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REGULATORY POLICY REGARDING ELECTRONIC COMMUNICATION, EXECUTION AND DELIVERY OF DOCUMENTS TO CUSTOMERS OF FCM/BDs

by

Paul B. Uhlenhop
LAWRENCE, KAMIN, SAUNDERS & UHLENHOP
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INDEX

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I. Customer Agreements, Consents, Account Opening Disclosures

A. Futures

The Commodity Futures Trading Commission ('CFTC") has taken a definitive position that electronic signatures are permitted for customer agreements, required disclosure consents and other documents where signatures were previously required. CFTC Rule 1.4, 17 C.F.R. 1.4. Neither the CFTC nor the National Futures Association ("NFA') mandate customer agreements; however, they do 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.

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

1. The electronic medium or source for delivery.

2. The period of the consent's effectiveness.

3. A description of the information to be delivered.

4. The cost that will be charged to the customer for electronic delivery.

5. The customer's right to revoke.

[1] Mr. Uhlenhop is a Senior Partner at the law firm of Lawrence, Kamin, Saunders & Uhlenhop, Chicago, Illinois and is a member of the Bars in the states of Illinois and New York. The author would like to recognize and thank his associate, Paul M. Weltlich, and legal assistant, Susan Johnson, in connection with their valuable contribution to this outline. (Research cut-off May 20, 2000).

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

Execution of contracts by electronic signature in lieu of handwritten signature is permitted in some states, but its legal status is unclear in many states. It is unclear whether a choice of law provision in a customer agreement specifying a state where electronic execution of a contract is permitted will bind a customer that is a resident of another state. For this reason, most Futures Commission Merchants ("FCMs") require 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.

B. Securities

The Securities and Exchange Commission ("SEC") permits electronic consent and disclosures provided that the consent is informed, meaning that certain disclosures must be first made, which include:

1. Specification of the electronic medium or source by which the information is to be delivered.

2. The period during which the consent will be effective.

3. A description of the information to be delivered.

4. Disclosure of any potential cost associated with electronic delivery, such as on-line 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. Rule 3c-1 and Rule 15c2-1 consent to hypothecation.

2. Rule 9b-1 option disclosure.

3. Rule 11Ac1-3 disclosure regarding order flow and order routing.

4. Rules 15c1-5, 15c1-6 and 15c2-12 disclosures concerning certain municipal securities activities.

5. Rule l0b-10 confirmations.

6. Rule 10b-16 margin disclosures.

7. Rule 15c2-1 financial and other information.

8. Rule 15c2-5 insurance premium funding disclosures.

9. Rule 15c2-11 provides certain information by market maker.

10. Rule 15c3-2 notification under records of free credit balance.

11. Rule 15c3-3 repurchase agreement consents and confirmation.

12. Rule 17a-5 disclosure of broker-dealer financial position to customers.

13. Rules 15g-3 through 15g-8 disclosures regarding certain penny stock. (However, with respect to the penny stock disclosures, while they can be delivered electronically, a written consent is required).

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); 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).

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 PDF format is acceptable so 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.

Importantly, 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 seems to be at odds with another statement in the release that an issuer could 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. *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).

Although the SEC permits electronic signatures, most broker-dealers still require a handwritten signature for account and other agreements because state law in many states is

unclear as to the effectiveness of electronic signatures. Broker-dealers usually have their agreements on their websites with instructions for printout, completion and return by mail.

II. Confirmation and Account Statement Delivery

A. 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 I. A. above. 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).

B. Securities

As discussed in I. B. above, 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 that are set forth and discussed in I B above.

III. On-Line Disclosures

A. Futures

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 on-line customers. Further, many futures firms that have on-line 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 on-line trading has been developed by the FIA and is attached as Exhibit A. The uniform disclosure of the FIA is supplemented by many firms with additional disclosure and an on-line service agreement. See website at Lind-Waldock.com. 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* CFTC Rules: Distribution of Risk Disclosure Statement by Futures Commission Merchants and Introducing Brokers, 63 F.R. 8566 (February 20, 1998).

