

*Investing Online: Concerns about the  
Evolving Use of the Internet as an  
Investment Tool in the Secondary Market  
Context*

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## Introduction

1. Recent innovations in the trading of securities in Cyberspace have presented the securities industry with opportunities for increased efficiency, information flow and trading volume. The complex World of electronic securities trading is truly booming, as more and more market participants are turning to the Internet to conduct securities activities.

2. Many issuers are using the Internet to assist them in the public offering process<sup>1</sup>. The Internet allows them to raise capital more efficiently by improving access to potential investors. Issuers who are using the Internet to communicate directly with their shareholders and potential investors enjoy faster, less expensive and more widespread dissemination of information. Within the securities industry, financial service providers have actively used the Internet for marketing and advertising purposes, and for communicating with, and receiving orders from, potential investors<sup>2</sup>. Electronic brokers are either extensions of existing brokers, who view the Internet as another channel for providing their clients with access to a variety of services, or purely Web-based brokerages that take advantage of low overhead costs. The explosive growth of electronic brokers has provided investors with worldwide access to financial services, allowing individuals to manage their own investments in a manner never before possible. Retail investors are increasingly using the Internet to open and maintain accounts on-line and to place trading orders without the assistance of a registered securities intermediary. The Internet provides an unprecedented amount of information to individual investors, previously available only to market analysts. Investors can now readily access a range of sophisticated research material and financial data directly from the Web sites of most online trading firms and communicate information quickly through e-mails, message boards and chat rooms.

3. The *Canadian Securities Administrators*<sup>3</sup> and *U.S. Securities and Exchange Commission*<sup>4</sup> have indicated broad support for the use of new technologies in capital market transactions as well as for electronic delivery of documents via the Internet and other electronic media. These initiatives are an aspect of global process initiated in 1998 by the *International Organisation of Securities Commissions (IOSCO)* adopting the convention «Securities activity on the Internet»<sup>5</sup>. This document stated that the fundamental principles of securities regulation such as investor protection, guarantee of fairness, efficiency and transparency of securities markets and the reduction of systematic risk do not change because of the involvement of the Internet. As many existing legal principles can be applied to online investing, the statutory requirements relating to securities trading should not be modified as a result of the involvement of the Internet or other electronic means. Therefore, securities regulators do not need to rethink the foundation of the law, but to adapt existing securities laws to the emerging markets, ensuring market integrity and investor protection. Securities regulators are addressing the growth of securities transactions on the Internet with statements, rules and interpretations, specifically adapted in response to the use of the Internet by the securities industry.

4. Internet securities trading in Canada has been made possible by new regulatory positions taken by the *Canadian Securities Administrators* in two national policies adopted in December, 1999: National Policy 11-201 «Delivery of documents by electronic means»<sup>6</sup> and National Policy 47-201 «Trading in securities using the Internet and other electronic means»<sup>7</sup>. Securities regulatory authorities will continue to devote attention to developing an appropriate legal framework for the operation of capital markets in an increasingly electronic age. The present study intentionally does not cover regulatory approaches to online investing; as it will be the subject of detailed analyses in future research projects.

<sup>1</sup> U.S. SEC Report to Congress "The Impact of Recent Technological Advances on the Securities Markets", 1997, pp. 60-65, <<http://www.sec.gov/news/studies/techrp97.htm>>.

<sup>2</sup> *Ibid.*

<sup>3</sup> See, for example, CSA Strategic Plan 1999 – 2001, July 1999,

<[http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Notices/csanotices/csastaffnotice\\_11\\_301\\_19990702.html](http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Notices/csanotices/csastaffnotice_11_301_19990702.html)>.

<sup>4</sup> See, for example, A. LEVITT, "Common Sense Investing in the 21st Century Marketplace", May 1999, <<http://www.sec.gov/news/speeches/spch280.htm>>.

<sup>5</sup> IOSCO, "Securities Activity on the Internet", 1998, <[http://www.iosco.org/docs-public/1998-internet\\_security-document03.html](http://www.iosco.org/docs-public/1998-internet_security-document03.html)>.

<sup>6</sup> National Policy 11-201 "Delivery of Documents by Electronic Means", Dec. 1999, <[http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/11-201\\_19991215\\_txt.html](http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/11-201_19991215_txt.html)>.

<sup>7</sup> National Policy 47-201 "Trading in Securities Using the Internet and Other Electronic Means", Dec. 1999, <[http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/47-201\\_19991215\\_txt.html](http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/47-201_19991215_txt.html)>.

5. Due to recent technological developments, investor participation in secondary markets has increased dramatically and electronic trading should be considered a present-day reality. While the use of the Internet is primarily beneficial to market participants, it can also raise investor protection concerns as well as issues relating to the application and compliance with the securities laws. Like any technology still in its infancy, the Internet has its own set of growing pains and as its ultimate potential is still unknown, many of cyberspace's hidden dangers are only beginning to surface. Taking into consideration the complexity of the subject, the present study will focus primarily on the identification of online investing problems leading to investor dissatisfaction as well as on suggesting appropriate solutions. While it focuses on the American experience and practice, due to the border-less nature of the Internet, the concerns discussed in this paper are common to all jurisdictions.

6. The present research paper is divided into three chapters. The purpose of the first chapter «Characteristics of the Internet and its Impact on the Securities Industry» is not to provide a comprehensive statement of the constantly evolving characteristics of the Internet, but rather to set the context for the discussion of online investing issues that follows in the next chapters. The second chapter «Investor Complaints against Online Brokers» concentrates on the dramatic rise in investor claims relating to services provided by the online brokerage industry. It discloses common misconceptions regarding electronic trading as well as the limits and weaknesses of information systems' capacity and functionality. The third chapter «Online Fraud: Old Fraudulent Schemes Using New Technologies» emphasises the problem of illicit and abusive online investment schemes, which have the potential to spread like wildfire. Over the next few years, problems related to investment fraud could reach epidemic levels as several million unsophisticated newcomers crowd onto the information superhighway. As a result, cyberspace may come to be regarded as a lawless haven for investment swindlers.

7. The purpose of securities regulatory authorities is to protect investors from unfair, abusive or fraudulent practices, and fostering fair, efficient and competitive capital markets that will provide investment opportunities and access to capital. However, before proceeding to analyse the regulatory approaches to the use of new technologies in the securities industry, it is critical to understand the factual background of online investing, which is the main purpose of the present study.

## **1. Characteristics of the Internet and its impact on the securities industry**

8. The present chapter focuses on evolution of the Internet from a former "ivory tower" to a highly commercialized investment tool. It describes the technical characteristics of various methods of electronic communication that have advanced the progressive development of online investing. Furthermore, this chapter presents an overview of near-term forecasts and current Internet use by investors as well as its impact on the capital markets. Finally, it provides a technical description of the operation of online brokerage systems and reviews its current development trends. Comprehension of these rather technical characteristics is necessary for a better understanding of rising concerns related to online investing, discussed in the following chapters.

### **1.1. An overview of Internet developments in the context of securities trading**

9. Cyberspace was once a place inhabited largely by government agencies and academics linked together through a decentralised collection of computer networks that came to be known as the "Internet". History will no doubt record the evolution of the Internet as among the most significant developments of all time. The past decade has witnessed more explosive growth in capital markets and more rapid technological change than any other time in history<sup>8</sup>. The late 1980s and early 1990s gave birth to a torrent of commercial entrants into cyberspace. The result is that cyberspace is no longer an ivory tower World. Thanks to a new generation of sophisticated software programs that take much of the pain out of navigating the Internet, more and more of those who are online spend much of their time in the confines of commercial services. One of the most powerful "magnets" drawing consumers to Internet based commercial services is the growing number of bulletin boards and discussion groups

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<sup>8</sup>L. S. UNGER, "Customer Expectations Online: Are They Your Obligations?", Jan. 1999, <<http://www.sec.gov/news/speeches/spch249.htm>>.

devoted to investment tips, advice and solicitation. By providing cheap, quick and easy access to vast sources of investment opportunities, the Internet is revolutionizing the securities industry.

10. Internet trading has become pervasive since March 1996, the year of the first direct public offering by *Spring Street Brewing Company*<sup>9</sup> (“*Spring Street*”). To sell stock to the public directly online, *Spring Street* created a Web site on which it posted its offering materials. As in any other traditional distribution of securities, investors were invited to study the documents, which could both be downloaded from the Internet and printed. All interested investors had to complete a subscription agreement and send a payment to receive their share certificates. Using direct public offering, *Spring Street* managed to attract more than 3 500 investors and raise about 1.6 million dollars without any underwriter participation. The absence of an underwriter during its primary offering implied that no market maker would be likely to make a secondary market at the conclusion of the initial *Spring Street* offering. To remedy this problem, *Spring Street* again relied on the Internet, this time as a substitute for a market maker. At the conclusion of the company’s primary offering, an electronic bulletin board was posted on its Web page where shareholders could trade their shares without the intervention of any broker or dealer. More specifically, *Spring Street* created Wit-Trade, which it described as a “bulletin board based stock market” for trading in its stock. Although the ambitious Wit-Trade bulletin board was never fully implemented, the principals behind *Spring Street* have announced plans to develop a broker-dealer firm that will assist in both online public offerings and bulletin board trading.

11. Today trades placed with online brokers account for 25 percent of all trades on the New York Stock Exchange and NASDAQ<sup>10</sup>. Any home equipped with a computer and a modem is just a few keystrokes away from a wealth of instantly accessible research data and financial news. All this investment information is available through the electronic methods of communication, which are discussed below.

#### 1.1.1 . Electronic methods of communication

12. Although the information disseminated over the Internet may not be different from the information disseminated by telephone or fax machine, the Internet provides new methods of communication, which present new opportunities for the securities industry. Generally, communications are sent through the Internet via the World Wide Web (Web), electronic bulletin boards, e-mail and personal broadcast networks<sup>11</sup>. A common characteristic of these methods is the widespread and almost instantaneous communication with other users.

13. A widely publicized mechanism to distribute information on the Internet is the *Web*. The Web is a vast network of sites, which are collections of Web pages stored on a single computer. Web pages are graphical, audio and textual presentations of information that can be revised and updated. The mere posting of information on a Web site potentially makes it available World-wide. While access to Web sites can be restricted through the use of technologies that can require passwords or identification, the majority of Web sites are currently freely accessible. As to applications of Web sites in the securities industry, they can be used to distribute information about securities to a wide audience as well as to dispense investment advice and to effect transactions. Web sites designed to solicit business are advertisements, because they are addressed to an anonymous audience. Consequently, they are subject to internal company approval prior to publication<sup>12</sup>.

14. A second mechanism used to distribute information on the Internet is the electronic bulletin board, also referred to as a newsgroup or a message board. An electronic bulletin board is analogous to its physical counterpart, and accessible to any member of the public with a personal computer and Internet access. As such, bulletin board postings soliciting business are considered to be advertisements. A *chat room* is a form of bulletin board that enables users to communicate with each other one-on-one or in a group on a real-time basis. Chat rooms are subject to the same guidelines as public appearance on radio or television, as they are considered to be public forums. Moreover, scripted chat presentations in contrast with the unprepared chat room communications are considered to be advertisements. Because

<sup>9</sup> J. C. COFFEE, “Brave New World?: The Impact of the Internet on Modern Securities Regulation”, 52 *Bus. Lawyer*, Aug. 1997, pp. 1214-1215.

