform disclosure of the FIA is supplemented by many firms with additional disclosure and an online service agreement.⁶

⁴ See Use of Electronic Media: Interpretation and Solicitation of Comments, Release Nos. 33-7856 and 34-42728, 65 F.R. 25843 at 25845 (May 5, 2000).

⁵ CFTC Rule 1.4, 17 C.F.R. 1.4; CFTC Advisory, Alternative Method of Compliance with Requirements for Delivery and Retention of Monthly Confirmations and Purchase and Sale Statements, 62 F.R. 31507 (June 10, 1997).

⁶ These disclosures have been generated to a large extent by the aggressive positions of the SEC and the NASD discussed below. CFTC Rule 1.4, 17 C.F.R. 1.4. See also

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As to securities, the SEC and the NASD advised, urged and have come close to mandating that broker-dealers make specific online disclosures to customers trading online, even if the firm does not recommend any securities or type of trading. Suggested disclosures include:

1. Potential for loss, particularly if there is frequent in and out trading.
2. Capacity limitations of the system.
3. Alternative communications system for execution and problems.
4. Potential for failure of the system.
5. Types of orders and how they function.
6. Execution delays and risks.
7. Quotation and pricing delays.
8. Execution of orders for new issues.
9. Types of risks involved in margin, short selling, and day trading.

Some firms have warnings that pop up on a customer's screen regarding certain types of transactions.⁷ The NASD Regulation has emphasized improper disclosure and advertisements regarding electronic trading and day trading in a recent NASD publication.⁸ The NASD warned member firms against exaggerated and unwarranted statements in the following areas:

1. A customer's ability to access particular markets.
2. References to fast or instantaneous executions must be balanced with disclosing that there may be delays and that the system may go through filters.
3. An adequate discussion of risk and costs associated with a high volume of trades.
4. Incomplete comparisons of day-trading costs compared with other forms of securities trading at other firms.

Online Approval of Accounts

The CFTC and the NFA appear not to have issued interpretive releases with respect to online approval of accounts. A number of FCMs follow SEC procedures. The NFA staff has indicated that online approval is permitted.⁹

CFTC Rules, Distribution of Risk Disclosure Statement by Futures Commission Merchants and Introducing Brokers, 63 F.R. 8566 (February 20, 1998).

⁷ See NASD Notices to Members 99-32 (day trading), 99-33 (margin disclosures), 99-11 (price and volume volatility and execution risk), and 98-102 (calculating margin for day trading).

⁸ NASD Regulation, Inc. Regulatory and Compliance Alert, pp. 7-8 (NASDR Spring 2000).

⁹ See David and Roth, "Supervisory Procedures for Electronic Communication," FIA Law and Compliance (May 6, 1999).

Online electronic signatures for approval of accounts by supervisors are permitted by the NASD.¹⁰ Under NASD Rule 3110(c) and (d),¹¹ the system must:

1. Have adequate security and be restricted to authorized employees.
2. Must monitor current written procedures and policies at each site using the system.
3. Must allow NASD and their regulatory staff immediate access to records.
4. Must have indexing and cross-reference.
5. Must maintain records as requested by the SEC.
6. Must be able to download and print all documents.

The firm must renew and test systems periodically (at least once a year) to be certain the system operates as designed and meets the requirements of 1 through 6 above.

Online Supervision

FCMs and Introducing Brokers (IBs) have the same duty to supervise online trading as they do off-line trading. The risk of churning and unauthorized trading is significantly less for firms that do not make recommendations and all trading is online. However, if the FCM provides research—particularly targeted research—to customers based on their trading profile or investment information, there may be an indirect recommendation and the advertising and promotional rules apply.¹²

Electronic systems provide compliance and supervisory personnel the ability to electronically supervise by creating filters to prohibit certain types of transactions for certain accounts, real time account analysis, warnings to personnel of possible churning or unauthorized trading, and other exception reports. Sophisticated electronic systems provide excellent tools for compliance analysis by supervisors and compliance personnel.

Online broker-dealers have the same duty to supervise as any other broker-dealer.¹³ Most online broker-dealers do not make explicit recommendations to their customers. *However, the SEC and the NASD appear to be taking the position that targeted research to a customer based upon a customer's past trading, request for information or investment profile*

¹⁰ See NASD Staff Interpretation on Use of Electronic Signatures.

¹¹ November 26, 1997.

¹² NFA Rule 2-29. See also NFA Compliance Rule 2-9: Supervisory Procedures for E-Mail and The Use of Web Sites, NFA Manual ¶9037 (August 19, 1999).

¹³ See NASD Notice to Members 98-11 (January 1998).

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*may be a type of solicitation and recommendation.*¹⁴ The SEC and the NASD have also taken the position that recommending particular styles of trading, such as day trading, may involve a suitability obligation.¹⁵ Online brokers must have a system of supervisory and compliance procedures to monitor all online trading. Electronic systems can provide review tools for supervisors through filters, exception reports and warnings.

Placement and Execution of Orders

To satisfy the CFTC Rule regarding written recordkeeping electronic order entry systems must satisfy a number of requirements, including recording the required data and order-related times (entry, execution and exit) to the highest level of precision, but at least to the second.¹⁶ The CFTC and futures SROs generally have uniformly required electronic order placement and execution systems to meet audit trail, recordkeeping, and other security concerns. The CFTC's position in the release dealing with confirmations and account statements seems to indicate that a customer must execute, in writing or electronically, some sort of customer agreement or consent to electronically trade before placing orders through an electronic communication media.

Agreements between an FCM and customers regarding electronic order execution generally include special provisions as to use of system license, security, errors, risk of system failure and various other issues unique to electronic order entry and execution. Some FCMs use a supplement to the customer agreement; others use a separate online services agreement. Because of state law concerns and the CFTC position, many firms require a written signature to a customer agreement, including agreements regarding electronic placement and execution of orders.

