

STROOCK CAPITAL MARKETS

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SECURITIES TRADING ON THE INTERNET: SEC REGULATION OF INTERNET BROKER-DEALERS AND ALTERNATIVE TRADING SYSTEMS

Success of Online Broker-Dealers Attracting Increased Attention From Regulators

Recent headlines capture both the increasing impact of new technologies on the securities industry and the increasing regulatory attention technology-driven changes are attracting. Headlines proclaim possible extended trading hours for Nasdaq and the New York Stock Exchange ("Nasdaq Prepares for Evening Hours," "NYSE Moves Up Night Trading Plans"; "SEC, NASD and NYSE to Convene Industry Summit on After-Hours Trading Issues"), globalization of the securities markets ("NASD Explores German Tie;" "Japan to Get Own Nasdaq"), and moves by prominent financial services firms, Nasdaq and the NYSE, to position themselves for the competitive environment of the future ("NYSE to Go Public"; "Schwab, DLJ and Fidelity to Form Electronic Communications Network").

The regulatory counterpoint has come in headlines like "SEC Works to Halt Online Offerings of 'Free' Stock," "SEC Announces Increased Inspections, Enforcement for Internet Brokerage Firms," and "Senator to Introduce Bill Aimed at Protecting Online Investors."

What is easily overlooked in stories like these is the relative *lack* of incident that has characterized an otherwise dramatic transformation of securities trading — in little more than five years — from a "bricks and mortar" past to a "point and click" future. In 1995, E*Trade was the pioneer Internet broker-dealer. Today an estimated 77 million Internet users in the United States have opened nearly 5 million online trading accounts at over 100 Internet broker-dealers, with entire web sites devoted to rating the leading players, and chat rooms and Internet bulletin boards where online traders swap war stories about online trading highs and lows.

Though discount broker-dealers were the first

wave to hit the Internet, full service firms have steadily joined them. Citibank, Morgan Stanley Dean Witter and Prudential Securities now offer online trading. Merrill Lynch, a stubborn holdout with 8 million customers and 18,000 retail brokers, recently put an exclamation point on the process when it announced it too was starting an online trading venture. An unanswered question is what "value added" services will be offered to online customers as broker-dealers look to compete effectively in the new online trading environment.

Another significant change has been the development of alternative trading systems ("ATs"). ATs include "passive" bulletin board systems enabling participants to post interest in buying or selling securities, systems used by broker-dealers to manage customer orders, and electronic communications networks ("ECNs"), like Instinet and Island. ECNs are private, computerized stock trading networks historically used by institutional customers to post bids and offers anonymously, but increasingly used to execute trades for retail customers. ATs have functioned, in many ways, like traditional registered stock exchanges and Nasdaq, but for the most part have been regulated as broker-dealers.

As ATs have grown in prominence, the SEC has attempted to address regulatory concerns by issuing a series of releases and no-action letters. In April 1998, the SEC proposed a new regulatory framework (the "ATS Release") for ATs, which was adopted, after a comment period, in December 1998.

This issue of *Stroock Capital Markets* examines how existing SEC, NASD and NYSE regulations apply to online activities of broker-dealers, considers some regulations aimed specifically at the online activities of broker-dealers, and discusses some of the key provisions of the new regulatory framework for ATs. We also take a quick look at some recent SEC enforcement actions related to online trading, and some proposed legislation that is on the horizon.

We think this issue of Stroock Capital Markets highlights the need for broker-dealers and other online sponsors to exercise caution in structuring their online activities. Existing broker-dealers should consider the additional liability and increased regulatory scrutiny that may result from doing business online. For sponsors of new ATSs, the key question may be what regulatory framework to choose — regulation as an exchange or as a broker-dealer. In either case, the ATS Release provides clarity that can only help this decision-making process. And though it may be axiomatic in the Internet Age, we think recent developments covered in this issue point to new opportunities for broker-dealers, other online sponsors, individual investors and issuers.