B. Securities

The SEC and the NASD advised, urged and has come close to mandating that broker-dealers make specific on-line disclosures to customers trading on-line, even if the firm does not recommend any securities or type of trading. These disclosures include the following:

1. The 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. The 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. Particular 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. *See* NASD Notice to Members 99-32 (day trading); Notice to Members 99-33 (margin disclosures); Notice to Members 99-11 (price and volume volatility and execution risk); and Notice to Members 98-102 (calculating margin for day trading).

The NASD Regulation has emphasized improper disclosure and advertisements regarding electronic trading and day trading in a recent NASD publication. *NASD Regulation, Inc. Regulatory and Compliance Alert*, pp. 7-8 (NASDR Spring 2000). The NASD warned member firms against exaggerated and unwarranted statements in the following areas:

1. Market access – statements exaggerating customer's ability to access particular markets.

2. Immediate execution – 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. Disclosures regarding risk – success of any trading, including electronic trading requires an adequate discussion of risk and costs that are associated with a high volume of trades.

4. Cost of trading – incomplete comparison of cost of day trading versus costs associated with other forms of securities trading at other firms.

IV. On-Line Approval of Accounts

A. Futures

The CFTC and the NFA appear not to have issued interpretive releases with respect to on-line approval of accounts. However, a number of firms follow the SEC procedures in this regard as discussed below in Section III. B. The NFA staff has indicated that on-line approval is permitted. *See* David & Roth, Supervisory Procedures for Electronic Communication, FIA Law and Compliance (May 6, 1999).

B. Securities

On-line electronic signatures for approval of accounts by supervisors are permitted. *See* NASD Reg. Staff Interpretation on Use of Electronic Signatures. Under NASD Rule 3110(c) & (d) (November 26, 1997) the Interpretation requires the following:

1. The system must have adequate security and be restricted to authorized employees.

2. The member must monitor current written procedures and policies at each site using the system.

3. The system must allow NASD and their regulatory staff immediate access to records.

4. The system must have indexing and cross-reference.

5. The system must maintain records as requested by the SEC. *See* section XIII B. below.

6. The system must have capability to download and print all documents.

7. 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.

V. On-Line Supervision

A. Futures

FCMs and Introducing Brokers ("IBs") have the same duty to supervise on-line trading as they do off-line trading. See David & Roth, Supervisory Procedures for Electronic Communication, FIA Law and Compliance (May 6, 1999). The risk of churning and unauthorized trading is significantly less for firms that do not make recommendations and all trading is on-line. 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 would be applicable. 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).

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.

B. Securities

On-line broker-dealers have the same duty to supervise as any other broker-dealer. *See* NASD Notice to Members 98-11 (January 1998). Most on-line 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 may be a type of solicitation and recommendation. Remarks at National Regulatory Service Fall 1999 Compliance Meeting by Laura Unger (September 14, 1999). 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. *See* NASD Notice to Members 99-32 (April 15, 1999) (Proposed NASDR Rules 2360, 2361). On-line brokers must have a system of supervisory and compliance procedures to monitor all on-line trading. As explained above, electronic systems can provide outstanding tools for review by supervisors and compliance procedures through the use of filters, exception reports and warnings.

VI. Placement and Execution of Orders

A. Futures

The CFTC's position on many aspects of electronic order placement and execution by customers has been stated in a CFTC advisory. 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). Electronic order entry systems satisfy the CFTC Rule regarding written recordkeeping provided they comply with the following:

1. The same information is recorded electronically including any changes or modifications.

2. The system records the required data and order-related times (entry, execution and exit) to the highest level of precision, but at least to the second.