Electronic placement and execution of orders is not precluded by any SEC or securities SRO constraints. These regulators, like the futures regulators, have required as a condition for approval of electronic executions systems, an adequate showing of audit trail and recordkeeping capability.

New Offerings

While new offerings are not regulated by the CEA, disclosure statements and other client documents of commodity pools and commodity trading

¹⁴ Remarks at National Regulatory Service Fall 1999 Compliance Meeting by Laura Unger (September 14, 1999).

¹⁵ See NASD Notice to Members 99-32 (April 15, 1999) (Proposed NASDR Rules 2360, 2361).

¹⁶ CFTC Rule 1.35, 17 C.F.R. 1.35. See CFTC Advisory: Alternative Method of Compliance with Written Record Requests, 62 F.R. 7675 (February 26, 1997).

advisers may be displayed and/or delivered electronically, provided the customer consents and the required disclosures are made.¹⁷

The structure of the Securities Act of 1933 and the regulations of the SEC and the NASD regarding public and private offerings were not designed for a paperless environment. This has created a number of issues, which the SEC staff has attempted to circumvent or alleviate by interpretations and no-action letters. Numerous firms that rely on those interpretations are using the internet for initial public offerings, secondary offerings, private placements and Rule 144A transactions. Discussed below are some of the key no-action letters.

Public Offerings

The Wit Capital no-action letter provides a framework for conducting an IPO on the internet without violating Section 5 of the '33 Act.¹⁸ Section 5 of the '33 Act permits an *oral* indication of interest without incurring a binding legal obligation prior to the effectiveness of a registration statement. The oral indication is then confirmed after the registration or statement is effective by a confirmation with a final prospectus. Section 5 precludes investors from making a formal written commitment to buy. An electronic indication of interest would thus be a problem if it is an offer to buy into an IPO. The SEC's Wit Capital no-action letter solves this dilemma by a construct developed by the SEC staff. The key provisions in the letter require the following structure for an electronic internet offering:

1. The firm must establish a website cul-de-sac (CDS) for each offering in which it participates with a Rule 135 notice and a *red herring prospectus*.
2. When the red herring prospectus is available, the firm must e-mail customers having an interest, notifying them of the offering and the availability on the website of the prospectus.
3. The CDS website must provide instructions or hyperlink to instructions on how to participate in the offering electronically.
4. *Customers may submit a conditional offer to buy electronically.*
5. Within two business days prior to the expected effectiveness, an e-mail must be sent to a customer who has made a conditional

¹⁷ See CFTC Final Rule Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisors for Delivery of Disclosure Documents and Other Materials, 62 F.R. 39104 (July 22, 1997); Use of Electronic Media by CPOs and CTAs, 61 F.R. 44644 (August 27, 1996); Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisors, 61 F.R. 42146 (August 14, 1996). See also CFTC Rule 1.4 regarding electronic signatures.

¹⁸ Wit Capital [1999] Fed. Sec. L. Rep. (CCH) ¶ 77,577 (July 14, 1999).

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offer, requesting an affirmative reconfirmation, which is binding for five days.

6. The firm then notifies these customers that the registration is effective, but must allow them to withdraw a reconfirmation at any time until the firm accepts it.
7. Most firms require that a participating customer have an account with a specified dollar amount deposited.
8. Firms may allocate shares on a first come/first serve basis or on a basis of other procedures.

Additional procedures are necessary for delayed offerings and recalculation of preliminary prospectuses.

The SEC staff has provided on Section 5 issues arising in online offerings.¹⁹ The SEC's most recent release discusses the general legal principle regarding online public offerings, but leaves the development of detailed procedures to staff guidelines and no-action letters.²⁰ The SEC in their Guidance Notes make it clear that all of the provisions of the Wit Capital no-action letter need not be slavishly followed and that other means of compliance with Section 5 and the '33 Act are possible provided certain concepts that the SEC have articulated in the Guidance Notes are followed.

Conditional Offers To Buy. *E-brokers should not to take conditional offers to buy from prospective investors more than seven days before the offer is accepted.* Acceptance cannot occur until after effectiveness, pricing and a meaningful opportunity to withdraw. If an e-broker does take conditional offers more than seven days before acceptance of the offers—i.e., when an offering is delayed—the conditional offers must be reconfirmed no more than seven days before acceptance. If the deal is delayed or, for whatever reason, the offer is not accepted within seven days, the SEC staff wants e-brokers to obtain new conditional offers to buy or to obtain reconfirmations of the expired conditional offers to buy. E-brokers must notify customers and obtain new conditional offers to buy or reconfirmations of prior conditional offers to buy if (1) there is a material change in the prospectus that requires recirculation; (2) the offering price range changes pre-effectively; or (3) the offering prices outside the range.

Offers to buy must be conditioned upon the following steps and cannot be accepted by e-brokers until each step occurs:

¹⁹ Section 5 – *Issues Arising From On-Line Offerings and Related Communications, Inc., Including Offers to Buy, Current Issues and Rule Making Projects of the Division of Corporation Finance*, pp. 28-29 (SEC April 13, 2000).

²⁰ See *Use of Electronic Media: Interpretation and Solicitation of Comments*, Release Nos. 33-7856 and 34-42728, 65 F.R. 25843 at 25851 (May 5, 2000).

1. The registration statement is declared effective.
2. Customers are given notice, before or after pricing, of effectiveness after the registration statement is declared effective.
3. Customers must be given a meaningful opportunity – *at least one hour* – to withdraw their offers to buy between the notice of effectiveness (or notice of pricing) and acceptance of the offer to buy.
4. The offering must price before offers are accepted.
5. The offering must price within the customer's range and the range in the preliminary prospectus or the e-broker must receive affirmative confirmations of conditional offers to buy at the revised price; and
6. Customers must be able to withdraw their offers to buy at any time up to notice of acceptance.

