

ONLINE BROKERS AND THE SEC: STILL WORKING OUT THE GLITCHES

On March 1, 2001, The New York Stock Exchange, at the urging of the SEC, censured and fined TD Waterhouse Investor Service, Inc. for problems associated with repeated system outages that left many customers unable to trade.¹ This move was viewed as a “warning shot across the bow for the online industry.”² The SEC’s recommendation to the NYSE demonstrated a remarkable turnaround from its February, 2000 commitment to focus on cases that “involved yesterday’s garden variety fraud using today’s technology.”³ This iBrief will examine the SEC’s treatment of technical problems encountered by the online brokerage industry, and illustrate the SEC’s hesitancy to establish strict regulations to prevent these problems from recurring.

Introduction

“I think that it should always be a cause for alarm when a regulator predicts the future of any particular industry.”⁴

Since buying and selling stocks online became fashionable, the Securities & Exchange Commission (“SEC”) has devoted a significant amount of its time and resources to understanding the opportunities for investment that online brokers provide. The SEC has also imposed requirements on online brokers concerning the content of the brokers’ websites, the information that they dispense to their clients, the prices they provide, and the security of their clients’ accounts. However, the SEC has not yet managed to extend its regulatory capabilities to ensure that clients can access their accounts whenever they need to, and that the online account statements will accurately represent the clients’ holdings. These problems are not invisible to regulators; they are the subject of litigation, arbitration, and the focus of a majority of the complaints the SEC receives about online trading. Currently, the recommendations and words of advice the SEC has given to online brokers, either through its commissioner, its legal memoranda, or its compliance inspectors, has not been enough to sufficiently improve online

¹ Ruth Simon, *TD Waterhouse Will Pay Fine Over Outages*, WALL STREET JOURNAL, Mar. 1, 2001, at C1.

² *Id.*

³ Laura S. Unger, *Investing in the Internet Age: What You Should Know and Your Computer May Not Tell You*, Address Before the Association of Retired Persons National Legislative Council Annual Meeting, at <http://www.sec.gov/news/speech/spch342.htm> (Feb. 3, 2000).

⁴ Laura S. Unger, *Does the Internet Empower or Just Excite Investors?* Address Before The Harvard Club, at <http://www.sec.gov/news/speech/speecharchive/1999/spch294.htm> (Sept. 10, 1999).

brokerage system capacity policies. Given the potential pitfalls to investors, it is time for the SEC to do more than make recommendations.

Identifying Problems With Online Brokers' System Capabilities

The SEC first began to scrutinize the technical capabilities of online brokerage firms following October 27 and 28, 1997, when the Dow Jones Industrial Average fell by 554.26 points during record-volume trading days and online brokers were unable process many clients' trades.⁵ The insufficient technology used by online brokerage firms presented problems which, at the time, were not addressed by the SEC. In Staff Legal Bulletin No. 8 ("Bulletin No. 8"), the SEC legal department determined that "the internet contains multiple potential choke points that can slow the flow of information, it is difficult to determine what caused the delays faced by online users attempting to request information or place orders electronically."⁶ It further recognized that the problems differed from region to region based on user traffic and the capacity of local Internet Service Providers (ISPs).⁷

The SEC was able to isolate certain problems that online brokerage firms' clients faced that were directly related to the brokers' websites.⁸ The most significant problem the SEC found was the inability for some online brokerage firms' servers to handle many simultaneous users because the servers reached their maximum capacity too easily.⁹ There were also findings that online brokers had difficulties executing orders on a timely basis due to lack of capacity. Bulletin No. 8 noted "poor distribution of demand across system resources . . . , slow access equipment, slow web server software, and poor integration with back end databases."¹⁰

While the SEC did express its concern about the technical shortcomings of individual online brokerage firms and the online brokerage industry as a whole, it explicitly declined to mandate standards for broker-dealer capacity. Instead, the SEC took a softer position and only suggested that online brokerage firms examine SEC findings more closely and react under their own discretion.¹¹

⁵ SEC, *Trading Analysis of October 27 and 28: A Report by the Division of Market Regulation*, at <http://www.sec.gov/news/studies/tradrep.htm> (Sept. 1998).