<sup>10</sup> *Supra*, footnote 8.

<sup>11</sup> *Supra*, footnote 5, Part I “Characteristics of the Internet”.

<sup>12</sup> “The Internet Guide for Registered Representatives”, Sep. 2000, p. 7, <<http://www.nasdr.com/4040.htm>>.

of the difficulties of supervision and the potential liabilities resulting from participating in chat rooms and bulletin boards, many brokerage firms limit or prohibit the participation of their representatives in such activities. If a firm permits its representatives to discuss securities in chat rooms or bulletin boards, its procedures must reflect how the firm will supervise this activity in the same way as any other advertisement. Some firms require representatives to obtain written approval before participating in these activities. In addition, firms have adopted content guidelines that their representatives must review, acknowledge in writing, and adhere to during chat room discussions. Firms may also require their representatives to provide print copies of chat room comments to their compliance department for monitoring purposes.

15. A third mechanism used to distribute information over the Internet is electronic mail (e-mail). An e-mail is an electronic message, similar to a letter or a fax, that is directed to a particular or to a vast number of addressees. Group e-mails, identical electronic messages sent to multiple individuals, are considered to be sales literature<sup>13</sup>.

16. A fourth mechanism used to distribute information is the personal broadcast network. When using this technology, consumers download computer "tuners", similar to radio or television station tuners, free of charge. Providers of information then pay a fee to transmit information to anyone who has activated a tuner.

17. The Internet allows Web site sponsors, bulletin boards and newsgroups to establish electronic links, known as "hypertext" or "hyperlinks", which allow the interconnection of information and materials within (internal hyperlinks) and between (external hyperlinks) Web sites. A person accessing a specific Web site typically sees the home page first. The home page may contain internal hyperlinks to additional information on the Web site or external hyperlinks to information on other Web sites. Hyperlinks allow viewers to move quickly and easily through documents to find the desired information and create proximity between information sources that is not available in the paper context. This rapid, cross-referencing mechanism provides readers with a unique and valuable information-gathering tool. Because hyperlinks can send a reader to a page in the middle of a document or a Web site, the information may be provided out of the context and without necessary cautionary or explanatory language. The improper use of hyperlinks is of concern to securities regulators because a hyperlink can give the appearance of legitimacy to otherwise non-legitimate information. The same care should be exercised in choosing links as in referring customers to any outside source of information. It is also important to disclaim any responsibility for the content of any external Web sites that may be linked to the company's Web site<sup>14</sup>.

18. Each of the new methods of communication discussed above provides the dissemination of information about investing, which can reach a broad audience in seconds for a low cost. Basic access costs normally include the telecommunication cost involved in connecting to a local Internet service provider and the fee charged by the provider. No special equipment is required, other than browser software and a modem connection to an Internet service provider, which have become standard features of most personal computers. These low costs contribute to the enormous amount of information that is available to investors. Moreover, the Internet is a very flexible medium, in that the information can be easily and inexpensively erased or updated within minutes.

### 1.1.2. The impact of the Internet on the securities industry

19. Technological innovations have transformed capital markets and brought significant benefits to market participants. The introduction of the Internet had a uniquely positive implication on investor empowerment. While the global Net may assist a prospective issuer in accessing a market, it does even more to enable investors to obtain significantly more information at lower costs without filtration by brokers or other securities professionals who may have self-interest in promoting transactions. As a result, people are now investing not only more than ever before, but increasingly investing via the Internet. On the other hand, the cost of acquiring and processing information concerning issuers has been recognised as one of the constraints that determine the boundaries of the efficient market<sup>15</sup>.

<sup>13</sup> *Ibid.*, p. 4.

<sup>14</sup> Osler, Hoskin & Harcourt publications, Winter 1998, <<http://www.osler.com/publications/SecuritiesWebsite.html>>.

<sup>15</sup> *Supra*, footnote 9, pp. 1196-1198.

Reduction of these costs will occur as the Internet expands its boundaries for the efficient market outward to include less actively traded securities.

20. U.S. investors utilise electronic trading in the most aggressive way. Nineteen ninety-seven will be remembered as the year when the Internet entered the mainstream of U.S. capital markets. During the first quarter of 1997, online trades in the U.S. comprised of just over 7 % of total trading volume. By the first quarter of 1999, this percentage had more than doubled. Online trading grew nearly 50 % during that quarter alone, with one in six equity trades occurring online. Analysts foresee that one in every four trades will take place online by the end of 2000<sup>16</sup>. On the contrary, a survey conducted for *Canadian Securities Administrators*<sup>17</sup> cited the relative conservatism of Canadian investors. Only 8 % of Canadian investors with Internet access used investment dealers' Internet-based services in 1999. The same survey showed a more significant number of people using the Internet for investment research. Of all people surveyed with Internet access (58 % of those surveyed) 39 % said they use the Net for investment research, while 61 % said they do not. These forecasts of the aggressive growth of online investing in the United States can be partly explained by psychological reasons related to overconfidence resulting from the access to vast quantities of investment data. A study conducted by Brad M. Barber and Terrance Odean<sup>18</sup> showed that once online, investors have an illusion of knowledge, which increases overconfidence. The fact that online investors generally manage their own stock portfolios and execute trades at the click of the mouse fosters an illusion of control, which reinforces overconfidence.

21. The Internet and online brokerage have become a driving force in transforming not only investment behaviour, but also the markets themselves. Capital markets are responding to this increased participation by investors. Technological advances have played a key role in the recent growth of alternative trading systems known as Electronic Communications Networks ("ECNs")<sup>19</sup> and the increased opportunities for retail investors to trade securities in after-hours markets<sup>20</sup>. Though these two issues require particular attention, the analysis of their impact on financial markets is not the main purpose of the present paper. Therefore, the following is only a brief overview of the interaction of the securities industry and new technologies. Electronic communication networks are challenging traditional trading venues. They are defined as any electronic system that widely disseminates to third parties orders entered into it by an exchange market maker or over-the-counter market maker, and permits such orders to be executed in whole or in part. Electronic trading technology has blurred the distinction between broker-dealer and exchanges. Broker-dealers developed electronic trading systems that function like exchanges: integrating customers' "buy and sell" orders, and providing a means for customers to interact with each other's orders. Electronic trading technology has a great potential for "disintermediating" the markets, as it provides means for buyers and sellers to meet directly without intermediaries like markets makers or specialists. By some estimates, up to 40 % of online investors' orders are entered after the markets close<sup>21</sup>. As a result, trading periods will be expanded – both to accommodate investors who want to trade outside of the traditional trading times and to address World-wide investing activities. By the next decade, average investors may be able to view trading activity 24 hours a day from a single computer screen.

22. Technology is changing the securities industry in ways that no one could predict with certainty. Although a decade is a relatively short period compared to a millennium, if the decade ahead is anything like the last one, we will witness much more remarkable changes in capital markets.

<sup>16</sup> E. SPITZER, "From Wall Street to Web Street: a Report on the Problems and Promise of the Online Brokerage Industry", *Exec. Summary*, Nov. 1999, p. 2,

<[http://www.oag.state.ny.us/investors/1999\\_online\\_brokers/execsum.pdf](http://www.oag.state.ny.us/investors/1999_online_brokers/execsum.pdf)>.

<sup>17</sup> See, for example, Angus Reid Group survey, April 1999,

<[http://www.osc.gov.on.ca/en/About/News/NewsRelease/poll\\_shows\\_lowuse\\_19990425.html](http://www.osc.gov.on.ca/en/About/News/NewsRelease/poll_shows_lowuse_19990425.html)>.

<sup>18</sup> B. M. BARBER & T. ODEAN, "Online Investors: Do the Slow Die First", Dec. 1999, pp. 6-7,

<<http://www.gsm.ucdavis.edu/~bmbbarber/working.html#online>>.

<sup>19</sup> L. S. UNGER, "The Internet – Will It Be the End of the Stock Market as We Know It", April 1999,

<<http://www.sec.gov/news/speeches/spch288.htm>>.

<sup>20</sup> SEC Special Study, "Electronic Communication Networks and After-Hours Trading", June 2000,

<<http://www.sec.gov/news/spstindx.htm>>.

<sup>21</sup> L.S. UNGER, "After-hours Trading: are Retail Investors Ready for Prime Time", June 1999,

<<http://www.sec.gov/news/speeches/spch267.htm>>.

## 1.2. The operation of the online brokerage system

23. Electronic brokerage actually predates individual investors' access to the Internet. In the mid-1980s, a number of broker-dealers offered customers software and direct dial-up access that permitted them to submit orders via their personal computers. In the early 1990s, several financial intermediaries gave customers the ability to enter orders through private computer networks. Finally in 1995, the first systems allowing customers to submit orders through the Internet were introduced. In less than five years, on-line brokerage has become an important channel<sup>22</sup> for conducting retail brokerage transactions. According to the SEC special study on online brokerage<sup>22</sup>, by the end of the second quarter of 1999 there were 9.7 million on-line accounts, up from 3.7 million in 1997 and 7.3 million in 1998.

24. Many of the brokerage firms offering online trading services are not new to the securities industry. In fact, these same firms have been servicing the securities industry well before the advent of online trading. As a result, some of these older brokerage firms already had substantial technology in place for providing brokerage services, before entering the online market. As full-service firms go on-line, the most significant challenge they face is a potential "channel conflict" between their traditional method of distributing financial services - the registered representative - and their new distribution method - the Internet. In the traditional full-service model, the customer typically develops a stronger relationship with the registered representative than with the firm itself. In the on-line model, however, the customer develops the stronger relationship with the firm itself, rather than with any registered representative.

### 1.2.1. The technical characteristics of the online brokerage system

25. When servicing traditional brokerage clients, a broker manually entered orders into the system after he received instructions from the client. In contrast, online investors place orders directly into the brokerage firm's trading system, via the Internet, and circumvent the need for order entry by a broker. Many of the online brokerage firms utilise a three-tier architecture system consisting of the following: a front-end system, middleware and back-end system<sup>23</sup>. This system is comprised of numerous complex components, any one of which can become a bottleneck that constrains the firm's overall ability to accommodate customer demand.

26. The first tier of architecture consists of the "front-end system". It enables online investors to place orders directly into the firm's trading system. Generally, it consists of computer servers or Web servers, which are controlled by application software designed to manage individual client sessions. After accessing the Internet through an Internet Service Provider, an online investor connects to the online brokerage firm's system. For certain features, such as free research and delayed quotes, the online investor can obtain the information without logging into the firm's secure investor account and trading areas, also known as "member areas". When logging into member areas, the online investor is asked to provide his or her account name and password. Once this information is authenticated by the brokerage firm's member database, the online investor is admitted into the member area and may begin requesting account information and making trades.

27. The second tier of architecture, or "middleware", provides messaging, routing, and access to the firm's trading system. The middleware determines the type of request that the user is placing, such as a request for research, quotes, or customer support, and routes that request to the appropriate part of the system for a response. For example, if the user requests a quote for a security, the middleware sends a message to the quote server in order to retrieve that quote. The quote server forwards the appropriate response through the front-end system, through the Web servers and eventually back to the user, via the Internet. Similarly, if the online investor places a trade, the middleware routes the transaction to the system's trading and account components in order to accomplish the requested task.