A preliminary prospectus that omits required information does not comply with Section 10. An offer to sell, a solicitation of an offer to buy, or solicitation of a written indication of interest by means of a prospectus that does not comply with Section 10 would violate Section 5. Similarly, the SEC staff has taken the position that brokers may not rely on the safe harbor of Rule 134 if a prospectus that complies with Section 10 is unavailable.

Certification Of Having Read Prospectus. The SEC staff has taken the somewhat strange position that *e-brokers should not require prospective investors to certify that they have read the prospectus before these investors can give indications of interest or make conditional offers to buy.* Although encouraging customers to read a prospectus should be encouraged by the staff, the staff is apparently concerned that the certification could induce investors to believe that they have waived rights under the securities laws. *Wording that encourages investors to read the prospectus is permitted but not if it requires investors to certify that they have read the prospectus.* In addition, certification that investors have accessed or received the prospectus is acceptable.

Also, *e-brokers may not require any part of the purchase price to be paid before effectiveness.* However, brokers may require new customers to make a small deposit to open an account, but this amount cannot be restricted in any way to the purchase price of the securities. In most cases, this amount is \$2,000. Funds in the account must remain in the control of the customer at least until his or her conditional offer to buy is accepted after effectiveness and pricing. Also, funds in any account cannot be earmarked for the purchase of securities in any particular offering before effectiveness.

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Continuous Offering

The SEC, in October 1995, proposed rules and released a significant interpretation regarding the use of electronic media for delivery of prospectuses and other information for continuous public offerings of securities.²¹ These releases have been relied on by mutual funds and others to provide online electronic sale and redemption of mutual funds and other securities. The issuer, or in most cases a broker-dealer, has a website listing products offered. To purchase a particular fund or security, the customer must complete an application, scroll through, download or otherwise indicate review of a prospectus and either complete the application or register online and then mail or wire-transfer the funds. The customer can consent to electronically receive annual reports, proxy statements and other required shareholder communications subject to revocation as explained above.²²

Hyperlinks

*A recent SEC release states unequivocally that a hyperlink embedded in a prospectus or in any other document required to be delivered under the federal securities law is part of the document notwithstanding clear disclosures to the contrary.*²³ *This same release, however, states that information on a website in close proximity to a public offering document does not by itself make the information an offer to sell within the federal securities law.* The recent release emphasizes that material on a hyperlinked site from an issuing site may be an "offer to sell," "offer for sale," or "offer."

Electronic Road Shows

The SEC has permitted electronic road shows in connection with public offerings to institutions and certain analysts, but the SEC does not allow broad dissemination of road shows electronically to the retail public. Re-

²¹ Later, the SEC provided further guidance. See Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisors for Delivery of Information; Additional Examples Under the Securities Exchange Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940, Release No. 33-7288, 61 F.R. 24646 (May 15, 1996); Use of Electronic Media for Delivery Purposes, Release No. 33-7289, 61 F.R. 24652 (May 15, 1996); SEC Interpretation: Use of Electronic Media for Delivery Purposes, Release No. 33-7233, 60 F.R. 53457 (October 13, 1995).

²² For details regarding a Rule 415 shelf offering, see Mortgage and Asset-Backed Securities [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,941 (May 20, 1994).

²³ See Use of Electronic Media: Interpretation and Solicitation of Comments, Release Nos. 33-7856 and 34-42728, 65 F.R. 25843 at 25846 (May 5, 2000).

cently, the SEC has reinterpreted and, for all practical purposes, restricted the broader interpretations of some of the earlier no-action letters.²⁴

Private Placements and Rule 144A Placements

The private nature of private placements and Rule 144A offerings place some limitations on use of the internet in connection with these offerings. Nevertheless, the SEC staff, by no-action letters, has established procedures for private placements and 144A offerings that are effected through a website. These no-action letters generally require that an individual or institution wishing to participate in unidentified prospective offerings must pre-qualify for private placements as a "accredited investor" or, for Rule 144A offerings, as a "qualified investor." *Once qualified, an investor, by its password, may access a broker-dealer's website that links the investor to a particular offer or a limited number of suitable offers.*²⁵ The effectiveness of a legal signature on private placements or 144A documentation electronically is permitted by the SEC, but may not meet state law requirements for limited partnership agreements or other agreements where a written signature is controlled by state law.

In the SEC's recent release, the SEC reminded private offerors that online private offerings must not constitute a general solicitation. Importantly, the SEC made clear that private placement website activity must be conducted by a broker-dealer in almost all cases. The only exception would be issuer offerings meeting the issuer exemption, but in most cases, such an issuer offering would necessarily involve a general solicitation.²⁶

Capacity Issues

The futures exchanges and the CFTC have begun to focus on capacity issues of electronic order execution systems and disclosures regarding the

²⁴ See Charles Schwab & Co., Inc., Fed. Sec. L. Rep. (CCH) ¶ 77,650 (Nov. 15, 1999); Thompson Financial Services, Inc., SEC No-Action letter, 1998 SEC No-Act. LEXIS 837 (Sept. 4, 1998); Net Roadshow, Inc., [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,412, 1998 SEC No-Act. LEXIS 107 (Jan. 30, 1998); Bloomberg L.P., SEC No-Action letter, 1997 SEC No-Act. LEXIS 1023 (Oct. 22, 1997); Net Roadshow, Inc. [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,367 (Sept. 8, 1997); Private Financial Network, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,332 (Mar. 21, 1997); Charles Schwab & Co., Inc. 2000 WL 146586 (Feb. 9, 2000).