⁶ SEC, *Staff Legal Bulletin No. 8 (MR)*, at <http://www.sec.gov/interps/legal/slblr8.htm> (Sept. 9, 1998).

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ SEC, *Staff Legal Bulletin No. 8 (MR)*, *supra* note 6.

In March 1999, the SEC proposed systems capacity regulations as a safeguard for Y2K concerns.¹² The proposed rules were prefaced with concern that broker-dealers had not yet eliminated problems regarding system capability to process customer transactions and to update customer accounts in a timely fashion.¹³ The SEC statements demonstrate that the problem had not been remedied since the 1997 failures when it announced that “securities market participants are facing a critical test of their operational capability.”¹⁴

The SEC’s Authority to Regulate

While the SEC has routinely suggested that online brokers improve the way they handle system capacity, it is empowered to do far more than recommend. It is within the power of the SEC to require the online brokerage industry to adopt its recommendations by enacting regulations. Part of the SEC’s charge is “to remove impediments to and perfect mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions.”¹⁵ According to the enabling statute, the SEC is supposed to:

- “Assure that all exchange members, brokers, dealers, securities information processors, and, subject to such limitations as the Commission, by rule, may impose as necessary or appropriate for the protection of investors or maintenance of fair and orderly markets, all other persons may obtain on terms which are not unreasonably discriminatory such information with respect to quotations for and transactions in such securities as is published or distributed by any self-regulatory organization or securities information processor;”¹⁶
- “Assure that all exchange members, brokers, and dealers transmit and direct orders for the purchase or sale of qualified securities in a manner consistent with the establishment and operation of a national market system;”¹⁷ and
- “Assure equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers effecting transactions in such securities.”¹⁸

¹² Operational Capability Requirements of Registered Broker-Dealers and Transfer Agents and Year 2000 Compliance, 64 Fed. Reg. 12,127, 12,128 (March 11, 1999).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ 15 U.S.C. § 78b (2002).

¹⁶ 15 U.S.C. § 78k-1(c)(1)(D) (2002).

¹⁷ 15 U.S.C. § 78k-1(c)(1)(E) (2002).

Even without new regulation, the Securities Exchange Act sets strict requirements for a brokerage firm's ability to handle its clients' trading needs. Brokers (both traditional and online) shall not allow "any transaction in, or induce or attempt to induce the purchase or sale of, any municipal security unless such municipal securities broker or municipal securities dealer meets such standards of operational capability."¹⁹

The Unger Report

In November 1999, the then SEC Commissioner Laura Unger released a report entitled "On-Line Brokerage: Keeping Apace of Cyberspace"²⁰ ("Report") that recognized the growing prominence of online trading and predicted that online brokerage assets would reach \$3 trillion sometime in 2003.²¹ The Report noted an industry-wide problem: the number of new clients using online brokers was growing, and growing faster than the brokers could handle the new customers. They needed more capacity to handle heavy trading, but the Report said that when some online firms attempted to add capacity, they were unable to do so successfully. The Report noted that "several of the leading on-line firms experience well-publicized delays and outages [that] have renewed regulatory concern as to whether firms are maintaining sufficient operational capability."²²

Appendix 5 to the Report, "On-line Trading Complaints Received by the Commission: Leading Complaint Categories," demonstrates that the types of problems online traders reported were most frequently related to online brokers' capability to handle heavy Internet traffic.²³ Of the fifteen complaints listed, the top three appear to be directly or indirectly related to systems capacity. Among them were complaints of "difficulty in accessing account, failures/delays in processing orders, [and] errors in processing orders."²⁴ It is no surprise then, that a large segment of the Report was devoted to problems arising from online brokers' systems capacity.

The Report's most significant findings concerned the lack of industry uniformity in measuring system capacity. The different standards included basing capacity on number of shares traded, number of trades executed, number of total website users, number of simultaneous

¹⁸ 15 U.S.C. § 78k-1(c)(1)(F) (2002).