Regulation of Internet Broker-Dealers and Online Trading

In early May, SEC Chairman Arthur Levitt gave a speech to the National Press Club in which he voiced concerns about online securities trading. His remarks received widespread media coverage – particularly comments he made about advertisements for online broker-dealers creating “grandiose and unrealistic” expectations for online trading.

Though Chairman Levitt’s speech received considerable attention, SEC regulation of online broker-dealers is not a new topic. The SEC began addressing a wide range of issues relating to online trading and the online activities of broker-dealers in October 1984, and numerous releases and no-action letters have followed. Among these are two no-action letters issued to Charles Schwab & Co. The first, issued in November 1996, permitted Schwab to enter into separate agreements with online service providers under which Schwab made its services available to subscribers of the online services, without the online services registering as broker-dealers or otherwise being subjected to regulation as broker-dealers. The second, issued in July 1997, permitted Schwab to enter into separate compensation arrangements with Standard & Poor’s, a division of The McGraw-Hill Companies, and First Call Individual Investor Services (the “Providers”) under which the Providers made their content available to Schwab’s customers, without the Providers being subject to regulation as broker-dealers.

Though regulation of online broker-dealers and online trading is not new, because *anyone* can access a web site, the regulatory implications of online activities of broker-dealers and other web site sponsors can be unexpected. Broker-dealers and other web site sponsors need to assess even seemingly innocuous online activities (for example, finance-based “strategy games”) with an eye toward their possible regulatory implications.

As a practical matter, this means putting into place comprehensive compliance procedures to ensure that online activities meet applicable regulatory requirements and regularly updating those procedures. In addition, broker-dealers and other web site sponsors

need to consider whether their procedures are adequate in view of the target audience for their online activities, as well as the audience actually accessing their sites.

With that as background, the following are among the issues relating to the online activities of broker-dealers addressed by the SEC, the NASD or the NYSE:

Broker-Dealer Web Sites are Advertising

Web sites used by broker-dealers are “advertisements” for purposes of NASD and NYSE rules on broker-dealer communications with the public. As such, web sites cannot omit material information (including risk disclosure), must not make exaggerated or misleading claims, and must not contain predictions or projections of investment results. The NASD also requires broker-dealers to maintain records of their web sites in accordance with applicable Rules under the Securities Act of 1934 (the “Exchange Act”).

The NASD requires broker-dealers to adopt procedures for the supervision, review and approval of material placed on their own web sites. In a November 1997 letter to the Investment Company Institute, the NASD stated that it would not hold broker-dealers responsible for the content and filing of material linked to the broker-dealer’s site by an “ongoing hyperlink” to the web site of an “independent third party.” The NASD letter defined an “ongoing hyperlink” as follows:

- The hyperlink must be continuously available to investors who visit the broker-dealer’s web site;
- The broker-dealer has no discretion to alter the information on the web site of the independent third party;
- Investors have access to the hyperlinked site whether or not it contains favorable material about the broker-dealer; and
- Investors continue to have access to the hyperlinked site even if it is updated or changed by the independent third party.

An “independent third party” is defined in the 1997 letter as “an entity that is independent of the [broker-dealer] and its affiliates, and whose services are not procured by the [broker-dealer] or any of its affiliates to develop or provide information on the third-party site.”

Opening an Online Account

Broker-dealers using their web sites to open and maintain accounts for retail customers must comply with various SEC requirements set forth in a May 9, 1996 Release (the "1996 Release"). Among other things, broker-dealers must obtain the customer's informed consent before using electronic delivery in the account. The 1996 Release provides guidance about the proper form for the informed consent, and information a customer must be given before obtaining consent.