²⁵ See Lamp Technologies, Inc., [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,453, 1998 SEC No-Act. LEXIS 615 (May 29, 1998); Lamp Technologies, Inc., [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,359, 1997 SEC No-Act. LEXIS 638 (May 29, 1997); IPONET, [1996-97 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252, 1996 SEC No-Act. LEXIS 642 (July 26, 1996).

²⁶ See Use of Electronic Media: Interpretation and Solicitation of Comments, Release Nos. 33-7856 and 34-42728, 65 F.R. 25843 at 25851 (May 5, 2000).

same, but not to the extent that the SEC has. The CFTC has concentrated on order entry and execution audit trails and recordkeeping. The futures exchanges have concentrated on developing audit trail information to be recorded and maintained for electronic order routing systems. These procedures are quite complex, but not impossible to meet and some firms have readily adapted.²⁷

The SEC and securities markets have been concerned about capacity limitations of electronic order entry and trading systems for some time because the huge amount of trading on certain days has caused trading disruptions, delays and shut downs. In September of 1998, the SEC, Division of Market Regulation staff issued a bulletin entitled "Staff Legal Bulletin" No. 8 (MR) dealing with capacity disruption and other key market issues.²⁸ These releases discuss the staff's view on handling electronic orders in times of volatility and fast markets. The SEC requires firms with electronic online trading to provide notices on their web page or other disclosures regarding trading halts and the effect on orders. In this release, the SEC also stated that broker-dealers should have adequate capacity to handle average to heavy traffic at multiple, above average trading volumes. *Many broker-dealers with electronic execution capability have had their systems crash because of system problems and lack of capacity caused by high volume, notwithstanding their efforts to enhance their system's capacity.* The NASD has also provided guidance concerning fast market issues.²⁹

In March 1999, the SEC proposed a new rule, Rule 15b7-2, requiring broker-dealers to have and maintain operational capacity for execution and trading systems.³⁰ The proposed rule discusses areas encompassed within the definition of operational capability and capacity, and articulates many of the things that should be considered. However, the proposed rule did not appear to have any specific standards. It is interesting to note that the proposed rule stated that it is not intended to address the occasional delay or outage. The proposed rule received substantial criticism and, to date, has not been adopted.

²⁷ See for example, Chicago Mercantile Exchange Memorandum, April 21, 1999 regarding electronic compliance with written record requirements and CFTC Regulation 1.35.

²⁸ See Release No. 34-29185, 56 F.R. 22490 (May 9, 1991); Release No. 34-27445 54 F.R. 48703 (November 16, 1989). See also NASD Notice to Members 99-11 (February 1999).

²⁹ See NASD Guidance to Investors Regarding Stock Volatility and Online Trading (January 26, 1999). See also NASD Notice to Members 99-33 (April 1999).

³⁰ Release No. 34-41142, 64 F.R. 12127 (March 2, 1999).

Capacity issues have figured prominently in recent reports reviewing the on-line brokerage business that have been issued by SEC Commissioner Laura S. Unger, New York Attorney General Eliot Spitzer, and the General Accounting Office.³¹ All the reports recommended additional disclosure by broker-dealers regarding capacity.³² In light of the attention which capacity issues have received, it seems likely that issues of regulating additional disclosure of capacity will be revisited.

Day Trading

Day trading has not been a significant issue for remote electronic customer execution of futures transactions because day trading has always been a part of trading in the futures and futures options markets by customers. Furthermore, the mandated risk disclosures regarding futures trading are relatively explicit regarding trading risk and appear on websites. Nevertheless, some of the guidance, proposed rules and warnings by the SEC and the NASD appear to be creeping into online customer electronic execution systems. As a matter of good practice, many retail futures websites for remote online order execution systems have disclosures regarding capacity, fast markets, market functions, types of orders, time delays and quotes. Most firms supplement the FIA uniform disclosure discussed above with additional disclosures and an online service agreement.

Day trading of securities through electronic execution has received an enormous amount of publicity. Most online firms have promoted active trading and some firms have actively promoted day trading by offering instruction on day trading, facilities for day traders, and seminars on the subject. Some of the advertisements have been very aggressive in promoting day trading. A number of national television advertisements have, without explicitly mentioning day trading, implied that active trading can generate huge profits. The number of active day traders has skyrocketed along with complaints of loss to the SEC. Congress, the state regulators, the SEC, and the NASD have reacted as expected, calling for substantial additional regulation.³³

³¹ "On-Line Brokerage: Keeping Apace of Cyberspace," Report of Commissioner Laura S. Unger (November 22, 1999) ("Unger Report"), available at www.sec.gov/pdf/cybrtrnd.pdf; "From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry," Report of the Office of New York State Attorney General Eliot Spitzer (November 22, 1999) ("AG Report") available at www.oag.state.ny.us/investors/1999_online_brokers/full.pdf; "On-Line Trading: Better Investor Protection Information Needed on Brokers' Web Sites," Report of the United States General Accounting Office (May 9, 2000) ("GAO Report"), available at www.gao.gov/new.items/gg00043.pdf.

³² See, e.g., Unger Report at page 5, AG Report at page 187, and GAO Report at page 30.

³³ Report of NASDR Concerning the Advertisement of On-Line Brokerage (September 21, 1999).