3. The data is readily available in machine-readable or hard copy substitute for the CFTC or SRO.

4. The records stored electronically in machine-readable media use a format and coding specified in the CFTC's request.

5. The system has appropriate security against erasure and unauthorized access.

The CFTC and the futures SROs have acquiesced in the use of electronic means for customer placement and execution of orders. The CFTC and futures SROs generally have uniformly required electronic order placement and execution systems to meet audit trail, recordkeeping and other security concerns. However, the CFTC's position in the release dealing with confirmations and account statements leads one to believe that the customer would have to execute, in writing or electronically, some sort of customer agreement or consent to electronically trade before placing orders through an electronic communication media. In any event, a firm would need such an agreement to protect itself. As noted above, the CFTC permits a customer to electronically acknowledge risk disclosures and other consents necessary to open accounts.

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 on-line 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.

B. Securities

The SEC, as noted above, has permitted electronic signatures for a variety of consents, disclosures and confirmations. Consequently, 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. As described in Section III. above, the SEC and the NASD require extensive disclosures for on-line execution systems. The disclosures include potential for loss, capacity, alternative communication methods for execution and potential for system failure, types of orders, executions and quote and price delays and risks and a variety of other issues. *See* NASD Notices to Members 99-32 (April 1999), 99-11 (January 1999), 98-102 (December 1998).

Because of state law, broker-dealers like FCMs generally require customers to manually sign a customer agreement with special on-line supplement provisions or execute a separate on-line services agreement before permitting on-line electronic order placements and executions.

VII. New Offerings

A. Futures

While new offerings are not regulated by the CEA, disclosure statements and other client documents of commodity pools and commodity trading advisers may be displayed and/or delivered electronically, provided the customer consents and the required disclosures are made. *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.

B. Securities

1. General

The structure of the Securities Act of 1933 ("33 Act") 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 who rely on those interpretations are using the Internet for initial public offerings, secondary offerings, private placements and Rule 144A transactions. A full discussion of all of these issues is beyond the scope of this paper. Discussed below are some of the key no-action letters.

2. Public Offerings

(a) The Wit Capital No-Action Letter

This no-action letter provides a framework for an initial public offering ("IP0") offering on the Internet without violating Section 5 of the 33 Act. Wit Capital [1999] Fed. Sec. L. Rep. (CCH) ¶ 77,577 (July 14, 1999). 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 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 Wit Capital no-action letter require the following structure for an electronic Internet offering:

(i) 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;

(ii) when the red herring prospectus is available, the firm sends an e-mail to customers having an interest notifying them of the offering and the availability on the website of the prospectus;

(iii) the CDS website provides instructions or hyperlink to instructions on how to participate in the offering electronically;

(iv) customers may submit a conditional offer to buy electronically;

(v) within two (2) business days prior to the expected effectiveness, an e-mail is sent to each customer who has made a conditional offer, requesting an affirmative reconfirmation, which is binding for a period of five (5) days;

(vi) the firm then notifies such customers that the registration is effective, but allows the customers to withdraw their reconfirmation at any time until the firm accepts them;

(vii) most firms require that a participating customer have an account with a specified dollar amount deposited;

(viii) firms may allocate shares on a first come/first serve basis or on a basis of other procedures;

(ix) certain additional procedures are necessary for delayed offerings and recalculation of preliminary prospectuses.

(b) Recent SEC Position Regarding Internet Offerings

The staff of the SEC in recent publication set forth guidance with respect to Section 5 issues arising in on-line offerings. 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). The SEC's most recent release discusses the general legal principle regarding on-line public offerings; however, the SEC leaves the development of detailed procedures to staff guidelines and no-action letters because of the dynamic changing landscape of electronic communication. *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). 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. Most of these concepts are derived from the *Wit Capital* no-action letter. The guidance, because it is so important and succinct, is quoted in large part below:

(i) Communications During the Offering Process

"Before effectiveness, communications on an e-broker's (as well as on the issuer's) web site that make an offer to sell or solicit an offer to buy may only be made by means of a prospectus complying with Section 10 or by communications that come within the safe harbor of Rule 134. Communications that are merely instructional and are not designed to generate interest in a particular offering typically are unobjectionable even if they do not fall within the safe harbor of Rule 134. See, for example, *Wit Capital* (July 14, 1999), such as general information on how to use the web site, how the brokerage service operates and how to open an account."