In addition, online broker-dealers must:

- (1) be capable of providing timely and appropriate notices to their online customers regarding delivery of information in electronic form (including through the website) about their online account;
- (2) explain to the customer the type of computer, modem and software required for the customer to access and properly use the account;
- (3) provide appropriate access to the web site and the customer's account, including multiple means of accessing the account in the event of a technological problem in the web site, server or e-mail systems, and the means to retain account information (or ongoing access equivalent to personal retention);
- (4) document delivery of notices, etc. to the customer by, for example, securing e-mail return receipts;
- (5) obtain appropriate account information, including, where required, suitability information; and
- (6) take all reasonable precautions to insure the integrity, confidentiality and security of transmissions of financial information to and from clients.

Suitability Obligations of Internet Broker-Dealers

Broker-dealers, including online broker-dealers, have an obligation to "know their customer" -- to exercise care in determining an investor's financial qualifications and suitability for particular investments recommended by the broker-dealer. An SEC release in

1984 stated that broker-dealers who provide customers with "research and analysis amounting to recommendations of individual securities through a computer system" must exercise care in determining an investor's financial qualifications and suitability for "large and risky investments."

More recently, questions have arisen regarding how the NASD's suitability rule – Rule 2310 – should be applied to online broker-dealers. Under the Rule, if a broker-dealer recommends that a customer purchase, sell or exchange a security, it must have "reasonable grounds" that the recommendation is suitable based on the customer's other security holdings and financial situation and needs.

But what constitutes a "recommendation" in the world of online trading, with electronic bulletin boards, Internet chat rooms, newsgroups and hyperlinks between sites all having possible regulatory implications? Until the SEC provides additional guidance, a conservative approach by online broker-dealers in determining customer suitability seems prudent.

Because broker-dealers who provide research to their customers can be deemed to be making a recommendation, broker-dealers distributing research through their web sites should obtain appropriate information about each customer's financial qualifications and suitability when the customer opens the account. In addition, online broker-dealers should be aware research provided in electronic form (including through a web site) is subject to the same requirements as apply to research provided in paper form. Finally, the NASD may treat research of another firm accessible through a broker-dealer's web site as having been adopted by the broker-dealer as its own. Therefore, broker-dealers need procedures for appropriate review and approval of research of other firms that is accessible through the broker-dealer's web site.

Best Execution for Online Trades; NASD Issues Guidance on Procedures for Extreme Market Conditions

All broker-dealers are required to use reasonable diligence to obtain "best execution" for orders they receive from their customers. Neither the SEC nor the NASD has defined "best execution," but both have provided some guidance.

Among the factors considered in determining whether a broker-dealer has been "reasonably diligent" are the "character" of the market for the security, including volatility and relative liquidity, the size and type of transaction, the number of primary markets checked, and the accessibility to the broker-dealer of primary markets and quotations sources at the time of execution.

With online trading volume soaring to almost 600,000 trades per day, questions about the application of this guidance to online broker-dealers have become more frequent. Online broker-dealers face a digital dilemma. On the one hand, they want to increase their customer base. On the other hand, each new customer

requires more capacity – more hardware and more communications bandwidth to handle the increased order flow.

A recent example occurred the morning of July 9, 1999, when customers of Internet broker-dealer E*Trade discovered they were unable to place trades through the E*Trade web site. This was the second “service outage” for E*Trade in less than six months (in February, its web site was down for three days). Charles Schwab and DLJdirect, among others, have also suffered highly publicized service outages.

In response to surging trading volume and increased market volatility, the NASD recently issued two Notices to Members. Notice to Members 99-11 (Guidance Regarding Stock Volatility), suggests all member firms consider making several types of disclosures to educate retail customers about the firms’ procedures for handling execution of securities transactions during periods of high volume or high market volatility.

Notice to Members 99-11 suggests:

- disclosing how high volume or high market volatility may affect trading, including delaying execution of orders, or resulting in execution at prices significantly away from the market price at the time an order is entered;
- explaining in detail the difference between market and limit orders and the benefits and risks of each; and
- disclosing to customers the possibility of market losses if periods of high trading volume or price volatility result in an inability to place buy or sell orders.