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In a series of releases and statements relating to day trading, the SEC and the NASD have strictly interpreted various current rules applicable to online trading. In addition to interpretations of current rules and Notices to Members, *the NASD has proposed two rules regarding day trading, Rules 2360 and 2361.*³⁴ The proposed Rules attempt to characterize certain strategies as a day trading strategy. The rules would apply to broker-dealers that promote day trading. They would apply to new accounts and any other accounts where activity in the account demonstrates a pattern of day trading. This necessarily means that a firm will have to monitor all accounts for a pattern of day trading. *Thus, if a firm promotes day trading strategies, the broker-dealer would have to approve non-institutional customer accounts for day trading based upon reasonable grounds to believe that day trading is appropriate for the customer in view of the customer's circumstances.* Firms would be required to monitor accounts that are not opened as day trading accounts. If such an account showed a day trading pattern, the firm would be required to determine whether day trading strategy is appropriate for the customer. The Rules would require explicit risk disclosures to day trading accounts. The risk disclosure statement would advise the client that:

1. Day trading is not generally appropriate for investors with limited resources, limited experience or low risk tolerance.
2. Day trading is risky and only risk capital should be used.
3. Claims of large profits from day trading should be viewed with caution.
4. In-depth knowledge of the securities markets is required for day trading.
5. Day trading requires understanding of the operations of the execution and clearing firms' policies and procedures.
6. Day trading will generate large commissions and other costs.
7. Day trading on margin or short selling may result in losses beyond the original investment.

Day trading also has raised various margin issues. The SEC, NASD and state regulators have targeted a number of abuses involving arranging credit, cross guarantees, and a variety of other issues involving day traders. The NASD has also reminded members of their obligations regarding short selling and related margin issues during periods of market volatility.³⁵ The

³⁴ See NASD Notice to Members 99-32 (April 1999). The NASD has made various changes as a result of public and SEC staff comment. See Release No. 34-42452; 65 F.R. 11353 (February 23, 2000).

³⁵ See NASD Notice to Members 99-11 (February 1999); NASD Notice to Members 99-33 (April 1999). The NASD provided advice regarding the calculation of margin for day trading and cross-margined accounts. See Notice to Members 98-102 (December 1998).

NASD has also proposed additional margin requirements for particular types of volatile stock.³⁶ The proposed NASD rule has been recently amended by the NASD as a result of SEC staff and public comments.³⁷ Further, the proposed rule defines day trading for margin purposes and imposes additional margin requirements on "pattern day traders" as defined in the rule, including a minimum equity requirement of \$25,000. *Pattern day traders cannot trade equity securities in excess of their "day trading buying power," which is account equity (minus any maintenance margin requirement) times four.*

E-Mail and Customer Correspondence

The NFA has directly addressed electronic supervision of customer correspondence.³⁸ The staffs of both the CFTC and the NFA have made clear that their rules apply to electronic communications. The rules of the CFTC and NFA also regulate electronic communications that constitute promotional material. *Supervisory procedures must include prior review of correspondence to customers constituting promotional material.*³⁹ The CFTC and the NFA requirements for supervisory procedures include review of correspondence to and from customers, even if it does not constitute promotional material. Because of the nature of electronic communication, prior review of all outgoing and incoming e-mail creates special problems. The NFA interpretative notice requires supervisory procedures, but does not specify what procedures are to be employed. The NFA and the CFTC staffs appear to acquiesce in procedures developed by securities regulators which, at a minimum, require *sampling* of all such communications. Software is available to electronically sample and monitor e-mail. The software creates exception reports for those e-mails that meet certain criteria. These procedures are acceptable to the NFA staff. The NFA interpretation also mentions that *all* e-mail to customers is subject to supervision. E-mail outside of an FCM's own communication system is, in most situations, impractical or impossible to monitor. For that reason, most firms prohibit customer's communication outside the firm's own e-mail system.

The SEC has approved rules of the NASD and rules of the New York Stock Exchange for supervising e-mail and other electronic communications with customers.⁴⁰ These rules, in essence, require that a broker-dealer

³⁶ See Notice to Members 99-33 (April 1999).

³⁷ See Release No. 34-42418, 65 F.R. 8461 (February 11, 2000).

³⁸ See NFA Compliance Rule 2-9: Supervisory Procedures for E-Mail and The Use of Web Sites, NFA Manual ¶ 9037 (August 19, 1999); David and Roth, Supervisory Procedures for Electronic Communication, FIA Law and Compliance (May 6, 1999).

³⁹ See e.g. NFA Compliance Rule 2-29 NFA Manual ¶5147.20.

⁴⁰ See SEC Approval of NYSE Customer Communications Rules, Release No. 34-39510, 63 F.R. 113 (January 8, 1998); SEC Approval of Electronic Messaging Rules

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have written supervisory procedures and policies for reviewing different types of electronic communications. The procedures must identify how reviews will be conducted and memorialized. The rules specifically allow procedures to include post-review or audit of communications. *E-mail communications must be preserved and reviews documented.* As discussed above, electronic communication outside a broker-dealer's house system may be difficult or impossible to supervise.

Electronic Promotional Material

The CFTC has not issued a formal announcement regarding websites and promotional material of FCMs. However, the CFTC's releases regarding use of electronic media by commodity pool operators and commodity trading advisers discuss use of websites and information on websites, including the anti-fraud rules of the Commodities Exchange Act, which would be applicable to FCMs and IBs.⁴¹ The position of the staffs of the CFTC and the NFA is that promotional material and any other material displayed on websites is subject to all of the same constraints as any other advertising, promotional material or communications to customers or clients.

FCMs must have written supervisory procedures for websites. The procedures should require documented review and approval of the website and all changes by a supervisor. All updates and changes should be approved in advance. Records should be maintained of each page of the website, all changes, all revisions and approvals. Any personal website designed to attract futures business would be considered a firm website.

The NFA has stated that the existence of a hyperlink from an FCM's site to another website does not in and of itself make the member accountable for the other website. However, the NFA cautions that the member may not hyperlink to a site that the member knows or has reason to know contains deceptive material. The NFA seems to suggest that some review of hyperlinked sites "may be" required from time to time.