¹⁹ 15 U.S.C. § 78o-4(b)(2)(A) (2002).

²⁰ Laura S. Unger, *Online Brokerage: Keeping Apace of Cyberspace*, at <http://www.sec.gov/pdf/cybrtrnd.pdf> (Nov. 1999).

²¹ *Id.* at 1.

²² *Id.* at 58.

²³ *Id.* at 115.

²⁴ *Id.*

transactions, and number of users on the system for any purpose.²⁵ The Report further found that online firms adopted different period increments for monitoring their system capacity, with some continuously monitoring system capacity, some only monitoring during likely overload periods, others using weekly or monthly increments and others never testing system capacity at all.²⁶

One of the features of the Report is its inclusion of and reliance upon a roundtable of industry experts who provided opinions and concerns about online brokerage firms. These experts suggested that among other things, online brokers' systems capacity was strained by a substantial increase of website use for non-trading activity (such as researching stocks).²⁷ The roundtable experts also warned that online brokers with more nationally dispersed client bases would have additional trouble because some regions could suffer system overloads while others would not, and that as long as some regions' systems were working, the brokerage firm might not be aware of that other regions were without service.²⁸

The Report did find that many online brokers already had some (limited) contingency plans in place for system overloads. These plans emphasized allowing trading to continue and diverting resources from less essential services provided on the websites, such as confirmation delivery and updating accounts.²⁹ As a last line of defense, these firms also maintained a network of telephone representatives to execute trade orders as a traditional broker would.³⁰

The Report concluded its analysis of online broker systems capacity problems with a series of recommendations to the SEC concerning advice that the SEC should give to the online brokerage industry.³¹ The most stressed recommendation in the Report was a requirement that all firms "regularly subject their systems to a rigorous stress test to evaluate systems at maximum capacity."³²

For all the emphasis placed on the importance of maintaining the viability of online broker's system capacity, problems continued, even in times where trading volume was not out of the ordinary.³³ These problems³⁴ received attention from regulating agencies and from angry

²⁵ Unger, at 61.

²⁶ *Id.* at 61-62.

²⁷ *Id.* at 62.

²⁸ *Id.*

²⁹ *Id.* at 64.

³⁰ *Id.*

³¹ Unger, at 65.

³² *Id.*

³³ Greg Ip, *Casualties in Online-Trading Revolution Are Putting E*Trade on the Defensive*, WALL ST. J., Jun. 13, 2000, at C1.

clients who filed arbitration claims against their online brokers,³⁵ but no lasting, bright line regulation was implemented. Prior to the March 2001 NYSE censure of TD Waterhouse discussed above, the NASD censured E*Trade and fined it \$20,000 for failure to respond to regulators requests for information concerning E*Trade's ability to handle customer complaints.³⁶

Online Brokerage Cases and the Courts

There have been recent, and as of yet unsuccessful, attempts to present online brokers' limited systems capacity to courts. While it is likely that plaintiffs hope to reap awards from juries that would exceed arbitration awards, putting online brokers before the courts would also produce case law and therefore legal standards that online brokers could be more easily compelled to follow.

Some of the most recently dismissed online brokerage cases dealt with systems capacity claims. In *Hoang v. E*Trade*, plaintiff's orders were delayed and not filed accurately from the time she began trading, and she was unable to cancel the orders once she received the trade confirmation announcements that notified her of the prices she had actually paid.³⁷ In *Abda v. Charles Schwab & Co.*, the plaintiff was unable to log on to his account to sell shares, and once he did access his account, he was unable to sell because his earlier purchase of the stock had not yet been registered in his account.³⁸ In *Abda*, the plaintiff wanted to present evidence that his online broker's "system could only support 4% of its on-line customers simultaneously [and that] this capacity was insufficient to meet customer demand, particularly during the initial trading of new Internet stocks."³⁹

The initial problem with bringing online brokerage claims to court is that the industry standard for opening an online (or any other) brokerage account requires the prospective client to sign an agreement to arbitrate.⁴⁰ However, it is possible to circumvent the arbitration requirement if the claim is brought as a class action lawsuit⁴¹ under the Securities Litigation Uniform Standard

³⁴ *Id.* The most common problem that surfaced was the execution of orders at prices that clients did not approve. The causes of this problem included both actual stock price change during the time it took the order to be processed and software glitches.

