



*Public Documents
of the XXVIth Annual Conference of
the International Organization of
Securities Commissions
(IOSCO)*

23-29 June, 2001, Stockholm, Sweden

Plenary 1

**Impact of the Internet on the Functioning and Regulation of
Markets**

*5. Impact of the Internet on the Functioning and Regulation of Markets,
Speech by Mr. Georg Wittich*

*Chairman of the IOSCO Internet Task Force, President of the
Bundesaufsichtsamt für den Wertpapierhandel (BAWe), Germany*

27 June 2001

Panel One
Mr. Georg Wittich

XXVI Annual Conference of the International Organisation of Securities Commissions in Stockholm, Sweden 2001
Panel 1: Impact of the Internet on the Functioning and Regulation of Markets

Mr. Georg Wittich, President
Bundesaufsichtsamt für den Wertpapierhandel, Germany
(Federal Securities Supervisory Office)

Dear Mr. Norgen,

Ladies and gentlemen,

In the light of this year's topic of IOSCO's Annual Conference I am particularly glad to be able to present to you the The impact of the Internet and its related technologies on the functioning and regulation of financial markets has increasingly become a focus of regulatory attention. Ever since 1997, the year in which the first IOSCO Internet Task Force was established, the rapid growth of Internet technology has profoundly affected the structure and evolution of the financial industry. While on the one hand, regulators should welcome and pave the way for these technological innovations, they also need to identify and assess the potential risks that may arise from such market developments. From a regulatory perspective, the question raised by these changes is *how* this technology is affecting the regulation of markets and *whether the current approach* to financial market regulation *is efficient and adequate* .

Against this background, it was the purpose of the Internet Task Force to examine the broader regulatory issues raised by the use of electronic networks and to obtain information from the member jurisdictions on the use of the Internet in the securities industry.

The first Report *Securities Activity on the Internet* -published in September 1998 - identifies the Internet issues to be addressed by each jurisdiction and provides guidelines on how to approach these issues. The recommendations given in the report are based on the principle that the fundamental rules and standards of securities regulation are applicable under all circumstances, irrespective of the medium that is used.

The first report was well received by the regulators and the financial industry, and the fundamental principles contained therein continue to appear as relevant now as they did in 1998. However, increasing use of the Internet for the purpose of conducting securities business has given rise to additional concerns meriting further regulatory consideration.

In a reaction to the above, the IOSCO TC mandated the Internet Task Force to conduct a further analysis of new developments, in order to identify those Internet securities activities and cross-border issues of such activities which warrant further guidance. The results of this analysis were taken account of in the report *Securities Activity on the Internet II*.

The report addresses the current use of the Internet by the securities industry and regulators, reviews the implementation of the recommendations made in the 1998 report, and explores the issues raised by the evolution of the Internet. It is also accompanied by four annexes which are intended to provide the industries and regulators throughout the world with an overview of industry-related regulatory provisions: Annex I illustrates the Internet-related regulations by individual jurisdictions and is an update of the Annex of the 1998 Report. Annex II illustrates in

detail, by means of a jurisdiction-by-jurisdiction description, the use of the Internet by the securities industry and regulators of the countries represented in the Task Force. Annex III contains a consolidated list of all official web addresses of regulators, self - regulatory organisations and other securities-related entities, whereas Annex IV reviews the work of other International Fora and Committees relating to the Internet.

Regulatory interest has turned to a growing range of new issues after the first report of the Internet Task Force was published in September 1998. Questions of reliability of electronic systems and the issue of liability for the contents of web sites or hyperlinks have become of major importance for the industry. Regulators are increasingly faced with new Internet activities such as day trading or fraudulent behaviour on Internet discussion sites. Equally important is the question under which circumstances it is possible to obtain information from Internet service providers.

As market participants increasingly use the Internet to route orders and place trades, the **capacity, resilience and security** of online brokers is becoming of greater moment. In Germany, for example, investors complained last year about the insufficient availability, both electronically and on the phone, of many online banks and discount brokers. This was attributable to private investors' surging demand for securities trading and new IPO's, which in some cases overstrained systems capacities. Other member states made a similar experience. As a result, the report makes it clear that brokers need to ensure that periodic spikes in message traffic do not overwhelm their systems. In the light of the above, the report points out that regulators may wish to consider whether online brokers, as a matter of business interest, legal

requirements or regulatory guidance, are prepared to address risks relating to system capacity, by, among other things for instance

- conducting periodic capacity stress tests;
- providing adequate investor telephone access; or
- developing backup technology systems to handle outages.