(ii) Conduct of the Offer and Sale of the Security

The SEC staff requires that each e-broker has procedures in place to assure compliance with Section 5.

a. 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 – which 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.

b. Resolicitation of conditional offers to buy from a customer during the seven-day period

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.

c. Conditional offers to buy at a price above the range in the prospectus

E-brokers should treat these offers as limit orders at the top of the range disclosed in the preliminary prospectus. If the price range changes pre-effectively or the offering prices outside of the disclosed range, customers must be contacted and must reconfirm their offers to buy at the new price.

d. Acceptance of a conditional offer to buy

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

(1) the registration statement is declared effective;
(2) customers are given notice of effectiveness after the registration statement is declared effective (this notice can be before or after pricing);
(3) customers are 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."

e. Before effectiveness, e-brokers may not sell or solicit offers to buy by means of a prospectus that does not comply with Section 10

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.

"The practice of filing the registration statement for an initial public offering without a bona fide estimated offering price range has created concerns with respect to some e-brokers' compliance with Section 5. Because a bona fide estimated range is required in a prospectus used for an IPO, the use of a prospectus without a price range would not comply with Section 5. Similarly, brokers cannot rely on the safe harbor of Rule 134 until the prospectus includes a bona fide estimated range. Therefore, brokers should be careful when communicating in writing before a prospectus that complies with Section 10 is available, and take appropriate steps to ensure that no such communications constitute an "offer" within the meaning of Section 2(a)(3)."

f. E-brokers may not require customers to certify that they have read the 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.

(iii) Payment of the Purchase Price

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 in order 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.

(c) Continuous Offering of Mutual Funds or Other Securities

The SEC, in October of 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. 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). These releases have been relied on by mutual funds and others to provide on-line 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. As explained above, the customer can consent to electronically receive confirmations and account statements from the broker-dealer. Furthermore, the customer can consent to electronically receive annual reports, proxy statements and other required shareholder communications subject to revocation as explained above. 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).

(d) Hyperlinks in Prospectus and Other Offering Documents

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. *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). 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".

(e) 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. The no-action letters are quite complex and beyond the scope of this article. Recently, the SEC has reinterpreted and, for all practical purposes, restricted the broader interpretations of some of the earlier no-action letters. *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).

3. 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 an "accredited investors" 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. *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). 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 on-line 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. *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).

VIII. Capacity Issues

A. Futures

The futures exchanges and the CFTC have began to focus on capacity issues of electronic order execution systems and disclosures regarding the same, but not to the extent that the SEC has. The CFTC has concentrated on order entry and execution audit trails and recordkeeping. See section VI. A. above. 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. *See* for example, Chicago Mercantile Exchange Memorandum, April 21, 1999 regarding electronic compliance with written record requirements and CFTC Regulation 1.35.

B. Securities

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. *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). These releases discuss the staff's view on handling electronic orders in times of volatility and fast markets. Importantly, the SEC requires firms with electronic on-line 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. *See* NASD Guidance to Investors Regarding Stock Volatility and Online Trading (January 26, 1999). *See* also NASD Notice to Members 99-33 (April 1999).

The SEC recently proposed a new rule, Rule 15b7-2, requiring broker-dealers to have and maintain operational capacity for execution and trading systems. The proposed rule discusses areas encompassed within the definition of operational capability and capacity, and articulates many of the things that should be considered. The Rule appears not to have any specific standards. It is interesting to note that the proposed Rule states that it is not intended to address the occasional delay or outage. *See* Release No. 34-41142, 64 F.R. 12127 (March 2, 1999).