28. Trading functions occur within the third tier of architecture known as the "back-end system". Generally, the back-end of the system is where the firm maintains its customer trading information and its "trading functionality" on either database servers or a mainframe. Once an investor enters an order,

<sup>22</sup> SEC Special Study, "On-line Brokerage: Keeping Apace of Cyberspace", *Exec. Summary*, Dec. 1999, p. 1, <<http://www.sec.gov/news/studies/cybexsum.htm>>.

<sup>23</sup>E. SPITZER, "From Wall Street to Web Street: a Report on the Problems and Promise of the Online Brokerage Industry", Nov. 1999, pp. 56-60, <[http://www.oag.state.ny.us/investors/1999\\_online\\_brokers/full.pdf](http://www.oag.state.ny.us/investors/1999_online_brokers/full.pdf)>.



the front-end system will return the message asking for confirmation of that order. At that time, the customer is usually provided with a real-time quote for that security. From the time the order is confirmed and until the order is routed to the market for execution, the order passes through the front end to the back-end of the system. It is at that time that the order undergoes a vetting procedure to check for restrictions on the customer's account, to verify that it has adequate capital and to ascertain whether he is authorized to trade on margin. Generally, the vetting procedure is performed by the firm's systems without human intervention according to pre-programmed instructions. While some firms perform these checking functions through their own systems, others contract with third party back-office providers, which serve as the firm's clearing agent. One example of a prominent back-office provider is Automated Data Processing ("ADP").

29. Once an order passes through all of the firm's pre-programmed vetting criteria, it is sent to the market for execution. If the order does not pass the pre-programmed vetting procedures, it will become what is called an "exception," and will be manually reviewed by a broker. After being reviewed and assuming that the reason for the exception has been adequately addressed, the order will be submitted for execution. Once the order has been executed, the market maker, an exchange or an ECN, forwards an execution report back to the online brokerage firm, through the firm's back office provider or clearing agent. The agent or the provider then forwards the execution notification to the online brokerage firm's back-end system, which is used to update the user's account information and order status screens. At times of high market volume or volatility, these execution reports may be delayed due to capacity limitations or system bottlenecks. As a result, although an online investor's order may have already been executed, the online investor's account may not be updated to reflect the execution. Once the investor's account information is updated, however, the investor may log into member areas and review the status of his or her order. In some firms, the investor may also be able to check the new buying power of the account. The brokerage firm's clearing agent also generates a paper confirmation, which is sent to the user through regular mail. The investor then has three days from the date of execution, known as the "settlement date", within which to fund the transaction.

### 1.2.2. Development trends of the online brokerage industry

30. Though it is difficult to anticipate where technology will take the securities industry in the next few years, industry analysts foresee such trends in the development of online brokerage as the customisation of online content and financial advice, the continued growth of the online channel and the convergence of online and offline brokerages<sup>24</sup>.

31. A number of broker-dealers have begun to personalize investment information and advice to create dynamically generated Web site content relevant to each user. Online brokerage firms are segmenting products by customer to take care of their best customers by account assets and trade rates. By personalizing Web site content, broker-dealers can create customer loyalty, lower administrative costs, increase revenues, and cross-sell products and services. There are two general types of personalization: "push" and "pull" technology. With pull technology, the customer sets his preferences and the online broker sends information tailored to these preferences. With push technology, the broker develops a user profile based on observations about the user's behaviour online or his transaction history. The broker can either classify users and target different information to different categories of customers or recommend products based on user profiles that he has developed, a practice known as "data mining". For example, since the online broker observes that a customer tends to purchase certain types of stock when certain market conditions are prevalent, he can send to the customer e-mail recommending similar stocks when similar market conditions are present.

32. Industry analysts foresee a continued growth both in the number of on-line brokerage accounts and account assets. The five sources of on-line market growth today are expected to be the following: (1) traditional mutual fund investors investing incremental income in stocks; (2) employees who previously let employers invest for them now investing for themselves; (3) new investors in the market favouring online firms; (4) investors transferring their accounts from full-service firms; and (5) investors who open online accounts while maintaining their full-service accounts.

<sup>24</sup> SEC Special Study, "On-line Brokerage: Keeping Apace of Cyberspace", Dec. 1999, pp. 17-22, <<http://www.sec.gov/news/spstindx.htm>>.

33. The main question is whether online brokerage represents a natural evolution of discount brokerage from a telephone-based technology platform to an Internet-based one or rather a revolution in the way brokerage will be conducted in the future. The majority of industry analysts believe that registered representatives will not disappear as full-service firms go on-line, because while most investors will use the Internet to retrieve investment information, not everyone will trade online. Their role will, however, evolve, as full-service firms will have fewer representatives to serve their clients and will leverage their resources to provide customers with more and better technology-related services. Customers are expected to gravitate toward firms that give them the choice of investing both on-line and off-line, what will lead to the progressive convergence of online and full-service brokerage.

34. The information transparency will create more intelligent customers, changing the registered representatives' advisory role and consequently the culture of larger broker-dealers. Online investors can click onto a firm's Web site and, frequently at no charge, find market data, historical charts, securities analyses (e.g., analyst reports, industry reports, earnings estimates, comprehensive charts, news stories), stock and mutual fund screeners, asset allocators, mutual fund supermarket offerings, interactive calculators, and customisable home pages.

35. Though there are predictions of an approaching revolution of direct transactions between issuers and investors in primary offering and between investors in secondary market transactions, the disappearance of traditional financial intermediaries – the so-called “disintermediation” – is not likely to happen in the near future<sup>25</sup>. But still a partial disintermediation is a real prospect, as intermediary-less transactions become more common due to the investor empowerment discussed above.

## 2. Investor complaints against online brokers

36. As it was stated in the previous chapter, the online securities trading is experiencing an explosive growth. With such growth comes a risk that an increasing number of unsophisticated and novice investors will suffer substantial losses in their online accounts. As a matter of fact, the number of complaints against online brokers has increased dramatically over the last three years. During the fiscal year of 1999, the SEC received over 3 000 complaints against online brokers, an increase of close to 200% over the fiscal year of 1998 and about 1200% over the fiscal year of 1997<sup>26</sup>. According to SEC statistics, although sales practice complaints continued to decline, operational complaints rose sharply in 1999, reaching up to 56 percent<sup>27</sup>. Typical operational complaints include failure to process or delays in executing orders, difficulty in accessing accounts or contacting the broker and errors or omissions in account documents. The decrease in sales practice complaints can be explained by the fact that online investors can hardly become victims of such traditional malpractice as, for example, unauthorised or excessive trading, since the investor, being the only person who is authorized to trade in the account, maintains total control over the number of transactions. By way of contrast, the majority of complaints against off-line brokers, such as unauthorised trade, failure to follow customer's instructions and misrepresentation, involve a human component.

37. While it appears that online brokerage firms are well insulated from some traditional claims brought in arbitration, the brave new World of trading online has not eliminated every actionable cause and is sure to open up new areas of concern for investors and online brokerage firms alike. As mentioned above, there are certain traditional claims, which have been severely weakened by online trading while other areas remain strong. New areas of concern for investors and online brokers discussed in detail in the present chapter include: online investors misconceptions due to misleading advertising by online brokerage firms, the application of a suitability doctrine in Cyberspace, best execution issues raised by new technologies and the adequacy of system capacity and functionality according to the investors' needs and demands.

### 2.1. Traditional investor complaints in the online environment

<sup>25</sup> *Supra*, footnote 9, pp. 1200–1201.

<sup>26</sup> L. S UNGER, “Empowering Investors in an Electronic Age”, May 2000, p. 6, <<http://www.sec.gov/news/speeches/spch380.htm>>.

<sup>27</sup> “Dramatic Rise in Volume of Investor Requests for Help”, *n.d.*, <<http://www.sec.gov/consumer/jdatacom.htm>>.

### 2.1.1 . Misleading and false advertisements

38. The rapid growth of Internet-related commerce and marketing has given rise to increasingly aggressive advertising for online investment opportunities<sup>28</sup>. While online trading may offer significant advantages for investors, the facts about this kind of investing are in danger of disappearing behind the hype<sup>29</sup>. The information furnished by the online brokerage industry does not always apprise investors of all of the relevant risks and limitations of online trading. Online brokerage firms should ensure that advertisements do not foster unrealistic expectations regarding the potential of online trading. They must accurately describe their services and avoid language that misleads customers concerning their trading capacities<sup>30</sup>. When advertising their services, brokerages should use caution in promising unrealistic success rates or soliciting higher earnings from the advertised broker compared to competitors. According to the SEC statistics, investor complaints concerning misleading or false advertisements rose to 46 % in 1999<sup>31</sup>. The most common types of investor misconception due to false advertising that lead to complaints are discussed below.

#### (i) Online trading does not provide direct access to stock markets

39. Although online trading permits online investors to transmit orders without initiating direct voice contact with a broker, order handling and execution for online trading is similar to that of traditional trading. The common perception that online trading links an individual directly to the market is incorrect<sup>32</sup>. Despite the highly advanced technology employed by the online brokerage firms, there are still numerous instances of human intervention in the process. Regardless of whether the order is transmitted over the Internet or called in to a broker, the order must still be reviewed by the brokerage firm, which includes but is not limited to checking the order against the customer's account records, verifying the account buying power, and examining any trading restrictions imposed on the customer's account. If during this review process a problem is found concerning the order, often referred to as an exception, the order will be routed to a broker for a manual compliance review. Likewise, if a problem occurs after an order has been routed to a market maker for execution, the order might be returned to the brokerage firm for manual review, a procedure known as a "kickback". Investors are generally not informed of these exceptions to the normal automated processing of their orders. Moreover, since the investor who placed this order is generally not informed that the order has been kicked-back or flagged for manual review, the investor is left with the impression that the online brokerage firm somehow sat on the order and failed to execute it in a timely manner.

#### (ii) The execution of an order does not occur simultaneously with its submission

40. The transmission of an order request over the Internet does not necessarily mean that the order will be executed immediately<sup>33</sup>. A click of the mouse will send a request for a trade to the online broker who, after putting the trade through the proper vetting criteria, will, in turn, rout the order to the marketplace, to an exchange or an ECN. Once the trade request is sent to the marketplace, it is executed, and only then is a notice sent back to the investor informing him that the order was successfully executed. In addition to delays that might occur during the order verification procedures, the order may also be delayed by slowdowns, outages or capacity bottlenecks on the systems of the online brokerage firms, or at the market makers or exchanges to which the brokerage firms direct orders for execution. There may also be delays due to congestion of the lines that connect the brokerage firms, the clearing agents, back office providers or the markets. Online brokers can only provide a service of routing orders to the marketplace, but they do not execute the requested orders by themselves.

<sup>28</sup> J. KAHN, "Online Brokerages Use Advertising in a Battle for New Customers", *NY Times*, Oct. 1999, <[www.sec.gov/consumer/jdatacom.htm](http://www.sec.gov/consumer/jdatacom.htm)>.

<sup>29</sup> W. C. MACLEOD, "Online Brokerage Advertising: Let's Stop Within the Law", *n.d.*, <[http://www.cybersecuritylaw.com/articles/macleod\\_online\\_ads.htm](http://www.cybersecuritylaw.com/articles/macleod_online_ads.htm)>.

<sup>30</sup> NASD Advertising Regulation, March 1999, <[http://www.nasdr.com/3072\\_9903.htm](http://www.nasdr.com/3072_9903.htm)>.