Notice to Members 99-12 (Guidance Concerning the Operation of Automated Order Execution Systems During Turbulent Market Conditions) addresses the “best execution” obligations of member firms during extreme market conditions. It emphasizes that treatment of customer orders under any order execution algorithm or procedure must remain “fair, consistent and reasonable” even under extreme market conditions. If a firm utilizes modified order execution algorithms or procedures during periods of market turbulence, the firm should disclose to its order entry firms (and customers, if applicable) what those differences are, and the conditions under which the modified algorithms or procedures will be activated.

The Notice reminds member firms of their obligation to “ensure that they have adequate systems capacity to handle high volume or high volatility trading days,” and advises that unjustified use of modified order entry algorithms or procedures designed for turbulent market conditions could raise “best execution” concerns.

Confidentiality of Customer Information

The 1996 Release requires broker-dealers to take reasonable precautions to ensure the confidentiality and security of customers’ personal financial information, regardless of whether it is transmitted via electronic media or in paper form. It also requires broker-dealers transmitting such information electronically to “tailor those precautions to the medium used in order to ensure that the information is reasonably secure from tampering or alteration.”

A related issue is whether broker-dealers adequately inform customers of the ways in which customers’ information can be used (for commercial gain or otherwise) by the online broker-dealer. This issue is one facing the financial services industry and Internet businesses generally. Legislation that would require web site sponsors to include on their sites written policies regarding the use of private information gathered from consumers, and permit consumers to opt for their private information to be kept confidential, has been stalled in subcommittee.

Offshore Internet Offers of Securities by Foreign Broker-Dealers

The Internet permits foreign broker-dealers to post materials on web sites for securities offerings not registered under United States securities laws. Because Internet web sites are accessible without regard to national boundaries, an important question has been whether such “Internet offers” constitute activity taking place “in the United States.” In a March 1998 Release, the SEC provided clarification.

The release addresses only the use of Internet web sites, under the theory that Internet-based communication methods such as e-mail are more analogous to regular mail. The release states that when off-shore broker-dealers take “adequate measures” to prevent U.S. persons from participating in an offshore Internet offering, the SEC will not view the offer as taking place “in the United States.” What constitutes “adequate measures” depends on the facts and circumstances of each case. However, the release indicates the SEC generally will not deem an Internet offering as taking place in the United States if the following two measures are implemented:

- The web site includes a “prominent disclaimer” clearly indicating the offer is directed only to countries other than the United States; and
- The foreign broker-dealer takes reasonable precautions to ensure sales are not made to U.S. persons (including, for example, ascertaining the residence of purchasers by obtaining mailing addresses and/or telephone numbers, including area codes.)



The ATS Release: New Regulatory Framework for Alternative Trading Systems

Background to the ATS Release

For more than ten years, the securities industry has witnessed the evolution of ATSs and the increasingly prominent role they play in the purchase and sale of securities. For the most part, ATSs (including, for example, electronic communications networks and broker-dealer sponsored trading systems) have been regulated as broker-dealers. Given their functional similarity to traditional stock exchanges, questions have been raised as to whether they might more appropriately be regulated as broker-dealers or exchanges under the Exchange Act.

The SEC and sponsors of ATSs have expressed concerns that forcing all ATSs into a "strait-jacket" of exchange regulation would stifle innovation. Concerns have also been raised that a broad interpretation of the definition of "exchange" would unfairly and unnecessarily subject brokers, dealers and other regulated entities to regulations designed for traditional stock exchanges. Finally, questions have been raised about the advisability of treating non-member, for-profit proprietary trading systems in the same way as member-based, non-profit stock exchanges.