IX. Day Trading

A. Futures

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 on-line customer electronic execution systems. As a matter of good practice, many retail futures websites for remote on-line order execution systems have disclosures regarding capacity, fast markets, market functions, types of orders, time delays and quotes, and other issues discussed in III B. above. As noted in III. A. above, the FIA has developed a uniform electronic disclosure document. Most firms supplement the FIA uniform disclosure with additional disclosures and an on-line service agreement.

B. Securities

Day trading through electronic execution has received an enormous amount of publicity. Most on-line 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. 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. Report of NASDR Concerning the Advertisement of On-Line Brokerage (September 21, 1999).

In a series of releases and statements relating to day trading, the SEC and the NASD have strictly interpreted various current rules applicable to on-line 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. *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). 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. *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). The NASD has also proposed additional margin requirements for particular types of volatile stock. *See* Notice to Members 99-33 (April 1999). The proposed NASD rule has been recently amended by the NASD as a result of SEC staff and public comments. *See* Release No. 34-42418, 65 F.R. 8461 (February 11, 2000). 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.

X. E-Mail and Customer Correspondence

A. Futures

The NFA has directly addressed electronic supervision of customer correspondence. *See* NFA Compliance Rule 2-9: Supervisory Procedures for E-Mail and The Use of Web Sites, NFA Manuel ¶9037 (August 19, 1999); David & Roth, Supervisory Procedures for Electronic Communication, FIA Law and Compliance (May 6, 1999). 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. *See* e.g. NFA Compliance Rule 2-29 NFA Manuel ¶5147.20. 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 cited above 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 discussed below, 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 cited above also mentions that all email to customers is subject to supervision. This includes electronic communication to a customer outside an FCM's communication system, such as by means of a home personal computer. 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.

B. Securities

The SEC has approved rules of the NASD and rules of the New York Stock Exchange ("NYSE") with respect to supervision of e-mail and other electronic communications with customers. *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 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). These rules, in essence, require that a broker-dealer 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. The procedures are required to specify the medium frequency of reviews and procedures for periodic review. The procedures should also include training with respect to reviewing electronic communication. E-mail communications must be preserved and reviews documented. As noted in X. A. above, electronic communication outside a broker-dealer's house system may be difficult or impossible to supervise.

XI. Electronic Promotional Material Including Advertisements and Websites

A. Futures

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. *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); 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 Advisors, 61 F.R. 42146 (August 14, 1996). Careful attention should be directed to those releases. As noted above, the NFA has issued an interpretive release dealing with websites. *See* NEA Compliance Rule 2-9: Supervisory Procedures for E-Mail and The Use of Web Sites, NFA Manuel ¶9037 (August 19, 1999). 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 securities 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 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.

B. Securities

1. General

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. Report of NASDR Concerning the Advertisement of On-Line Brokerage (September 21, 1999). Hyperlinks to research also raise a host of unanswered questions described below. 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:

(a) 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.

(b) Implication that active trading results in high profits.

(c) Implication that third-party research is in fact the research of the broker-dealer.

(d) 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.

As noted above, the NASD Notice to Members 99-11 cautions members that statements in advertising or sales literature about speed and reliability of their services may not be exaggerated. Further, risk involved with on-line trading, including outages and capacity and alternative execution methods, should be disclosed and it applies equally to websites.

2. Banner Advertisements

Many broker-dealers have arrangements with Internet access providers, such as Compuserve and America On-Line to have a banner advertising the broker-dealer and its services (web portals). The banners, by their very nature, must be 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 on-line service providers. On-line payment of transaction base compensation is not permissible. However, by SEC no-action letter, a nominal or flat rate per order may be provided to an on-line service provider. *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).

3. Hyperlink to Third Party Internet Sites

The NASD has established certain other requirements for hyperlinks, including the following:

(a) The hyperlink must be continuously available.

(b) A broker-dealer cannot alter the information on a third-party site.

(c) A broker cannot deny access if it contains material unforeseeable to the broker-dealer or its recommendations.

NASDR Interpretation Letter to Investment Company Institute from R. Clark Hooper NASDR (November 11, 1997).