<sup>31</sup> *Supra*, footnote 27.

<sup>32</sup> *Supra*, footnote 23, pp. 41, 61-62, 69.

<sup>33</sup> *Ibid.*, pp. 35-36, 62.

### (iii) The truth about the commissions of online brokerage firms

41. Online brokers should be careful that investors opening an online account are informed of the applicable fees in a clear and concise manner<sup>34</sup>. The broker commission fees can be divided into initial and handling costs<sup>35</sup>. In general, starting an account at an online brokerage is cheaper than establishing a similar account with a traditional broker. The initial cost generally depends on what type of account the investor establishes and the types of securities he plans to trade. There is so much competition between brokerages that many have special incentives for investors starting new accounts (e.g., sign-up bonuses for new accounts). As with start-up costs, managing an account at an online brokerage typically has fewer costs than conducting business at a traditional brokerage. But investors must take in consideration that the advertised prices per trade apply only to orders meeting certain guidelines<sup>36</sup>. Many advertisements highlight their lowest commission fees without a clear disclosure of what the fee constitutes. It is only upon reading the fine print at the bottom of the full-page advertisement that the prospective investor learns the real commission fee applicable to his particular case. Sometimes the low rate only applies to purchases of small number of shares or to purchases of shares listed on the NASDAQ or NYSE. Limit orders cost an extra fee in comparison with market orders and brokerage firms usually charge higher fees for touch-tone automated phone ordering service or a broker-assisted order. Thus, most advertised commission rates apply only to a limited number of trades.

#### 2.1.2. Suitability rule

42. Among the hottest issues currently facing the securities industry is the extent to which online trading should be subject to suitability and best execution rules. According to the traditional suitability rule<sup>37</sup>, known as the requirement to "know your customer", a broker must have reasonable grounds for believing that the recommendation is suitable and appropriate for that particular customer based upon his individual financial situation, investment objectives, level of understanding and risk tolerance. The "know your customer" rule requires that the broker obtain a customer profile so that he will be able to properly match the needs of his customer with appropriate investments.

43. Until recently, online securities trading did not appear to implicate suitability considerations, as no recommendations were being made. Traditionally, leading online brokers have been discount brokers that have merely executed customer orders to buy or sell particular securities. Within the past years, the traditional model of online trading - customers executing transactions through discount brokerages - has experienced several significant changes<sup>38</sup>. First, there has been a discernible move by full-service firms, which routinely do offer trading recommendations to their customers, to establish an online presence. Second, there has been a growing tendency for traditional discount brokers to offer the kind of investment assistance that investors expect from full-service firms, such as access to research, portfolio management tools, financial planning and, increasingly, recommendations for trading particular securities.

44. According to the SEC Report issued in November 1999 entitled "Online Brokerage: Keeping Apace of Cyberspace"<sup>39</sup> (hereinafter the "Report"), the online trading industry has been at odds over the applicability of the traditional suitability rule in the online investing context, since online accounts, being typically non-discretionary, involve little interaction with the broker, much less any communication that could be viewed as a "recommendation" or specific advice. Thus, according to some in the online trading industry, suitability obligation applies to online brokers in only the most limited circumstances, particularly when the latter has made a specific "recommendation" of a securities transaction to the customer. This situation is unlikely to occur when the investor merely accesses the firm's trading site to make trades upon his own research without any advice from the broker.

<sup>34</sup> *Ibid.*, pp. 42-43.

<sup>35</sup> "Online investing basics", Sep. 1999, pp. 3-4, <<http://www.smartcomputing.com/editorial/article.asp?article=articles%2Farchive%2F10509%2F02109%2F02109%2Easp&guid=crsc1nk8&searchtype=0&WordList=investing+basics>>.

<sup>36</sup> B. A. CARLIS & B. S. HAMBURGER, "The True Cost of Internet Investing", July-Aug. 1999, [*Westlaw*], 1131 PLI/Corp 175, \*177.

<sup>37</sup> NASD Conduct Rule 2310, <[http://www.nasdr.com/conrule\\_2310.htm](http://www.nasdr.com/conrule_2310.htm)>.

<sup>38</sup> M. J. MISSAL & G. C. MILLER, "Online Trading is Creating Expanded Obligations for Brokers", March 2000, [*Westlaw*], 2 No. 7 e-security 1.

<sup>39</sup> *Supra*, footnote 24.

45. The main concern is that in the online environment, taking into consideration push and pull advertising technologies, it is rather difficult to determine what constitutes a recommendation, and thus it is not always obvious when the suitability rule can be applied. *NASD* defined a recommendation to include any instance in which an online broker brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail or the transmission of electronic messages<sup>40</sup>. The suitability of the security should be determined with respect to each customer who responds to the message before effecting a transaction. Despite the acknowledged difficulty of ascertaining precisely where to draw the line, the Report, nevertheless, concluded that brokers, whether online or offline, have a "reasonable basis suitability obligation", since any recommended investments or strategies must be appropriate for at least some customers.

46. There can be several hypothetical situations that lead to the controversial application of the suitability rule<sup>41</sup>. However, there is no customer-specific suitability obligation when the online broker provides solely order execution services. Similarly, the suitability rule does not apply when a customer pulls research information or market commentary from a firm's Web site, makes his or her own investment decision and places an order through an online account. Research, being investment-specific and not investor-specific, does not trigger a broker's obligation to ensure that the security is appropriate for an individual customer. To the contrary, the broker would still have an obligation to have a reasonable basis for the product description contained in the research. Even if the firm initiates the dissemination of information, a customer-specific suitability obligation is not triggered as long as such information is generalized. Traditionally, impersonal mass advertising and sales literature and other promotional activities have not been considered as recommendations, since such activities are not targeted to particular investors. If, however, the firm makes individualized recommendations to a customer that are based on information it has collected about this investor or if selective information respecting particular securities was "pushed" by the broker through an e-mail to the investor, the firm would have a customer-specific suitability obligation. It depends on the facts and circumstances of each case whether the requisite "recommendation" has been made. Above all, until more regulatory guidance is available, it would seem prudent for online brokers to make clear that any form of information they provide to online account owners – via their Web sites, e-mails or otherwise - is provided solely for informational purposes, and does not constitute a recommendation of any particular security or security transaction. To avoid potential claims, some Internet-trading firms use computer programs to automatically monitor accounts for unusual trading activity.

47. Similarly, in Canada, in order to comply with regulatory provisions, all registered brokers were required to review each client's order for suitability before its execution, even if the client was not seeking the broker's advice. Recognising the changing needs of investors and brokers' community, in April 2000 the *Canadian Securities Administrators* announced by press release that securities regulators would grant relief from the suitability rule to brokers not in the business of giving advice<sup>42</sup>. Accordingly, the relief from suitability obligations will be granted on an application basis to brokers who provide only trade execution services to their clients. To safeguard the interests of investors, the *CSA* are imposing several conditions on brokers seeking this relief. First of all, the dealer must operate as a legal entity or business unit with separate registered representatives and account documentation limiting activities to the trade execution services so that no advice or recommendations will be given regarding the purchase or sale of any security. Second, the broker must not compensate individuals on the basis of transactional values, and finally, he must receive from the client a written informed acknowledgement that no advice or recommendation will be given. *E\*TRADE*, Canada's non-advice based service, has obtained first relief from the suitability rule from all Canadian provincial securities regulatory authorities<sup>43</sup>. However, *E\*TRADE*'s traditional advice-based brokerage services will continue to be subject to the suitability rule.

<sup>40</sup> *NASD* Notice to Members 96-60, 1996, [LEXIS], 76 at \*3 Sept. 1996.

<sup>41</sup> B. A. BELL, "Online Trading Losses and Suitability Claims against E-brokers", Feb. 1999, [Westlaw], 2 No. 9 Wallstreetlawyer.com: Sec. Elec. Age 18.

<sup>42</sup> *CSA* News Release, "CSA Provides Relief from Suitability Obligations", April 2000, <[http://www.osc.gov.on.ca/en/About/News/NewsReleases/csa\\_suitabilityobligations\\_20000410.html](http://www.osc.gov.on.ca/en/About/News/NewsReleases/csa_suitabilityobligations_20000410.html)>.

<sup>43</sup> *E\*TRADE* Canada, "Change in Suitability Review", Sep. 2000, <<http://www.canada.etrade.com/suitability/>>.

### 2.1.3. Best execution issues

48. Advances in technology, particularly the rise in online trading, have also had implications on the duty of best execution. The duty of best execution requires that brokers seek the most advantageous terms reasonably available under the circumstances for their customers' transactions. Best execution encompasses a number of factors starting with the price of the execution and the opportunity for price improvement as well as speed and likelihood of execution.

49. Securities authorities have recently focused heightened attention on online brokers' duty of best execution<sup>44</sup>, since its scope evolves in Cyberspace's dynamic environment, as market changes occur, giving rise to improved executions for customers' orders, including opportunities to trade at more advantageous prices. As these changes occur, brokers' procedures for seeking to obtain best execution for customer orders must also be modified to consider price opportunities as they become reasonably available. The widespread use of the Internet to facilitate the execution of online orders has made speed of execution a more important factor, which can be chosen over opportunities for price improvement in high volatility markets<sup>45</sup>. Because turnaround time is of utmost importance to many online customers, online firms should not be bound exclusively by price considerations in satisfying their best execution obligations. However, if a brokerage firm is claiming that speed is an important factor, it should be in position to demonstrate an impressive turnaround time.

50. Whether the order placed online is approved manually or electronically, ultimately the order is routed to the marketplace for execution. The order may be routed to various markets for execution depending in part on the market makers the brokerage firm has established a relationship with, and on the exchange in which the security is listed. Increased competition among market centres, particularly the development of ECNs, has provided new execution alternatives. An order may be routed to an electronic marketplace, such as the *NASDAQ* or it may be routed directly to an exchange such as the *New York Stock Exchange*. Orders may also be routed for execution to Electronic Communication Networks. As a way to attract orders, some marketplaces pay brokers for routing investors' orders to these very marketplaces. This is called "payment for order flow"<sup>46</sup>. The broker may also decide to send the order to another division of the brokerage firm to be filled out of the firm's own inventory. This procedure is called "internalisation". In this way, the brokerage firm may make money on the "spread" – which is the difference between the purchase price and the sale price.

51. Online brokers, as well as their offline counterparts, must not allow an order routing inducement such as payment for order flow or the opportunity to trade with that order as principal, representing conflicts of interests between customers and brokers, to interfere with the duty of best execution. To avoid the eventual investors' complaints, online brokerage firms should prepare documentation to demonstrate that there was a regular and rigorous evaluation of the execution quality of a number of market centres, including the primary markets, the regional exchanges, the ECNs and third market makers. Finally, it's important to outline the possibility of online brokers, provided by new technologies, to route orders to markets according to consumer choice. This raises the question whether the duty of best execution will be applied in these circumstances, since the investor assumes the responsibility of his own choice.

52. Debate over the duty of best execution will continue for the foreseeable future, particularly considering new developments, such as the growth of after-hours trading, that raise additional concerns. Clarity in this area is likely to come from the maturing of ECNs and from improvements in technology. For the long term, advancements and refinements in communications technology will enable firms to improve their order execution practices, resulting in lower transaction costs and speedier and more efficient executions for investors.