The SEC has attempted to address these issues through a series of no-action letters and releases. An early example is the 1989 request by Instinet Corporation ("Instinet") for no-action relief with respect to operation of an ATS without registering under the Exchange Act as an exchange. Instinet conceded its ATS provided a means by which its customers could communicate and receive information about possible securities trades, and brought together buyers and sellers of securities. However, Instinet maintained it did this in the capacity of broker, not as an exchange. Instinet argued its ATS did not meet the statutory definition of "exchange" because it did not provide a market place for bringing together purchasers and sellers of securities, did not have "members" and did not provide rules of conduct or other self-regulatory procedures characteristic of stock exchanges. The SEC issued a no-action letter to Instinet.

Another prominent case involved an ATS operated by RMJ Securities ("RMJ") referred to as the "Delta System." RMJ used the Delta System to issue, clear and settle put and call options, and had obtained from the SEC a no-action letter supporting its position that the Delta System did not have to register as an exchange.

The SEC's action was challenged in the U.S. Court of Appeals for the Seventh Circuit. As part of those proceedings, the SEC issued what is known as the "Delta Release," in which it set forth its definition of "exchange." Though the statutory definition of "exchange" is very broad, the Delta Release provided a fairly narrow focus for determining whether a system is an "exchange": is the system designed (whether through trading rules, operational procedures or business incentives), to centralize trading and provide

buy and sell quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations?

The SEC's position in Delta was upheld by the Seventh Circuit. Subsequently, the SEC applied this interpretation of "exchange" in no-action letters with respect to a number of ATSs, generally finding that the ATSs did not "enhance liquidity in traditional ways through market makers, specialists or a single price auction structure."

More recently, no-action relief was granted with respect to an issuer-sponsored Internet-based stock trading system, in which individuals could post quotations for the shares of the issuer on a "buyer" bulletin board or a "seller" bulletin board. No-action relief also was granted with respect to an Internet "passive bulletin board" in which registered participating individuals ("Participants") could post interest in buying or selling the common stock of certain corporations whose common stock is registered under Section 12 of the Exchange Act or who file reports with the SEC in accordance with Section 15d of the Exchange Act. The bulletin board provided a listing of the name, address and telephone number (or e-mail address) of each Participant interested in buying or selling, the number of shares in the potential trade, and the price proposed for the trade. Transactions were to be effected directly between Participants, not on the bulletin board itself.

New Regulatory Framework for ATSs

Before the ATS Release, the SEC had provided case-by-case guidance regarding registration of ATSs, but had not articulated a coherent framework for their regulation. The ATS Release provides a useful regulatory framework for ATSs, and also affords ATSs significant flexibility by allowing most ATSs the choice of registering as a broker-dealer (and complying with new Regulation ATS, discussed below) or registering as an exchange.

The ATS Release is too new to fully assess its impact. However, its combination of regulatory certainty and flexibility allows broker-dealers and other system sponsors greater creativity in using technology to access and link customers online, without the need to seek no-action relief. Though online trading and ATSs have developed at a remarkable pace, the regulatory certainty provided by the ATS Release should help stimulate even more dramatic innovation.

**Rule 300(a):
Definition of ATS**

The starting point for the regulatory framework in the ATS Release is the new definition of ATS, which is set forth in new Rule 300(a). Rule 300(a) defines an ATS as:

- (a) . . . any organization, association, person, group of persons or system:
- (1) That constitutes, maintains or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange [as defined]; and
 - (2) That does not: (i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or (ii) discipline subscribers other than by exclusion from trading.

The ATS Release notes this definition has the effect of precluding an ATS that performs self-regulatory functions from choosing to register as a broker-dealer rather than an exchange.

**Rule 3b-16:
New Interpretation of "Exchange"**

The Exchange Act defines an "exchange" as an entity that "constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange. . . ." Under Rule 3b-16(a), an ATS is considered to fit within this statutory language only if it:

- (1) brings together the orders for securities of multiple buyers and sellers; and
- (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

The ATS Release discusses examples of systems satisfying the "brings together orders" language of Rule 3b-16(a), such as the Nasdaq consolidated quote screen, systems that "display, or otherwise represent, trading interests entered on the system to system users," and

systems in which "orders entered in the system for a given security have the opportunity to interact with other orders entered in the system for the same security."