The CFTC Division of Enforcement has brought actions against a number of website operators where the website contained false and misleading information regarding futures, futures options and commodities and/or the website operator was not appropriately registered. The CFTC

of the NASD, Release No. 34-3955, 63 F.R. 1135 (January 8, 1998). See also NASD Notices to Members 98-11 (January 1998) and 96-50 (July 1996).

⁴¹ See CFTC Final Rule Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisers for Delivery of Disclosure Documents and Other Materials, 62 F.R. 39104 (July 22, 1997); CFTC Interpretation and Required Rule: Use of Electronic Media by CPOs and CTAs, 61 F.R. 44644 (August 27, 1996); CFTC Interpretation: Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisers, 61 F.R. 42146 (August 14, 1996).

has aggressively pursued the operators of such websites for failure to register as commodity trading advisers, FCMs or IBs, as the case may be, and for any anti-fraud violations.

The NASD has also taken the position that any information that a broker-dealer displays on its website would be subject to its advertising and sales literature provisions. Thus, *if the broker-dealer displays recent press releases or articles regarding a completed IPO or a security it is recommending, those materials would be required to comply with the NASD standards and, if applicable, filing requirements.*⁴² Hyperlinks to research also raise a host of unanswered questions. The SEC and the NASD have been reviewing broker-dealer's websites and banner advertisements. The SEC's and the NASD's review has focused on the following:

- misleading statements that a customer has direct access to a particular exchange or marketplace without recognizing the transaction must go through a broker-dealer filter
- implication that active trading results in high profits
- implication that third-party research is in fact the research of the broker-dealer
- misleading information that an advertised single discount commission would apply to all types of transactions where there are various types of commissions for different types of transactions.

Banner Advertisements. Many broker-dealers have arrangements with internet access providers, such as CompuServe and America Online to have a banner advertising the broker-dealer and its services (web portals). The banners, by their very nature, are extremely short and can contain generally no more than a few words or a trade name at a maximum. This creates a conflict with the affirmative disclosure requirements mentioned above. While the NASD has been understanding in this regard, the broker-dealer's website to which the banner hyperlinks must clearly have the required disclosures. Another issue with respect to banners is the compensation of online service providers. Online payment of transaction base compensation is not permissible. However, by SEC no-action letter, a nominal or flat rate per order (paid regardless of whether the order is ever actually executed) may be provided to an online service provider.⁴³

⁴² Report of NASDR Concerning the Advertisement of On-Line Brokerage (September 21, 1999).

⁴³ See Atkisson, Carter & Akers, 1998 SEC No-Act. LEXIS (Jun. 23, 1998); No Action Letter to Charles Schwab & Co., Inc., 1977 SEC No-Act. LEXIS 920 (Sept. 18, 1997); Charles Schwab & Co., Inc., 1996 SEC No-Act. LEXIS 976 (Nov. 27, 1996).

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Hyperlink to Third Party internet Sites. The NASD has established requirements for hyperlinks, including the following:

1. The hyperlink must be continuously available.
2. A broker-dealer cannot alter the information on a third-party site.
3. A broker-dealer cannot suspend or terminate the hyperlink due to the presentation of unfavorable information (or the absence of favorable information) about the broker-dealer's products and services.⁴⁴

Hyperlinks to third party internet sites for research and other information is problematic for broker-dealers. The problem is the position of the NASD and the apparent position of the SEC that *broker-dealers may not hyperlink to a site that the broker-dealer knows or has reason to know contains false or misleading information*. The NASD and the SEC appear to indicate that broker-dealers must periodically review third-party sites. The frequency of the review and the degree of the review are problematic because by hindsight, if there is a fraudulent site, the broker-dealer is likely to be held liable. The NASD has recently stated in the interpretive letter cited above that a hyperlink to a third-party site, which is intended for use by the public for general reference purposes and which does not refer to a broker-dealer, would not be subject to the NASD advertising, sales literature, or other constraints mentioned above.⁴⁵

The SEC in a recent release addressed the issue of hyperlinks on issuer websites.⁴⁶ The release states that the issuer's responsibility for information on a hyperlinked site depends upon "adoption" of the hyperlink site. Adoption is a circumstances and facts test. The SEC states that three non-exclusive factors should be considered:

- Context of the link.
- Risk of investor confusion.
- Presentation of the information on the website.

Although articulated differently, these tests parallel the NASD interpretation discussed above. If there is an ongoing hyperlink, an issuer, by the very nature of the tests, would have to monitor the hyperlinked site and information on the site. The recent SEC release states:

⁴⁴ See NASDR InterpretationNASDR Interpretive Letter to Craig S. Tyle, Esq. of the Investment Company Institute from R. Clark HooperThomas Selman, NASDR (November 11, 1997).

⁴⁵ *Id.*

⁴⁶ See Use of Electronic Media: Interpretation and Solicitation of Comments, Release Nos. 33-7856 and 34-42728, 65 F.R. 25843 (May 5, 2000).

We are not suggesting, however, that statements and disclaimers will insulate an issuer from liability for hyperlinked information when the relevant facts and circumstances otherwise indicate that the issuer has adopted the information.⁴⁷

If a broker-dealer is "involved" in preparation of material on a hyperlinked website, then broker-dealer would be liable for the content of the hyperlinked material under the "Entanglement" theory. Entanglement is a facts and circumstances test focusing on the amount of involvement with the information on the hyperlink site.

Electronic Exchanges and Contract Markets

The CFTC has recently approved two totally online electronic exchanges having no trading floor.⁴⁸ Access to such exchanges is limited to members as it is on exchanges with trading floor execution. Public customers must execute orders through members and may not directly access the futures exchange. However, a number of FCMs are providing electronic access for their customers directly to the FCM member and then to the electronic exchange. In such cases, electronic filters in the FCM's system block orders outside of credit limits, position limits or other parameters.