## 2.2. Deficiencies in online information systems' capacity and functionality

<sup>44</sup> A. LEVITT, "Best Execution: Promise of Integrity, Guardian of Competition", Nov. 1999, <<http://www.gov/news/speeches/spch315.htm>>.

<sup>45</sup> R. Y. ROBERTS & E. L. PITTMAN, "SEC Attention Turns to Best Execution", Dec. 1999, [*Westlaw*], 2 No. 4 e-security 1.

<sup>46</sup> "Investor Tips: Trade execution", March 2000, <<http://www.sec.gov/consumer/tradexec.htm>>.

53. A considerable number of investor complaints are due to problems related to electronic system capacity and functionality. This increase in operational complaints is due, at least in part, to the rise in popularity of online trading. During this three-year period, the number of on-line investor accounts jumped from 3.7 million in 1997 to 7.3 million in 1998 to about 12 million today<sup>47</sup>.

54. With the rapid growth of online trading, online brokerages are forced to upgrade system capacity on a regular basis. Online brokerage firms must balance pressures for speed, accessibility and reliability of electronic trading services with the disclosure of technical factors, which may delay system access and trade execution. To avoid eventual complaints, online brokers should maintain contingency plans and records of significant system outages, conduct regular systems testing and evaluations and include plain disclosure of the risks of system delays or outages in new account documentation. When acquiring new accounts, responsible online brokers should consider whether the capacity of their trading systems will permit them to appropriately handle the influx of new accounts. A good example can be the class action suit against *E\*Trade* commenced on November 21, 1997 in Santa Clara County Superior Court in California<sup>48</sup>. The complaint alleged that *E\*Trade* aggressively marketed its services despite a computer system that could not handle the additional volume. *E\*Trade's* alternative of permitting telephone trades was inadequate because callers experienced long delays due to busy signals and unanswered phones.

55. When an online investor wishes to place a trade, he should be informed that trading functionality was inoperative at the time the investor attempted to log in to his or her account to place an order. As a general rule, all firms should be required to post a notice of an outage on their home pages during the time that the outage is in effect. This would ensure that online investors learn of the outages in a timely manner, before spending a significant amount of time on the site, only to find out that trading is not working, or that the trading section of the Web site is not even accessible. Even after an order has been executed, online investors may experience delays in their receipt of reports confirming their order executions<sup>49</sup>.

56. Confirmation reports can be delayed for a number of reasons, including: (1) delays by the market makers and/or exchanges in reporting order executions to the online brokerage firms; (2) bottlenecks in the communication lines between market makers/exchanges and online brokerage firms; (3) system delays and capacity bottlenecks at clearing firms utilized by online brokerage firms; (4) delays in customer account updates due to an ongoing batch processing performed by the firm's systems; and (5) system delays and outages at the online brokerage firms themselves. Regardless of the underlying reasons for these reporting delays, however, online investors should not presume that the execution of an order has not taken place just because the execution has not yet been reported back to their account. Any attempts to shut down and reboot a computer to re-send a previous trade request could result in unintentionally submitting a second duplicate order and therefore incurring liability for multiple orders.

57. Online investors may also face difficulties in attempting to cancel an order. In light of the potential reporting delays discussed above, an order may in fact have been executed despite the fact that the investor's account has not yet been updated to reflect that execution. In such an instance, it would be impossible to cancel the order since it would have already been executed. Moreover, having placed a cancellation order, an online investor should not proceed to place a second order until he or she has received confirmation that the first order has been cancelled. Otherwise, the online investor may unintentionally purchase the same security twice. The case *Hoffman v. TD Waterhouse*<sup>50</sup> where an online investor has sued a brokerage firm for executing orders hours after they were cancelled can be a good example to illustrate the occurring difficulties.

58. Many online brokerage firms necessarily run substantial batch programs in order to update their customer accounts to reflect the most recent transactions from any given day<sup>51</sup>. Generally, firms that rely on nightly batch processing lack the ability to provide real time updates of account buying power, available margin, and positions. As batch processing generally does not occur until the evening, after

<sup>47</sup> *Supra*, footnote 26.

<sup>48</sup> B. A. BELL, "Online Brokerages under Siege for Trading Outages and Delays", April 1999, [*Westlaw*], 2 No. 11 Wallstreetlawyer.com: Sec. Elec. Age 10.

<sup>49</sup> *Supra*, footnote 23, pp. 63-64.

<sup>50</sup> "Online Investor Accuses TD Waterhouse of Executing Cancelled Orders", Feb. 2000, [*Westlaw*],

5 No. 12 Andrews Sec. Litig. & Reg. Rep. 9.

<sup>51</sup> *Supra*, footnote 23, pp. 72-73.

the markets have closed, the intra-day information in an online investor's accounts is often based upon the previous day's close. Additionally, online investors should also be informed that they might be unable to access their account information at certain times, because the account functionality is disabled while the batch process updates the account information.

59. It is extremely difficult to identify and assess factors that make a particular firm's information systems inadequate, taking into consideration that each system is composed of numerous complex components. The firm's operational capacity is therefore inevitably limited by its weakest link, even if virtually every other component operates at a low percentage of available capacity. Furthermore, the percentage of an information system's capacity used by customers generally varies throughout the day, reaching "high points" at market open and close. Thus, capacity that may be sufficient to accommodate trading volume during much of the day may not be adequate during these narrow windows of high demand.

60. Nevertheless, potential deficiencies can be identified in each "tier"<sup>52</sup> or major component of an online brokerage information system.

- (i) Deficiencies in the "front end" of an online brokerage information systems, which provides the Web interface used by online brokerage customers. Front-end hardware was in some instances insufficient to handle high-volume traffic. Moreover, some firms used older software to handle their front-end tasks, which is not optimal for high-volume Web traffic and can slow system performance. As a result, customer login posed particular problems for online brokerage firms. Login times were further delayed by capacity constraints on databases that are essential to the login process.
- (ii) Deficiencies in the "middleware" component of online brokerage information systems, which routes messages back and forth between the front and back ends of the system. Capacity constraints on the number of messages that could be routed, as well as software bugs, adversely affected customer response times.
- (iii) Deficiencies in the "back end" of online brokerage information systems, which controls order routing, the vetting of trade orders, maintenance and updating of customer accounts.

61. A number of constraints on firm capacity can also be identified, including the following<sup>53</sup>:

- (i) A number of online brokerage firms rely upon mainframe computer systems originally designed for use by brokers employed by the firms themselves, and not intended for 24 hours -a-day, 7 days -a-week high-volume transactions that involve a direct interface with customers.
- (ii) The architecture of online brokerage information systems may limit their "scalability," or ability to grow as customer demand increases.
- (iii) Physical limitations, including adequate space, power and cooling needs may also constrain the ability of online brokerage firms to expand their information systems as needed.
- (iv) Online brokerage firms may find it difficult to hire and train highly skilled technical staff, which is critical to the expansion of information systems capacity.

62. To address all these capacity and functionality issues, online brokerage firms are adding capacity to their information systems. Some firms have begun to compensate customers for execution price adjustment during periods of trading system delays and outages. The larger firms are expanding their customer service staff or broker phone banks to increase availability of telephone trading at times of outages. Other firms are scaling back their advertising plans to bring new customers online focussing on increasing its capacity. The deficiencies in system capacity and functionality cannot be eliminated entirely, even in the most sophisticated technological environments. While the risks of such failures must be minimised to the extent that is technologically and economically rational, no trading system will ever be rendered failsafe.

### 3. Online fraud: old fraudulent schemes using new technologies

63. As it was discussed in the previous chapters, the Internet serves as an excellent tool for investors, allowing them to easily and inexpensively research investment opportunities and place trading orders.

<sup>52</sup> *Supra*, footnote 16, pp. 4-6.

<sup>53</sup> *Ibid.*



The Internet makes it easier for individuals or companies to communicate with a large audience through Internet Web sites, posting messages on online bulletin boards, entering discussions in live "chat" rooms, or sending mass e-mails. But, unfortunately, con artists who promote fraudulent and abusive investment schemes exploit the anonymity of Cyberspace to the hilt. It is easy for defrauders to make their messages look real and credible, making it nearly impossible for investors to tell the difference between fact and fiction.

64. The types of online investment fraud mirror the frauds perpetrated over the phone or through the mail. The defrauders can use a variety of Internet tools to spread false information, including sophisticated Web pages, bulletin boards, and online newsletters or "chat" rooms. As all these tools make it cheaper and easier for defrauders to carry out their schemes, online investors are beginning to question the integrity and reliability of research provided over the Internet. Certainly, losses attributable to Internet schemes remain a small fraction of those resulting from abuse attributable to other violations of securities laws<sup>54</sup>. As the Internet continues to grow, however, the potential for wrongful conduct, and resulting losses to investors, may grow apace. Therefore, the future of the Internet as an investing tool can be optimistic only if securities authorities are able to detect, prevent and punish fraudulent conduct<sup>55</sup>.

65. The majority of the abusive investment schemes in Cyberspace are similar to those that have been used for decades in the "real World". The online World, however, represents an enormous advance in the ability of con artists to victimise the unwary. The present chapter focuses on the different types of fraudulent scams in the securities trading context. It outlines ways that the electronic methods of communication as well as the anonymous basis of the Internet have innovated traditional fraudulent schemes. There is no uniform classification of online fraudulent schemes. In monitoring Cyberspace, regulatory authorities have identified multiple scams.<sup>56</sup> These scams were consequently analysed by different authors using different approaches leading to a certain confusion between several types of online fraud. For the purposes of better comprehension, the present work classifies online fraudulent scams in three main categories: misrepresentation, market manipulation and fraudulent offerings. In order to simplify the analysis, illegal touting, which is usually an inherent part of different scams, is discussed in details in the second subdivision together with "pump and dump" schemes. For every type of fraud, the chapter presents an example of a recent case to illustrate the implication of the Internet on the traditional abusive schemes. It is important to note that, generally, each fraudulent scheme includes different interdependent scams violating several mandatory securities law provisions at once. Therefore, for a better comprehension, the present study focuses each time especially on the particular aspect of the illustrated fraudulent scheme.

### 3.1. Misrepresentation

#### 3.1.1. "Imposture" cases

66. The information on the Internet can be posted anonymously or through an alias, making it difficult to determine its origin. Securities authorities are receiving an increasing number of complaints about misrepresentations in investment information distributed through the Internet or by e-mail. A new variation of Internet securities fraud cases is a so-called "imposture" or "impostor" case, which involves fake Web sites and false news wire announcements regarding companies and their securities.

67. A famous fraudulent scheme concerning *PairGain Technologies Inc.* is a good example of an "imposture" case.<sup>57</sup> Its author, Gary Hoke, an employee of *PairGain Technologies Inc.*, disseminated to the investing public fraudulent statements concerning the latter, a public company whose shares are traded on the NASDAQ. More specifically, on the morning of April 07, 1999, Hoke, under an assumed name, posted a message on a Yahoo! bulletin board that falsely reported that *PairGain Technologies Inc.* would be acquired by an Israeli company. The posting provided a direct Internet link to another Web page, which appeared to be a Bloomberg News Service page containing an announcement of the

<sup>54</sup> *Supra*, footnote 1.

<sup>55</sup> R. WALKER, "A Bull Market in Securities Fraud?", April 1999, <<http://www.sec.gov/news/spchindx.htm#staff>> File name: spch265.txt.

<sup>56</sup> *Supra*, footnote 26.