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. *See* NASDR Interpretation Letter to Investment Company Institute from R. Clark Hooper NASDR (November 11, 1997).

The SEC in a recent release addressed the issue of hyperlinks on issuer websites. *See* Use of Electronic Media: Interpretation and Solicitation of Comments, Release Nos. 33-7856 and 34-42728, 65 F.R. 25843 (May 5, 2000). 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:

(a) The context of the link.

(b) The risk of investor confusion.

(c) The 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: "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." Release No. 33-7856, 65 F.R. 25843 at 25849 (May 5, 2000).

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.

XII. Electronic Marketplaces (Exchanges) and Contract Markets

A. Futures

The CFTC has recently approved two totally on-line electronic exchanges having no trading floor. *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). 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 United States contract markets, notably 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. As described above in Section VI. A., 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. *See* e.g. CFTC No-Action letter [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,917 (August 10, 1999). 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. A Recognized Futures Exchange ("RFE").

2. A Recognize Derivatives Transaction Facility ("DTF").

3. An exempt MTEF.

Each of these categories would have core principals that would be applicable. Each 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.

B. Securities

In the securities industry electronic execution facilities have existed for a number of years; however, they have evolved lately 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. *See* Release No. 34-40760 63 F.R. 70844 (December 8, 1998). 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. With the advent of electronic order execution and communication systems, a host of questions arose, which the SEC attempted to deal with in the form of no-action interpretations or exemptions from exchange registration. 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.

In order 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 ("ATS"). A detailed discussion of these changes is beyond the scope of this paper. 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. 17 C.F.R 240.300 Et seq. Electronic trading markets may elect ATS registration or exchange registration. An ATS entity must register as a broker-dealer and comply with new SEC Regulation ATS. New 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 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. *See* Release No. 34-40760, 63 F.R. 70844 (December 8, 1998).

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 aligorhythms 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. *See* Release No. 34-42455, 65 F.R. 11401 (February 24, 2000). 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 United States, although their pricing and quote information generally is permitted to be transmitted into the United States. *See* Release No. 34-27017, 54 F.R. 30013 (July 11, 1989). The SEC staff has recently issued a no-action letter to Tradepoint Financial Network PLC, a United Kingdom 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 United States. 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. *See* Tradepoint Financial Network PLC Order, Release No. 34-41199, 64 F.R. 14953 (March 22, 1999).

XIII. Electronic Recordkeeping

A. Futures

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

1. Availability of display facilities

   The FCM must make available upon request to the CFTC or the Department of Justice ("DOJ"):

   (a) Facilities to display the information stored on optical disk for immediate examination.

   (b) Facilities on the premises to produce complete, accurate and easily readable hard copy and the means to provide copies of compatible CFTC machine-readable media.

2. Indexing

   (a) The FCM must create and maintain index and directory structure for files on optical disk so as to permit immediate location of any particular file or record.

   (b) The FCM must maintain a hard copy of (a) above.

3. Copies of documents, disks and stored data

   The FCM must be ready at all times to provide immediate hard copies of any records stored on optical disk and/or copies of such records on approved machine readable media using format and coding structure specified and any request from the CFTC or DOJ.

4. Only CFTC Records

The FCM must keep only CFTC required records on the same disk. Any privilege with respect to any non-CFTC required record or a disk with required CFTC records is waived.

5. Write once

(a) All records must be non-rewriteable and preserved on non-rewriteable media.

(b) The technology must have write verify capabilities that continuously and automatically verifies the quality and accuracy of information stored and automatically corrects quality and accuracy defects.

6. Disk Requirements

The system must:

(a) Use removable disks.

(b) Serialize the disks.

(c) Use permanent non-erasable time date; all files must be time dated.

7. FCM must keep current or grant access to CFTC or DOJ, all information necessary to read, convert to hard copy and download records stored in optical storage units, including directory structures and indices, including:

(a) A copy of logical file formats and field formats of all different files written on optical disks.