Certain U.S. contract markets—the Chicago Board of Trade and the Chicago Mercantile Exchange—have electronic trading markets for certain products during floor trading hours. After floor trading hours, other products traded on the floor during floor trading hours are traded by electronic market (CBOT: Project A) and (CME: Globex). Again, access is limited to members. A number of FCMs that are members have electronic execution facilities for customers that transmit orders directly to such systems. Certain orders may be entered electronically and be transmitted through the FCM directly into a trading pit.

The CFTC has granted limited exemptions from contract market status to certain European electronic exchanges, including Eurex and the London International Financial Futures and Options Exchange.⁴⁹ Again, access is only through members. The CFTC currently has proposals pending to reconfigure its regulation of contract and over-the-counter markets. The CFTC would categorize trading markets named Multilateral Execution Facilities (MTEF) into three categories:

1. Recognized futures exchanges (RFEs).
2. Recognized derivatives transaction facilities (DTFs).
3. Exempt MTEFs.

⁴⁷ Release No. 33-7856, 65 F.R. 25843 at 25849 (May 5, 2000).

⁴⁸ See e.g. FutureCom, Ltd., CFTC Release No. 4378, 63 F.R. 1959 (March 14, 2000); Cantor Financial Futures Exchange Approval Order (September 4, 1998).

⁴⁹ See e.g. CFTC No-Action letter [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,917 (August 10, 1999).

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Each of these categories would be subject to different levels of oversight. A DTF market could be accessed only by "commercial" traders and an exempt MTEF only by institutional traders.

In the securities industry, electronic execution facilities have existed for a number of years. Lately, however, they have evolved into electronic execution systems in which orders interact automatically. The exchanges and Nasdaq for some period of time have had "small" order electronic execution systems for execution of customer orders by specialists or market makers. These systems not permit small orders to interact with each other automatically or to be executed by market makers or specialists. All customer orders have to be entered through a broker-dealer and be electronically routed to the exchange or a Nasdaq market maker. Today on Nasdaq, many orders between market makers on Nasdaq are also executed electronically. Likewise, many broker-dealers execute customer orders through ECN systems or alternate trading systems discussed below.

Effective April 1, 2000, the SEC created a new regulatory scheme for securities markets, including electronic trading markets.⁵⁰ Previously, a trading market was required to be either registered as a national securities exchange, meeting significant regulatory requirements under the '34 Act, or be exempt from exchange registration under the '34 Act. By no-action and interpretive letters, many electronic markets or communication systems were granted exemption from registration as national securities exchanges, but were required to have broker-dealer registration. Further, these no-action and interpretation letters added conditions and restrictions containing some of the provisions that otherwise would be applicable to exchanges.

To provide a new regulatory rationale and scheme, the SEC amended a series of rules relating to exchanges and established a new concept of Alternative Trading Systems (ATSs). In general, the new scheme provides for regulation of national securities exchanges as in the past; however, the term "exchange" is redefined. A new level of regulation is established under Regulation ATS.⁵¹ Electronic trading markets may elect ATS registration or exchange registration. An ATS entity must register as a broker-dealer and comply with the new regulation. Regulation ATS requires notification to the SEC, recordkeeping, fair access and periodic reporting to the SEC and the broker-dealer's self-regulatory organization. For certain securities that are "Covered Securities" (generally listed and NASDAQ securities), real time quote information and executions must be integrated into a national market display mechanism. In-house crossing systems and

⁵⁰ See Release No. 34-40760 63 F.R. 70844 (December 8, 1998).

⁵¹ 17 C.F.R. 240.300 Et seq.

in-house order execution facilities are not required to register as exchanges or ATS facilities. The SEC may require an ATS to register as an exchange if it exceeds certain volume parameters. An ATS may request a hearing and attempt to demonstrate that it should not be required to register as an exchange.⁵²

Regulation ATS is an attempt by the SEC staff to avoid the issuance of numerous no-action letters and provide a coherent scheme for regulation of electronic markets. Some ECNs and electronic execution facilities using algorithms have elected to register as exchanges. *The SEC has recently approved the International Securities Exchange as a wholly electronic exchange regulated as a national securities exchange.*⁵³ Certain ECNs are also seeking to register as national securities exchanges rather than ATS. Others have elected to register as ATS facilities.

Internationally, the SEC has not generally allowed foreign exchanges to operate in the U.S., although their pricing and quote information generally is permitted to be transmitted into the U.S.⁵⁴ *The SEC staff has recently issued a no-action letter to Tradepoint Financial Network PLC, a UK electronic trading market, exempting the exchange from registration.* The SEC letter indicated that the letter is issued because of the limited volume of trading in the U.S. Under the Tradepoint no-action letter, the SEC may require the exchange to register as a national securities exchange if it reaches certain volume thresholds.⁵⁵

Electronic Recordkeeping

The CFTC allows recordkeeping in a digital storage medial (DSM) providing certain conditions are met, which are described in a CFTC release and Rule 1.31.⁵⁶ The FCM must make available upon request to the CFTC or the Department of Justice facilities (1) to display the information stored on optical disk for immediate examination, and (2) on the premises to produce complete, accurate and easily readable hard copy and the means to provide copies of compatible CFTC machine-readable media.

The SEC allows recordkeeping in a DSM providing certain conditions are met, which are described in the SEC's release and Rule 17a-4.⁵⁷

⁵² See Release No. 34-40760, 63 F.R. 70844 (December 8, 1998).

⁵³ Release No. 34-42455, 65 F.R. 11401 (February 24, 2000).