<sup>57</sup> SEC v. Hoke, Litigation Release No. 16266, Aug. 30, 1999, <<http://www.sec.gov/enforce/litigrel/lr16266.htm>>.

acquisition. In fact, this Web page was also Hoke's fabrication. The result was a significant trading activity and 32 % increase in price of *PairGain Technologies Inc.*' securities. In the several hours after the report was exposed as a hoax, the securities price declined precipitously. The hoax was so convincing because of the similarity of the fake Bloomberg page and the authentic one. It included working electronic links to real Bloomberg News pages, a banner advertisement, and a colour background that exactly matched the one on the Bloomberg "Top financial news" site. Although the hoax was sophisticated, there were several subtle flaws<sup>58</sup>. First, the story did not contain a per-share purchase price. Second, it used "safe harbour" language, which is typical of corporate press releases but not of Bloomberg News articles. Finally, one of the many electronic links on the fake Web page took the viewer to the Lycos Inc. on which the page was created and not to a real Bloomberg site.

68. Despite numerous cases of misrepresentation, anonymity, being the characteristic style of much Internet communications, is not an evil to be suppressed. But an important distinction should be drawn between "anonymity" and "traceability"<sup>59</sup>. Securities regulators need the ability to trace identities on an after-the-fact basis of anonymous communications sent by e-mail or posted on bulletin boards. A major obstacle to traceability is the rise of anonymous "remailers"<sup>60</sup> that conceal the identity and even the location of the sender. Such attempts to hide the identity of the sender typically require a co-operating agent who re-mails the communication to a chat room or a newsgroup. Potentially, such a person could be seen as an aid and abetter of a securities law violation. The pessimistic bottom line for the present is that one can not identify a convenient gatekeeper that can easily be pressured or persuaded to monitor the content of messages posted on the Internet.

### 3.1.2. Misstatements by financial advisers

69. In other cases, the misstatements are made by companies or financial advisers who do not take the same care in preparing electronic communications as they would do in preparing an official filing for securities regulators and who give false and misleading stock recommendations in order to generate quick profits. Though involving misrepresentations as well, there are several differences between these scams and the "imposture" schemes. First of all, financial advisers committing fraud are not acting anonymously. Secondly, these scams generally require a higher level of organisation and activity (creation of a Web site, solicitation of customers, execution of orders, etc.) and are designed to exist for a longer time.

70. In particular, a considerable number of misrepresentations are made on claiming quick and sure profits from day trading<sup>61</sup>. Day traders rapidly buy and sell stocks throughout the day in the hope that their stocks will continue climbing or falling in value for the seconds to minutes that they own the stock, allowing them to lock in quick profits. Some Web sites have sought to profit from day traders by offering them hot tips and stock picks. Securities regulators have brought several cases against people who have passed themselves off on the Internet as expert stock pickers and sell their advice.

71. Currently, the SEC Division of Enforcement groups Internet publishers of investment recommendations in two categories<sup>62</sup>, "momentum" and "stock recommendation" sites. "Momentum" sites involve publishers who allegedly recommend the purchase of low priced thinly traded stocks, in which they own shares, and profit by selling their shares during the upswing in trading immediately following and resulting from their recommendations. Their sites offer daily or periodic stock recommendations designed to generate "momentum" for certain stocks from quick-fingered day traders and other investors. These often-artificial gyrations could in some cases be considered stock manipulation, particularly if Web site operators are profiting from the ups and downs themselves<sup>63</sup>.

<sup>58</sup> M. J. DORSEY & P. H. SCHWARTZ, "SEC Update", May 1999, [*Westlaw*],

2 No. 12 Wallstreetlawyer.com: Sec. Elec. Age 28.

<sup>59</sup> *Supra*, footnote 9, pp. 1225-1227.

<sup>60</sup> *Ibid*.

<sup>61</sup> "Day trading: your dollars at risk", Feb. 2000, <<http://www.sec.gov/cons/umer/daytips.htm>>.

<sup>62</sup> SEC Today, "SEC Director Highlights Emerging Enforcement Concerns", *CCH Washington Service Bureau*, Vol. 2000-11, Jan. 2000.

<sup>63</sup> R. BUCKMAN, "SEC Studies "Momentum" Stock-Pick Sites on the Internet", *Wall St. J.*, Nov. 02, 1999, [*Westlaw*], 1999 WL-WSJ 24920203.

72. There are two recent cases, which were of a serious concern for securities regulators. In the *DynamicDaytrader* case<sup>64</sup> David Rudnick, a Web site operator, provided real-time daytrading stock recommendations on a subscription basis from January 1998 to February 2000. This operation claimed a 747% return for calendar year 1999. Furthermore, Rudnick made false statements about his personal daytrading experience, the *DynamicDaytrader* organisation and the fictitious prices posted for trades. The main feature of the *DynamicDaytrader* site was a link to a real-time window referred to as the "Trading Floor", where subscribers could see actual trades done by a "daytrader". Rudnick induced subscribers to trade securities by falsely stating that, through the "Trading Floor" they would be able to see the real-time actual trades of a successful daytrader and thus be able to profit or approximate the performance of the trader by merely mimicking his trades. The *DynamicDaytrader* Web site had generated subscription revenues of \$ 40 107 from approximately 315 subscribers in at least thirteen countries.

73. Another case involving "momentum" trading on a free subscription Internet Web site called "*Fast-Trades.com*"<sup>65</sup> could be considered as stock manipulation. Its author, Douglas Colt, targeted low priced thinly traded stocks knowing that his trades and trades by subscribers would artificially increase the price of the selected stocks. During February and March of 1999, Colt had posted false and misleading messages on several hundred different Yahoo! Internet message boards promoting the site to potential subscribers. The purpose of these messages was to build a subscriber base by inducing readers of the message boards to visit the Web site, to review its recommendations and to become subscribers, so that they would in turn purchase *Fast-Trades* selected stocks and help drive up the price of the selection. Colt used multiple identities to enhance the credibility of their messages and to prevent the disclosure of his affiliation with *Fast-Trades*. Furthermore, for each of the manipulated stocks, Colt and the other participants collectively purchased a significant volume of the selected stock. In four instances, *Fast-Trades.com* purchases were made shortly before the Web site disseminated the recommendations to its subscribers. After making these purchases, and before the recommendations to purchase the stock were e-mailed to subscribers, Colt and the other participants entered sell limit orders expecting that unwitting subscribers would buy the recommended stock. The *Fast-Trades.com* Web site also contained a misleading disclaimer that *Fast-Trades* representatives "may" trade *Fast-Trades* selections "at any time." In fact, for each of the four stocks, Colt had already purchased the selected stock and entered sell limit orders before *Fast-Trades* even distributed the selection to its subscribers.

74. "Stock recommendations" sites are those operated by so-called "stock gurus". The best example would be the much-publicized case of "*Tokyo Joe*".<sup>66</sup> The accused, Park, engaged in a scheme to defraud members of his Internet stock recommendation service and the investing public by, among other things, his undisclosed trading of shares that he subsequently recommended over the Internet for purchase, posting of false performance results, and recommending the stock of an issuer without disclosing that he had indirectly received compensation from that issuer<sup>67</sup>. Specifically, he provided investment advice over the Internet, including stock picks, to his clients, largely members of an Internet day trading community who paid \$100 to \$200 per month for the privilege of receiving his advice. Park provided such advice via his own Web site, known as "*Tokyo Joe's*", via e-mails to subscribers of his stock recommendations, and via a real time chat room within his Web site where he discussed his picks and other investment matters in more detail. Park regularly bought shares before recommending them to the members of his Web site. Then he quickly sold the same stock at a profit during the buying flurry thus created, often entering sell limit orders within minutes of his buy recommendation. Thus, Park failed to adequately disclose his prior ownership of recommended stock and his intent to sell his shares while he simultaneously recommended the purchase of such shares. Moreover, Park recruited members to follow his recommendations by posting numerous effusive testimonials as well as false and misleading performance data on his Web site. More specifically, his performance data included winning trades he did not actually make and erroneous reports of his actual trading profits or losses. Finally, it is noteworthy that *Tokyo Joe* did not register as an investment adviser. Thus, his "clients" did not have the kind of background and performance information that securities regulators require of registered advisers. Similarly, many Internet publishers who disseminate free or non-individualized investment

<sup>64</sup> SEC v. DynamicTrader Com. L.L.C., C.A. No. 00-85-PC, March 20, 2000, Litigation Release No. 16475, <<http://www.sec.gov/enforce/litigrel/lr16475.htm>>.

<sup>65</sup> SEC v. Colt, CV-1:00CV00423 (D.C.D.C.) (EGS), <<http://www.sec.gov/enforce/extra/coltcomp.htm>>.

<sup>66</sup> SEC v. Yun Soo Oh Park a/k/a Tokyo Joe and Tokyo Hoe's Soci t  Anonyme Corp., Case No. 00C0049, Jan. 05, 2000, <<http://www.sec.gov/enforce/litigrel/lr16399.htm>>.

<sup>67</sup> M. SCHROEDER & R. BUCKMAN, "SEC Files Complaint against Trader, Alleging Scheme to Defraud Customers", *Wall. St. J.*, Jan. 06, 2000, [Westlaw], 2000 WL-WSJ 3012810.

advice believe they are not within the definition of "investment adviser" and are not subject to the registration. Tokyo Joe and similar cases raise the discussion about the necessity of rulemaking regarding the activities of online advisers order to protect the growing number of online investors<sup>68</sup>.

## 3.2. Market manipulation

### 3.2.1. "Pump and dump» schemes and illegal touting

75. In a "pump and dump" scheme, a long-time favourite amongst con artists, defrauders circulate widely false and misleading information to drive up a stock's price and sell their shares at the inflated price. Recently, the age-old scams used by swindlers to sell vastly inflated shares have moved fully into the digital age: investors are now being duped on the Internet, which has become the boiler room of the new millennium. "Pump and dump" schemes are different from "imposture" cases, discussed above, as the latter were created due to the anonymous nature of the Internet. "Imposture" cases involve a practice of deceiving by means of an assumed character or name that can happen to be a part of a "pump and dump" scam. Another point is that in a "pump and dump" scheme stock defrauders prefer "microcap" or "penny" stocks for their offerings, since microcap securities of little known, thinly traded companies, are often difficult to research and their shares are frequently not quoted on a daily basis. As these shares are usually not listed on any national exchange, but are rather sold on the over-the-counter market, information about their issuer is more difficult to obtain. Finally, a "pump and dump" scam is usually a more complex scheme involving other fraudulent activities such as "touting" and "scalping" which are discussed below.

76. In a "pump and dump" scheme, online defrauders offer advice after acquiring a large block of thinly traded company stock, in claiming that the share price of that stock is about to rise dramatically. The rise in price is sometimes linked to some pending future announcement regarding earnings, an eventual contract or a technological breakthrough. As the market reacts to this information and the share price rises, the defrauder sells his shares at a higher price, as only he knows the validity of the information. Eventually, the share price will return to its normal level leaving the investors who bought on the hot tip holding the higher priced shares<sup>69</sup>.