³⁵ *Id.* There were 122 arbitration claims filed against the major online brokerage firms between 1996 and 2000.

³⁶ *Id.*

³⁷ *Hoang v. E*Trade Group, Inc.*, 738 N.E. 2d 87, 89 (Ohio Ct. App. 2000).

³⁸ *Abda v. Charles Schwab & Co., Inc.*, 2002 U.S. App. LEXIS 17180, 3 (9th Cir. 2002).

³⁹ *Id.* at 3.

⁴⁰ *Hennemann v. E*Trade Group, Inc.*, 2000 U.S. Dist. LEXIS 18677, 18677 (V.I. 2000). For example, the E*Trade arbitration agreement includes clauses like "parties are waiving their right to seek remedies in court, including the right to jury trial," *Hoang*, 738 N.E. 2d at 88.

⁴¹ *See Hoang*, 738 N.E. 2d at 89.

Act of 1988.⁴² As of yet, courts have been suspicious of class claims based on insufficient systems capacity. *Benning v. Wit Capital Group, Inc.*, the Delaware Superior Court held that:

Common sense dictates that some customers of an on-line brokerage service are bound to have some of the same difficulties in conducting business but that does not mean all customers or even many customers had the same problems. In addition, as to customers who may have had problems executing buy and/or sell orders, there are many variables regarding the circumstances and conditions for each customer's transaction. Variables such as, but not limited to, account status, time of order, i.e., time of day and day of the week, and the customer's computer modem capabilities and internet service provider. Plaintiffs fail to allege sufficient evidence that this claim is typical of the proposed class under like or similar circumstances.⁴³

However, one class pending certification might be tailored so narrowly that it will be able to proceed.⁴⁴ This creates the difficult problem of finding a class broad enough to produce the number of plaintiffs necessary to circumvent the agreement to arbitrate, but narrow enough to have a good cause of action.

SEC Regulations Tailored to Online Brokers

Even though the SEC has not specifically targeted the systems capacity problems with online brokerage firms, it has recognized that online brokers present unique situations that require special attention. The SEC has enacted regulations that affect online brokers and require them to more thoroughly disclose their trading execution capabilities.⁴⁵ The new rules do not require a minimum for trade execution speed or system capacity, but do require brokers to disclose how quickly orders were carried out, how many are not carried out, how far the offered price varies from the best price available, and how the orders are routed.⁴⁶

This limited, disclosure-only regulation fits SEC policy as stated by former Commissioner Unger. "While the Commission has a great deal of regulatory authority, it is mainly a disclosure-based agency . . . [and] I don't believe that online brokerage creates the need

⁴² Pub. L. No. 105-333, 112 Stat. 3227.

⁴³ *Benning v. Wit Capital Group, Inc.*, 2001 Del. Super. LEXIS 7, 19 (Del. Super. Ct. 2001).

⁴⁴ *Abda*, 2002 U.S. App. LEXIS 17180 at 4. The suit was filed on behalf of plaintiff and a class of "all investors who had online accounts with Schwab on November 13, 1998 and: (A) who placed market orders to purchase or sell TGLO, (B) whose market orders were delayed by more than one minute and executed at disadvantageous prices, and (C) who were damaged thereby."

Id.

⁴⁵ Greg Ip, *supra* note 33, at C1.