⁵⁴ See Release No. 34-27017, 54 F.R. 30013 (July 11, 1989).

⁵⁵ See Tradepoint Financial Network PLC Order, Release No. 34-41199, 64 F.R. 14953 (March 22, 1999).

⁵⁶ See CFTC Rule 1.31, 17 C.F.R. 1.31; CFTC Release: Recordkeeping [Electronic], 58 F.R. 27458 (May 10, 1993).

⁵⁷ See SEC Rule 17a-4, 17 C.F.R. 240.17a-4; Reporting Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 34-38245, 62 F.R. 6469 (February 12, 1997).

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While language of the rule and the SEC release are somewhat different than the CFTC release, the principles are essentially the same. The SEC requires that files be compatible with the securities regulator's systems.

Privacy Regulations Affecting Electronic Communications

On November 13 of 1999, Congress adopted the Gramm-Leach-Bliley Act.⁵⁸ The privacy regulations under the Act are required to take effect on November 13, 2000. *All financial institutions, including FCMs, will be subject to the terms of the Act regulating privacy.* An FCM that is affiliated with and subject to the regulation of banking regulators by reason of being affiliated with a financial holding company or a bank holding company will be subject to the rules promulgated by the bank regulatory authorities. In addition to the Gramm-Leach-Bliley Act, a number of states have proposed privacy legislation with respect to electronic commerce and other commerce.

The Gramm-Leach-Bliley Act grants the SEC authority to and mandates that the SEC promulgate rules with respect to privacy regarding customer financial information held by broker-dealers and financial holding companies subject to the SEC's jurisdiction. The SEC has promulgated such rules in the recently adopted Regulation S-P.⁵⁹ The rules will become effective on November 13, 2000, but compliance will not be required until July 1, 2001. The rules provide for an initial disclosure to clients of a broker-dealer regarding its privacy policies followed by annual update notices to clients. The rules mandate the information to be included in the notices. Although there are limited exceptions, the rules generally preclude the disclosure of non-public personal information about customers to non-affiliated third parties. *Disclosures to marketing joint notices and services firms, such as a clearing firm or a clearing agency, would be permitted. The rule provides for an opt-out notice to consumers by which a customer may opt out of furnishing customer information to an unaffiliated third party other than the financial service provider.*

Prior to adoption, the rules received a significant amount of adverse comment from the industry, credit reporting firms and other interested parties. A number of commentators believed that the privacy rules will limit and restrict electronic communication with customers. *More importantly, they will prohibit certain types of activities that are currently usual practices in connection with online accounts, such as retrieving customers' specific data for use by third parties. The rules will clearly prohibit*

⁵⁸ 15 U.S.C. §§6081-6809.

⁵⁹ See Privacy of Consumer Financial Information (Regulation S-P) Release No. 34-42974, 65 F.R. 40334 (June 29, 2000).

financial service firms, such as banks, FCMs and broker-dealers from sharing information to deter fraud, such as manipulation, ponzi schemes, short-selling schemes and a variety of other fraudulent conduct that can only be detected by exchange of information between financial firms and their counsel.

European Union Data Privacy Accord

In 1998, the EU issued a Data Privacy Directive which is now in force. For over the last 18 months, the U.S. and the EU have been negotiating to come up with a safe harbor that U.S. companies may use to comply with the EU directive. The EU directive prohibits transfer to non-EU countries of personal identifiable data regarding EU residents that do not have "adequate privacy protection." *In the view of the EU, the U.S. does not have an adequate privacy protection.* Although data transmissions between residents of the EU and the U.S. have not been halted, they are not necessarily in accord with the privacy directive which is quite stringent. On March 14th, the European Commission of the EU and the U.S. finalized a data privacy agreement to give assurances to United States companies using certain voluntary safe harbors that they will not violate the EU directive while operating with the EU. This agreement must still be approved by the EU members and the EU parliament but such approval is expected in June or July. Unfortunately, financial service firms are excluded from the safe harbor because of the recent Gramm-Leach-Bliley Act referred to above, which has not yet been implemented by government agencies. It is hoped that the privacy regulations under the Gramm-Leach-Bliley Act will meet or exceed the safe harbor requirements and be added onto the EU agreement which has yet to be approved. Hopefully these concerns will be resolved by negotiation.

International Problems

The CFTC and NFA have not issued any release in this area, but the SEC has issued an instructive release on use of websites and other electronic means across national borders. The basic SEC concept is that if an offer of securities or investment service is offered by website or other electronic means, the offer will not violate the securities law of the U.S., provided the site makes clear the securities or service are offered only to residents of certain foreign states and are not offered in the U.S. or to U.S. residents. The SEC release discusses, in detail, security measures to avoid violation of the U.S. securities law. Most states acquiesce in this procedure.⁶⁰

⁶⁰ See SEC Interpretation: Use of internet Websites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Release No. 33-77516, 63 F.R. 14806 (March 27, 1998).

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The Securities and Futures Association of the UK has taken the position that website offers of investments or services accessible by the UK residents require compliance with the Financial Services Act. The SFA has recently stated that it would accept security measures limiting offers of service to UK persons similar to that in the SEC release noted above. Other European states are following the UK lead.

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Conclusion

Securities and futures regulation was largely developed in a pre-electronic era, and it has taken some time for the regulators to come to terms with some of the changes brought about by email and the internet. The rapid increase in day trading activity, and the opportunities for various kinds of fraud, have spurred investigations and required the development of means to protect the public. FCMs and broker-dealers must be careful that their websites, and the materials posted on them, do not contain hyperlinks to sites that can get them in trouble. The international nature of the internet will require greater cooperation between various national and regional regulators. The environment is not stable, and we can expect more regulation—even if some of it will be little more than wishful thinking—in the future.

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