77. Online "pump and dump" is better exemplified by the recent case brought against *NEI Webworld*<sup>70</sup>. In this case, three Southern California residents were charged with manipulating the price of a thinly traded stock by spreading false information on Internet message boards, allowing them to reap \$364 000 in trading profits. In November of 1999, the swindlers accumulated large blocks of stock for pennies per share in *NEI Webworld Inc. (NEIP)*, a microcap stock traded through the *NASD's* over-the-counter bulletin board system. *NEIP*, formerly a Dallas, Texas-based commercial printer, was in bankruptcy liquidation and had no assets or business operations. During the weeks before the defrauders began accumulating *NEIP*, there was virtually no market activity in the company's common stock. Shortly following the final purchases of *NEIP* stock, the defrauders posted multiple messages on Internet message boards falsely stating that the outstanding shares of *NEIP* would be acquired by *LGC Wireless Inc.*, a privately-held telecommunications company. One widely circulated message described the acquisition and predicted that *NEIP* would be "a fast mover" with a target price of "\$5-10" per share. Additionally, they posted diverse messages under multiple pseudonyms, which appeared to be comments made by third parties discussing the acquisition. In fact, there were never any discussions between *NEIP* and *LGC Wireless*. As a result of this "pump and dump" manipulation, the price of *NEIP* common stock rose from \$.13 (thirteen cents) per share at the close of trading on Friday, November 12, to a peak of more than \$15 per share soon after the opening of the market on Monday, November 15, before declining precipitously<sup>71</sup>.

<sup>68</sup> C. R. MILL, "Enforcement Program against Internet Publishers tests Limits of Investment Advisers Act", Feb. 2000; A. HORWICH & H. KRAMER, "SEC Update: "Tokyo Joe" on the Defensive, and Portland Brewing Company Gives Shareholders an Electronic Market", Feb. 2000, [*Westlaw*], 3 No. 9 *Wallstreetlawyer.com*: Sec. Elec. Age 17.

<sup>69</sup> OSC Investor Alert, April 2000, <<http://www.osc.gov.on.ca/en/Investor/onlineinvestment.htm>>.

<sup>70</sup> SEC v. Golshani, Melamed & Derzakharian, U.S. District Court for the Central District of California, Civ. Action No. 99-13139 (CBM) (AJWX) (C.D.Cal. Dec. 15, 1999), Litigation Release No. 16391, <<http://www.sec.gov/enforce/litigrel/lr16391.htm>>.

<sup>71</sup> "SEC, U.S. Attorney File Fraud Charges in Internet Stock Manipulation Case Involving UCLA computers", Dec. 1999, <<http://www.sec.gov/news/uclaenf.htm>>.

78. According to some securities analysts<sup>72</sup>, online penny stock offerings must be made under stricter regulatory control, as growing online microcap stock fraud presents a serious threat to investor confidence in the medium that is the Internet. This threat can ultimately undermine the stability and the integrity of national securities markets. Stricter regulatory control is also needed since the prevalence of microcap fraud over the Internet may create the impression among investors that all online penny stock offerings are illegitimate, seriously damaging an important source of capital for small companies.

79. In some cases, "pump and dump" schemes are made in conjunction with illegal *touting* of stock, where promoters are remunerated— by either cash or stock options - for making positive statements about a company or its securities without disclosing to investors the nature, the amount and the source of the compensation. According to SEC data, in 1999 the "touters" received over \$6 million in compensation and more than \$2 million shares and options for touting the stock of 235 microcap companies<sup>73</sup>. In some online newsletters "touters" falsely claim the independent research of the stocks they profile. In other cases they spread false information or promote worthless stocks. The "touters" lie about the payments they received, their independence, their so-called research, and their track records. Their newsletters are masqueraded as sources of unbiased information, when in fact they stand to profit handsomely if they convince investors to buy or sell a particular stocks<sup>74</sup>.

80. Often, these stock promoters purchase shares of a security for their own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following the recommendation. This is an unlawful practice known as "scalping"<sup>75</sup>.

81. Junk e-mail or "spam"<sup>76</sup> plays a major role in all sorts of market manipulation schemes. As "spam" is so cheap and easy to create, defrauders increasingly use it to find investors for bogus investment schemes or to spread false information about a company<sup>77</sup>. The con artists use spam to pitch securities in offerings that do not exist, are misleading or containing unrealistic price predictions. Spam allows unscrupulous swindlers to target many more potential investors than cold calling or mass mailing since, using a bulk e-mail program, spammers can send personalized messages to thousands and even millions of Internet users at the time. A spammer may use three principal methods to make his e-mails anonymous and to prevent victims from tracking its origin<sup>78</sup>. The first method is to make use of a domain name provided as part of a free Web service package from an Internet Service provider (ISP). A spammer can acquire free Web space from many ISPs without providing them with any sort of identifying or credit card information. A second way a spammer can engage in anonymous e-mail harassment is by using a public access e-mail address, such as is available from many public libraries. The third, and the best way a spammer may engage in using fraudulent junk e-mail is to send them through widely available Web sites known as "anonymizers". E-mails that come through an anonymizer are recognizable because the spammer's address will contain a domain suffix that identifies the anonymizer.

82. There are two recent cases that involve the violation of anti-touting provisions<sup>79</sup>. The first is a classic microcap market manipulation scam involving the securities of *Interactive MultiMedia Publishers Inc.*

<sup>72</sup> K. C. BARTELS, "Click Here to Buy the Next Microsoft": the Penny Stock Rules, Online Microcap Fraud, and the Unwary Investor", 75 *Ind. L.J.*, Winter 2000.

<sup>73</sup> *Supra*, footnote 26, p.4.

<sup>74</sup> C. P. MALONEY & S. P. VAUGHN, "Caveat Vendor: the SEC Cracks Down on Internet Stock Touting", Dec. 1998, [Westlaw], No. 7 Wallstreetlawyer.com: Sec. Elec. Age 18.

<sup>75</sup> L. S. UNGER, "Investing in the Internet Age", Feb. 2000, p. 3,

<<http://www.sec.gov/news/speeches/spch342.htm>>.

<sup>76</sup> See G. S. MOORFIELD, "Spam – It's not Just for Breakfast Anymore: Federal Legislation and the Fight to Free the Internet from Unsolicited Commercial E-mail", *Bost. Univ. J. of Science and Techn. L.*, Spring, 1999.

<sup>77</sup> "Internet Fraud: How to Avoid Internet Investment Scams", Jan. 2000,

<<http://www.sec.gov/consumer/cyberfr.htm>>.

<sup>78</sup> J. N. WALKER, "Can You Stop that Anonymous Spammer?", May 1999, [Westlaw],

4 No. 3 Cyberspace Law. 6.

<sup>79</sup> "SEC Continue Internet Fraud Crackdown: Agency Files Four More Cases Against Purveyors of Fraudulent Spam, Online Newsletters, Message Board Postings and Web Sites in its Ongoing Effort to Clean Up the Internet", Feb. 1999, <<http://www.sec.gov/news/spamcase.htm>>.

(IMP).<sup>80</sup> This fraudulent activity involved illegal touting and scalping as well as a “pump and dump scheme”. Its authors sold to the public essentially worthless unregistered securities of *IMP*, a software development company. They paid the “touters” an undisclosed compensation in the form of cheap or free stock for multiple publication on the Internet. When the stock’s price rose in the wake of these touts, the defrauders sold their shares at a profit using a deceptive practice of “scalping.” Subsequently, the stock collapsed and the company ceased its operations.

83. The second example consists of a typical touting fraud without a “pump and dump”, where the swindler used “spam” and a Web site to spread information about certain companies, without properly disclosing the receipt of compensation from those companies<sup>81</sup>. He was broadcasting or “spamming” “Low Price Stock Alerts” to 500 000 potential investors through unsolicited e-mails. The defrauder promoted the stock of ten different publicly-traded companies on the *Stockprofiles.com* Web site through his company, *Strategic Network Development Inc.*, without disclosing a cumulative compensation of at least \$183 200 in cash and 322 500 shares of stock.

### 3.2.2. Corporate “cybersmear”

84. With the emergence of online trading, financial message boards and chat rooms have become popular and controversial forums for the exchange of information on publicly traded companies. Corporate “cybersmear”<sup>82</sup> is a false and disparaging rumour about a company, its management or its stock posted anonymously on an Internet message board or in a live chat room. Corporate management is certainly concerned about this, as by enabling a rapid dissemination of information to a large audience, cybersmeas can raise serious issues for companies and their investor relations, damaging their reputation and manipulating their stock price on the basis of false information.

85. Exchanges and self-regulatory organisations are taking measures to deal with this problem. For example, in 1998, the *Toronto Stock Exchange (TSE)* proposed guidelines for the use of electronic communications<sup>83</sup>. The guidelines addressed Internet rumours, providing as follows:

- (i) A company is not expected to monitor chat rooms or newsgroups for rumours about itself. Nevertheless, the *TSE* recommends that the company’s standard policy for addressing rumours apply to those on the Internet.
- (ii) Whether a company should respond to a rumour depends on the circumstances. The *TSE* suggests that companies consider the market impact of the rumour, the degree of accuracy and significance to the company. In general, the *TSE* recommends against a company participating in a chat room or newsgroup to dispel or clarify a rumour. Instead, it is preferable for the company to issue a news release to ensure widespread dissemination of its statement.
- (iii) If a company becomes aware of a rumour in a chat room, newsgroup or any other source that may have a material impact on the price of its stock, it should immediately contact the *TSE Market Surveillance*, so that the *TSE* can monitor trading in the company’s securities. If Market Surveillance determines that trading is being affected by the rumour, it may require the company to issue a news release stating that there are no corporate developments to explain the market activity.

86. In practice, corporation management prefers to respond to cybersmeas by legal proceedings. Recently, the number of companies willing to sue to protect their good name and reputation has grown fast<sup>84</sup>. Much of the recent litigation has steamed from a handful of popular Web sites, sites such as *Yahoo! Finance*, *The Motley Fool*, *Raging Bull* and *Silicon Investor*. These Web sites allow investors, employees and others to post anonymous comments about companies, their financial prospects and

<sup>80</sup> SEC v. Vertucci, Civil Action No. 5:99CV426 (N.D. Ohio) Litigation Release No.16069, Feb. 24, 1999, <<http://www.sec.gov/enforce/arintel.htm>> #r16069.

<sup>81</sup> Re Flynn and Strategic Network Development Inc., Administrative Proceeding File No. 3-9835, Feb. 24, 1999, <<http://www.sec.gov/enforce/arintel.htm>> #34-41102.

<sup>82</sup> B. A. BELL, “Dealing with the Cybersmear”, April 1999, <<http://www.nylj.com/tech/041999t3.htm>>

<sup>83</sup> *Ibid.*

<sup>84</sup> For an extensive list of corporate “cybersmear” cases, see B. A. BELL, “Corporate Cybersmear cases”, <[http://www.cybersecuritieslaw.com/lawsuits/cases\\_corporate\\_cybersmeas.htm](http://www.cybersecuritieslaw.com/lawsuits/cases_corporate_cybersmeas.htm)>.

their stock prices<sup>85</sup>. In response, lawsuits claiming libel, breach of contract, defamation and theft of trade secrets are often filed against unnamed defendants - listed only as "John Does". Upon filing of civil complaints, plaintiffs' counsel serve subpoenas on message board operators and Internet service providers seeking the identities of anonymous posters. Some service providers, including America Online, notify subscribers when civil subpoenas are received and allow them a period of time to challenge the process. But many online services - most notably *Yahoo!* - comply with such subpoenas as a matter of course, without notice to their users. The common denominator in these suits is that they all raise significant privacy concerns for the average Internet user, as civil litigants are increasingly using the discovery process to pierce the veil of online anonymity<sup>86</sup>. In the absence of adversarial proceedings to determine a plaintiff's entitlement to the identity of an anonymous Internet poster, the civil discovery process is open to potential abuse.