Because Rule 3b-16(a) requires there be both multiple buyers and multiple sellers, an ATS in which there is a single seller (such as an ATS in which an issuer sells its own securities to investors) is not considered to be an "exchange" even though there may be multiple buyers.

The ATS Release also provides examples of systems meeting Rule 3b-16(a)'s second prerequisite for being an "exchange" — using "established, non-discretionary methods under which orders interact with each other." These include the rules of priority, parity and precedence of traditional exchanges, and the trading algorithms of electronic systems. One example discussed in the ATS Release is the imposition by Nasdaq of "affirmative obligations on market makers in Nasdaq National Market and SmallCap securities, including obligations to post firm and two-sided quotes."

The ATS Release emphasizes that an ATS may include automated broker-dealer functions without necessarily falling within the definition of "exchange." The ATS Release provides an illustration of this in example 2a, in which "System J" routes orders from broker-dealers to registered exchanges or to other broker-dealers for execution, and routes execution reports back to the broker-dealers who entered the orders. The ATS Release describes System J as a communications system for the transmission of orders and execution, with no facility for execution of trades. Therefore, System J falls within the exclusion from the definition of "exchange" in Rule 3b-16(b)(1) as a system that merely routes orders to other facilities for execution.

The point is an important one for broker-dealers, many of whom use ATSs to manage customer orders. Under the ATS Release, unless those systems themselves predetermine the handling and execution practices for the orders (thus replacing the broker-dealer's judgment and flexibility in working the orders), they will not meet the second test of Rule 3b-16(a) — using "established, non-discretionary methods under which orders interact with each other," — and therefore will not be considered "exchanges."

Also expressly excluded under Rule 3b-16(b) from the definition of "exchange" are:

- (1) systems operated by a single, registered market maker to display its own bids and offers and the limit orders of its customers, and to execute trades against such orders; and
- (2) systems that allow persons to enter orders for execution against the bids and offers of a single dealer.

**Rule 3a1-1:
Exclusions from
Definition of “Exchange”**

The ATS Release also includes new Rule 3a1-1, under which any organization, association, or group of persons is exempt from the definition of “exchange” if it:

- (1) is operated by a national securities association;
- (2) is in compliance with Regulation ATS. . . ; or
- (3) pursuant to . . . Regulation ATS, is not required to comply with Regulation ATS.

The ATS Release notes the SEC can require a “dominant” ATS to register as an exchange notwithstanding any exemption. This can be done only if the ATS exceeds certain volume levels, and the SEC has determined (after notice to the ATS and opportunity to be heard) that an exemption from exchange regulation is not “necessary or appropriate in the public interest or consistent with the protection of investors.”

Regulation ATS

According to the ATS Release, Regulation ATS was adopted to “impose essential elements of market-oriented regulation” on ATSs, and to allow new markets to develop through the mechanism of ATSs, without disproportionate regulatory burdens.

ATSs that are subject to Regulation ATS must satisfy certain obligations, the nature of which depends on whether they meet certain thresholds for trading volume in “Covered Securities.” The term “Covered Security” is defined as any exchange-listed, Nasdaq National Market or Nasdaq SmallCap security. These thresholds, and the requirements applicable to each, are as follows:

(1) An ATS With Less than 5% Trading Volume in all Covered Securities it Trades is Required to:

- be a member of an SRO;
- file with the SEC a notice of operation on Form ATS, and quarterly reports, as well as notifying the SEC of material changes to its operation by filing an amendment to Form ATS at least 20 calendar days prior to implementing such changes;
- maintain records, including an audit trail of transactions;
- refrain from using the words “exchange,” “stock market,” or similar terms in its name; and
- cooperate with inspections, examinations and investigations by the SEC or an SRO of the ATS or any of its subscribers.