⁴⁶ *Id.*

for the Commission to adopt an entirely new regulatory approach.”⁴⁷ Commissioner Unger did express a need for a system capacity rule, but noted that her attempts, at that point, had been criticized. She said that “the comments we received were almost uniformly negative . . . [the] biggest concern was that because the rule did not define ‘operational capability,’ it would not provide sufficient standards for broker-dealers to follow.”⁴⁸

Unger’s enthusiasm towards extending traditional regulations to online brokers was much more pronounced. When she spoke on the importance of access to information, and ensuring the accuracy of that information, Unger stated that “[o]nly regulation can accomplish that.”⁴⁹ While Unger’s concerns were not without merit, they disregard the data uncovered by SEC research that online trading complaints were increasing annually, and that three of the top five complaints were for failures or delays in processing orders, difficulty accessing accounts, and errors in processing orders.⁵⁰

In tandem with these findings, the SEC Office of Compliance Inspections and Examinations released a report that summarized the difficulties facing online trading (“Compliance Report”).⁵¹ In addition to addressing online brokers’ policies concerning information, advertisement, security and supervision, the Commission examined brokerage firms’ abilities to execute customer transactions and their capacity for handling customer trading volumes.⁵² Although the Compliance Report has no binding value, it did provide brokers with guidelines as how to evaluate their online trading systems.⁵³

The Compliance Report recognizes and provides clear recommendations in response to the discovery that investors’ most common complaints have been for failures or delays in processing their orders online, difficulty in accessing their online accounts, and errors in processing their orders.⁵⁴ The Commission also found that many investors were experiencing problems with duplicate orders and that these duplicates were caused by investors not receiving

⁴⁷ Laura S. Unger, *Regulating on Internet Time*, Address Before the Conference on Integrating Technological Advances for Online Brokerages, at <http://www.sec.gov/news/speech/speecharchive/1999/spch298.htm> (Sept. 22, 1999).

⁴⁸ *Id.*

⁴⁹ Laura S. Unger, *Technology and Regulation: The Road Ahead*, Address Before the San Diego Securities Institute, at <http://www.sec.gov/news/speech/spch343.htm> (Jan. 27, 2000).

⁵⁰ SEC, *Investor Complaints and Questions Continue to Rise*, at <http://www.sec.gov/news/data.htm> (Mar. 2001).

⁵¹ SEC, *Office of Compliance Inspections and Examinations: Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations*, at <http://www.sec.gov/news/studies/online.htm> (Jan. 2001) [hereinafter *Compliance Report*].

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

confirmation of trades due to processing delays, some of which would last for many hours and in some cases, days.⁵⁵ Although some firms recognized this problem and have added warning messages, automatic notification of pending transactions, and limits on abilities to cancel orders, none of these safeguards have eliminated all duplicate orders.⁵⁶

The Compliance Report also cites many of the recommendations made in Bulletin No. 8 to remind online brokers of the critical importance of having sufficient system capacity to handle a growing clientele.⁵⁷ However, the need to remind demonstrates the underlying problem that suggestions do not necessarily carry enough weight to yield the desired results. After the various SEC warnings, findings and recommendations from the previous few years, the Compliance Report still found that “a quarter of the firms examined either did not conduct any assessment of their operational capability or had difficulty responding to questions regarding their capacity.”⁵⁸

Conclusion

Because online trading has become commonplace, the SEC needs to make up its mind about how it will regulate online brokerage firms. The SEC should either follow the precedent set by the NASD and the NYSE and impose sanctions on online brokerage firms that do not meet standards, or suggest that self-regulating organizations like the NASD or the NYSE act as the primary regulators for online brokers. As things currently stand, the SEC is sending a mixed message to the online brokerage industry by, on the one hand, making recommendations and criticizing perceived problems, and on the other, failing to back up the recommendations and criticisms with punishments. If the SEC wishes to take an active role in regulating online brokerage firms or in influencing how they do business, it should look to the examples set by the NASD and the NYSE and publicly single out particular offenders by censuring or fining them. Hopefully, by doing this, the SEC will make it more economically sensible for online brokerage firms to conform to higher standards at the risk of providing clients with inferior service and losing them to competitors. Only when the unique technological issues that online brokers face are cleaned up will online brokerage firms be as reliable as their conventional counterparts.

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⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ SEC, *Compliance Report*, *supra* note 51.