87. Several legal observers have cited the case of *Raytheon Co. v. John Does 1-21*<sup>87</sup> as an example of the problem described above<sup>88</sup>. Alleging breach of contract and disclosure of proprietary information by company employees of a *Yahoo!* message board, *Raytheon Co.* sued 21 "John Doe" defendants and subpoenaed *Yahoo!* for information identifying the individuals. After the company obtained the identities of the 21 defendants, it voluntarily dismissed its suit claiming an internal investigation. This dismissal raises questions concerning *Raytheon's* abuse of the discovery process: if learning the identities of the "Doe" defendants was necessary for the adjudication of *Raytheon's* claims, why were those claims not litigated once the defendants were identified? The facts suggest that the company's sole objective was to unmask the anonymous posters, and that filing suit and obtaining subpoena power was the most expedient means of realizing that goal.

88. The same *Raytheon* case raises the question of appropriate guidelines concerning the anonymous posting of confidential company data on Internet message boards by its own employees<sup>89</sup>. After *Raytheon Co.* observed that the posted information could not be of public knowledge, *Raytheon* employees were identified as abusers and subsequently resigned. The conflicts posed by online anonymity obviously require that a balance be struck between its benefits and potential abuses. Clearly there will be cases where aggrieved parties should be entitled to learn the identities of anonymous Internet posters, and many others where the civil discovery process may be abused. Such a result would severely diminish the Internet's status as a democratic and vibrant marketplace of information and ideas<sup>90</sup>. In recognition of the important interests that Internet users have in the preservation of anonymity, legal protection should be established to provide a judicial framework and due process in the growing number of cases in which online anonymity is challenged.

### 3.3. Fraudulent securities offerings

#### 3.3.1. "Ponzi" and pyramid schemes

89. A characteristic of the Internet that makes it an attractive vehicle for stock fraud is the enormous volume of messages it can accommodate at low costs. This factor is illustrated by widespread

<sup>85</sup> B. A. BELL, "Plaintiff Corporations Face Reprisals from Cybersmear Defendants", Dec. 1999, [*Westlaw*], 2 No. 4 e-Securities.

<sup>86</sup> D.L. SOBEL, "The Process that "John Does" is Due: Addressing the Legal Challenge to Internet Anonymity", *n.d.*, <<http://www.vjolt.net/symp2000/johndoe.htm>>; H. MINTZ, "Cybersmear Lawsuits Raise Privacy Concerns", Nov. 28, 1999, <<http://www.mercurycenter.com/svtech/news/indepth/docs/boards112999.htm>>.

<sup>87</sup> *Raytheon Corp. v. John Does 1 through 21* Civ. Action No. 99-816 (Commonwealth of Massachusetts Superior Court, Middlesex County, complaint filed Feb. 01, 1999).

<sup>88</sup> M. THOMPSON, "ON the Net, in the Dark", Nov. 08, 1999, <<http://www.lawsnewsnetwork.com/stories/A9068-1999Nov5.html>>.

"Raytheon Sues 21 People Over Sharing of Company Secrets Online", *FreedomForum.org*, March 05, 1999, <<http://www.intelico.com/johndoe3.htm>>.

<sup>89</sup> B. A. BELL, "Reducing the Liability Risks of Employee Misuse of the Internet", June, 1999, [*Westlaw*], 3 No. 1 *Wallstreetlawyer.com*: Sec. Elec. Age 16.

<sup>90</sup> R. TRIGAUX, "The Fight to Speak their Mind, Anonymously", *St. Petersburg Times online*, May 28, 2000, <[http://www.stpetersburgtimes.com/News/052800/Business/The\\_fight\\_to\\_speak\\_their\\_mind.html](http://www.stpetersburgtimes.com/News/052800/Business/The_fight_to_speak_their_mind.html)>.

promotion of electronic versions of the classic Pyramid and "Ponzi" schemes<sup>91</sup>. These swindles promise high rates of return to investors, however the only people whom really win are the promoters who set these schemes in motion. Winnings come at the expense of funds taken from later investors, who end up losing their money when the house of cards inevitably collapses. "Ponzi" and Pyramid schemes may also violate laws against false advertising, misrepresentation and deceptive trade practices.

90. A "Ponzi" scheme is a phoney investment plan in which financial means paid by later investors are used to pay artificially high returns to the initial investors, with the goal of attracting more investors<sup>92</sup>. A good example illustrating the migration of "Ponzi" schemes to Cyberspace is a recent case filed against *Capital Acquisitions Inc.*<sup>93</sup> *Capital Acquisitions Inc.*, headed by Wayne Notwell. From 1996 and on, Notwell raised funds from investors with the purpose of conducting oil and gas drilling operations in Kansas and California, collecting approximately \$20 million from at least 600 investors through the sale of three-year notes offering an annual "guaranteed" return of 20%. Investors were solicited with offerings posted on the Internet, which led to detection of this investment scam by securities regulators. The defendants had defrauded investors by conducting a "Ponzi" scheme. While Capital claimed to be operating numerous oil wells in Kansas and California, it failed to disclose that the income from the wells was insufficient to pay the promised returns, which were instead paid from monies received from new investors.

91. A Pyramid scheme is a "property distribution scheme" in which an investor pays for a chance to receive compensation based on recruiting new persons into the program.<sup>94</sup> A recent case, "*Pentagono*"<sup>95</sup>, is one of numerous others involving electronic Pyramid schemes. The complainant alleged that, since at least May 1998, *Future Strategies* had promoted a worldwide Pyramid scheme known as "*Pentagono*" over the Internet, soliciting investors to purchase *Pentagono* "Certificates" through existing participants. As part of this solicitation, *Future Strategies* claimed on its Web site that investors could earn up to \$116,400 from an investment of approximately \$120 and guaranteed that each investor would eventually reach the top position in the *Pentagono* pyramid.

92. For many, electronic "Ponzi" or Pyramid schemes are typical affinity scams. Affinity fraud refers to investment scams that target members of identifiable groups, including religious, elderly, ethnic, and professional groups<sup>96</sup>. Using media advertising to identify potential victims, the defrauders who promote affinity scams are group members, claim to be members of the group, or enlist respected leaders within a group to spread the word about an investment deal. The swindlers increasingly use the Internet to target groups with spam, exploiting the trust and friendship that exist in groups of people who have something in common.

### 3.3.2. Cyberspace off-shore fraud

93. At one time, offshore schemes targeting national investors cost a great deal of money and were difficult to carry out. Conflicting time zones, differing currencies, and the high costs of international telephone calls and overnight mailings made it difficult for defrauders to prey on foreign residents. However, these obstacles have been eliminated by Internet based communications. Investors should be extra careful when considering any investment opportunity that comes from another country, considering that it's difficult for national law enforcement agencies to investigate and prosecute foreign frauds. Nevertheless, according to SEC Interpretation, antifraud provisions of the securities laws will continue to reach all Internet activities if these fraudulent actions have originated in the United States or

<sup>91</sup> A. KANDEL & J. M. SCHWARTZ, "Stateside Action: Nabbing Online Pyramid Schemes", April 1998, [Westlaw], 1 No. 11 Wallstreetlawyer.com: Sec. Elec. Age 30.

<sup>92</sup> See Webster's New World Dictionary 1049 (3d ed. 1988).

<sup>93</sup> SEC v. Capital Acquisitions, Inc., Civil Action No. 2:97CV-0977S (USDC UT.) (File names: lr15601.txt, lr15868.txt, lr16083.txt), <<http://www.sec.gov/enforce/arintrel.htm>>.

<sup>94</sup> *Supra*, footnote 91.

<sup>95</sup> SEC v. Future Strategies Srl, a/k/a Future Strategies International, CIV No. 1:99-CV-1199-JTC (N.D.GA.), Litigation Release No. 16135, May 11, 1999, <<http://www.sec.gov/enforce/litigrel/lr16135.htm>>.

<sup>96</sup> "Affinity Fraud: How To Avoid Investment Scams that Target Groups", Nov. 1999, <<http://www.sec.gov/consumer/affinity.htm>>.



placed United States investors at risk<sup>97</sup>. The Internet has increased the attractiveness of using foreign domains to promote investment schemes that take advantage of the jurisdictional challenges for national authorities. The difficulty of obtaining personal jurisdiction, serving subpoenas, locating assets and extraditing defendants, all place roadblocks for the securities authorities in such transitional cases.

94. One ongoing case illustrates the difficulty in tracing perpetrators of Internet offshore securities fraud<sup>98</sup>. On March 20, 1998, authorities from the United States, Canada and Sweden launched an investigation into an offering of fictitious stock to investors in Sweden. Using the name "Turner Phillips", an alleged registered Canadian brokerage firm, the scammer promoted fictitious stocks through a Web site that contained information taken from a legitimate brokerage firm's Web page, but superimposing the name "Turner Phillips" onto the legitimate firm's registration data. The defrauders contacted prospective victims by phone and referred them to the Phillips Web site for information about the firm. Investors were told that "Turner Phillips" was located in Vancouver, BC, but only maintained a mail drop and a telephone answering service there. Mail was forwarded to Ontario and phone calls were forwarded to Washington State and then relayed to another location. Authorities are still trying to locate the offending parties through the co-operation of all jurisdictions involved. While the enforceability of foreign judgements abroad seems in many cases doubtful, an alternative approach to the national protection and bilateral co-operation is the adoption of international agreements on a global level through the *International Organisation of Securities Commissions*.

## Conclusion

95. The migration of trading services to Cyberspace holds great potential for investors, as well as for the securities industry as a whole. The explosive growth of electronic trading also poses unique risks to market participants, and presents tough challenges to regulators charged with ensuring the integrity of the trading environment. While these new challenges may require the adaptation of the appropriate legal framework in the near future, the fundamental goals and approach of securities regulators can be expected to remain constant despite a changing technological environment.

96. The recurrent themes of this study have involved the implication of the Internet as a new investment tool on the relations between online investors and the online brokerage industry, both taking advantage of technological advances in their trading activities. Online brokerage firms must be responsive to legitimate investors' concerns. This goal can be achieved by ensuring that online brokerage advertising does not mislead investors about the limits and mechanics of online trading, by complying with their suitability and best execution obligations and by continuing to remedy technological constraints of information system's capacity and functionality. Securities authorities are concerned as well about the emergence of the Internet as a potential growth vehicle for securities fraud and abuse. Since the Internet has not so much produced new forms of fraud as it has expanded possibilities for traditional methods of separating investors from their money, the technological revolution does not imply a crisis for the future of securities laws, but only the need for some regular updating and streamlining. Regulatory decisions that will shape new emerging markets, will be critical to their effective development and growth in the future.

<sup>97</sup> SEC Interpretation, "Use of Web Sites Offshore", March, 1998, p. 2, <<http://www.sec.gov/rules/concept/33-7516.htm>>.

<sup>98</sup> S. D. MEISSNER, "Securities Fraud and Manipulation in Cyberspace", Aug. 1998, [Westlaw], 2 No. 3 Wallstreetlawyer.com: Sec. Elec. Age 12.