(b) The hardware make and model and operating system software version and release level of the computer system hosting the storage device.

(c) Identity of the device driver used to write the optical media, including the release level.

(d) If records are written in ASCII or EBCDIC format other than standard non-compressed ASCII or EBCDIC, documentation of the method used to encode data providing a thorough description of any compression algorithm, including the physical file format and conversion routines to transform the records to a non-compressed ASCII or EBCDIC format.

B. Securities

The SEC allows recordkeeping in a DSM providing certain conditions are met, which are described in the SEC's release and Rule 17a-4. *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). While language of the rule and the SEC release are somewhat different than the CFTC release, the principles are essentially the same and they include, among other things, the following:

1. Notification to the SRO 90 days prior to use and representation (or have third party represent to SRO) that the firm meets the specific requirements of the rule.

2. Preservation of the records exclusively in a non-rewriteable, non-erasable format.

3. Verification automatically of the quality and accuracy of the storage media recording process.

4. Serialization of the original and, if applicable, duplicate units of storage media and time-date for the required period of retention.

5. Capacity to readily download indexes and records in any medium acceptable to SRO or the SEC.

6. Equipment to display information stored electronically to provide for production of easily readable facsimile copies or enlargements in hard copy or in machine-readable form.

7. Separate storage of the original and duplicate copy.

8. All information organized and indexed.

9. Indexes available for examination with duplicate copies stored separately from the original copy of each index for the required time.

10. An audit system providing for accountability.

11. All current information necessary to access records and indexes or escrow of a current copy of the physical and logical file format of the electronic storage media, the field format of all different information types written on the electronic storage media and the source code, together with the appropriate documentation and information necessary to access records and indexes.

The SEC requires that files be compatible with the securities regulator's systems.

XIV. Privacy Regulations Affecting Electronic Communications

A. Futures

On November 13 of 1999, Congress adopted the Gramm-Leach-Bliley Act. 15 U.S.C. §§6081-6809. 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.

As described below, the financial service industry has considerable concerns regarding these regulations, not only to the extent that they add cost to the industry, but they also impose restrictions that may make it difficult to operate certain electronic communication facilities effectively. Further, as described below, the prohibition on sharing customer data will make various fraudulent schemes harder to detect resulting in losses to FCMs and to the public.

B. Securities

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 a proposed rule in Regulation S-P. *See* Privacy of Consumer Financial Information (Regulation S-P) Release No. 34-42484, 65 F.R. 12353 [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,242 (March 3, 2000). The proposed 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. The Act itself provides that the results are to be effective November 13, 2000. It is expected that the SEC rules will be in effect by that time.

The proposed rules have received a significant amount of adverse comment from the industry, credit reporting firms and other interested parties. A number of commentators believe 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 on-line accounts, such as retrieving customers' specific data for use by third parties. The rules will clearly prohibit 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.

C. European Union Data Privacy Accord

In 1998, the European Union ("EU") issued a Data Privacy Directive which is now in force. For over the last eighteen (18) months, the United States and the EU have been negotiating to come up with a safe harbor that United States 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 United States does not have an adequate privacy protection. Although data transmissions between residents of the EU and the United States 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 United States 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.

XV. International Problems

A. Futures

The CFTC and NFA have not issued any release in this area, but the staffs of the CFTC and the SEC follow the SEC guideline below.

B. Securities

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 United States, provided the site makes clear the securities or service are offered only to residents of certain foreign states and are not offered in the United States or to United States residents. The SEC release discusses, in detail, security measures to avoid violation of the United States securities law. Most states acquiesce in this procedure. *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).

C. United Kingdom/SFA

The SFA has taken the position that website offers of investments or services accessible by the United Kingdom residents require compliance with the Financial Services Act. The SFA has recently stated that it would accept security measures limiting offers of service to United

Kingdom persons similar to that in the SEC release noted above. Other European states are following the United Kingdom lead.

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