(2) An ATS With 5% or More Trading Volume of any “Covered Security” During Four of the Preceding Six Months:

- must comply with the requirements under paragraph (1), above; and
- must, subject to certain exceptions, be linked by August 30, 1999 with a registered market so as to disseminate the prices and sizes of the orders at the highest buy price and the lowest sell price for Covered Securities displayed in its system (including institutional orders) into the public quote stream. Such an ATS is also required to comply with the market rules governing execution priorities and obligations that apply to members of the registered exchange or national market association to which the ATS is linked.

(3) An ATS With 20% or More Trading Volume of any Covered Security.

- must comply with the requirements under paragraphs (1) and (2), above; and
- is required to (a) grant or deny access based on objective standards established by the ATS and applied in a non-discriminatory manner; and (b) establish procedures to ensure “adequate systems capacity, integrity, and contingency planning.”



**Enforcement Actions
Involving Online Trading
and Online Broker-Dealers**

**“Free Stock” Offerings
on the Internet**

Offerings of so-called “free stock” by issuers via their web sites have been of increasing concern to the SEC. In many cases, persons wishing to receive the “free stock” have been required to “sign up” at the issuer’s web site, a process typically involving disclosure of detailed personal information of potential value to the issuer. The SEC has reported that “free stock” offerings have generated a “flood” of investor complaints (and a letter to SEC Chairman Arthur Levitt from Rep. Edward J. Markey (D-Mass)). In response, the SEC initiated, and recently announced it had settled, four enforcement actions against four promoters and two Internet companies involved in unregistered offerings and distribution of “free stock” on the Internet.

Online Stock Auctions

In early April 1999, Amazon.com stopped an attempt by an individual to sell shares of net.Genesis, a company that markets a software product that helps web site operators analyze traffic on their sites, in an auction using Amazon.com's auction site.

The attempted auction presented at least two possible regulatory problems. First, the auction appears to have been an unregistered public offering of securities, in violation of the federal securities laws. Second, Amazon.com's auction site arguably was functioning as an ATS. As discussed below, an ATS must either register as an exchange under the Exchange Act, or register as a broker-dealer and comply with Regulation ATS.

Liability of Online Broker-Dealers for Computer Error

In July, published reports indicated an NASD arbitration panel had ordered E*Trade to compensate one of its customers for lost profits resulting from a computer error that, among other things, prevented the customer from accessing his customer account to make trades. The arbitration award was reported to be the first against an online broker-dealer for computer failure.



More Possible Regulation of Online Trading Pending

Two bills introduced this year in the United States Senate are aimed at combating perceived problems involving securities trading on the Internet. One is the 1999 Micro-Cap Fraud Prevention Act, sponsored by Sen. Susan Collins (R-Maine), intended to help regulators attack fraudulent schemes involving the sale of microcap securities, including Internet-based fraud.

The Collins bill would allow enforcement actions by the SEC on the basis of enforcement actions brought by state securities regulators, and would permit the SEC to keep persons barred from other segments of the financial services industry from working in the securities industry. It does not include a provision requiring a third party verification mechanism for web sites posting stock offerings.

A second bill, the "Online Investor Protection

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Act" introduced by Sen. Charles Schumer (D-NY), includes provisions to expand the SEC's powers to monitor online broker-dealers, strengthens penalties for online fraud, and gives investors access to information on a broker-dealers speed of execution before they sign up. The proposed bill:

- requires online brokers to make available on the Internet, a quarterly report listing, among other things, the date, time and duration of any system outage or other event that has prevented or materially delayed execution of online transactions. This report would also be submitted to the SEC;
- authorizes the SEC to study the effects of online trading by retail investors on the securities markets, including whether day trading activity increases the risk of fraud and market volatility and the quality of execution received through online trading services; and
- authorizes appropriations for the SEC's Office of Internet Enforcement of \$350 million over five years and doubles the monetary penalties for fraud.

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