Regulators may also wish to assess online brokers' legal or business interest in adopting specific measures relating to capacity, resilience and security of online systems, for instance availability measures, IT recovery measures or change control procedures.

To help inform investors with little or no prior investment experience and avoid subsequent complaints arising from inadequate knowledge of online trading, regulators should encourage online brokers to enhance their websites to provide a basic explanation of the risk of securities trading. Relevant information could include:

- a general statement and information regarding the manner in which orders are accepted, processed, settled and cleared via the Internet; or
- a statement of policies regarding the manner in which operational difficulties such as systems outages or power outages will be handled.

As websites progressively become the medium of choice for communicating with investors, and as Internet use has become more prevalent, issuers and intermediaries have raised a number of questions regarding the scope of their responsibility for Internet communications. There seems to be particular interest in understanding the scope of **liability for maintaining a website** during

registered offerings or for hyperlinks to third party information. The question arises as to whether issuers and intermediaries should be liable for false or misleading information to which they have hyperlinked. At its core, the issue is whether investors might perceive such information as being attributable to an issuer or intermediary. Attribution should depend on whether the issuer has involved itself in the preparation of hyperlinked information or has endorsed or adopted the information. In such fact-based determinations, the report points out that regulators should consider certain factors regarding whether an issuer or intermediary has “prepared”, “endorsed” or “adopted” hyperlinked information.

Of growing concern has been the facilitation of **day trading** by the Internet. In the past, day trading was confined to the offices of professional intermediaries. However, recent developments in Internet order-routing mechanisms have led to an environment that makes day trading for retail investors not only feasible but attractive. The primary regulatory concern with respect to day trading is investor protection. As soon as day trading became available to retail investors, it became apparent that day trading undertaken without sound knowledge of markets and trading conditions, and without sufficient financial means, could potentially result in serious financial difficulties for investors. Dangers for inexperienced investors lurk not only in the competition with professional traders but also in the high cost of repeated trading. The report describes- some of the measures associated with day trading, e.g. risk and cost disclosure. These measures include increased investor education and the establishment of specific regulatory requirements for day trading accounts.

A great deal of information and opinions about securities investment are available through **Internet Discussion** Sites, chat rooms and similar multi-user mechanisms. Of particular

significance for regulators is the fact that IDSs can be a cheap and effective way of disseminating false or misleading information about securities markets. Regulators should therefore be aware of the risk that IDS facilities might be misused, and consider how best to deal with that risk in the context of the regulatory framework that operates in their jurisdiction. The report describes -with regard to the different regulatory frameworks -the different possible approaches to dealing with this issue. In some jurisdictions for instance, a person who operates an IDS facility may be subject to direct regulation. In these jurisdictions an IDS facility and the persons making postings may qualify as investment advisers or broker-dealers. These jurisdictions may subject IDSs to the requirements imposed upon investment advisers or broker-dealers.

In other jurisdictions, the regulation of IDSs as investment advisers or broker-dealers raises serious questions regarding whether opinions posted on the site represent expressions that are protected by constitutional rights to free speech. In such jurisdictions, regulators have in the alternative instituted vigorous Internet surveillance and enforcement programs. Elements of programs that successfully combat illegal securities activity on IDSs include inter alia teams of investigators that regularly surf the Internet and visit IDSs to identify fraudulent or misleading postings or electronic complaints centers to which users of IDSs may forward concerns regarding suspicious postings.

Another significant issue is **Internet Enforcement**. Regulators investigate various securities violations that occur over the Internet. The growing use of the Internet to commit securities fraud and undertake market manipulation has led to an increasing need of regulators to obtain information from Internet Service Providers about subscribers and their communications. When the misconduct emanates from another jurisdiction, regulators often must rely on co-operation of their foreign counterparts to obtain this information. In order to investigate and prosecute domestic

Panel One
Mr. Georg Wittich

and cross border securities violations, the reports points out that regulators should ensure that subscriber data and certain traffic data are maintained by ISPs and that such data is available.

In my estimation, discussions with the members of the Internet Task Force about the appropriate regulatory framework for securities activities on the Internet have made it clear that the growing ability to deliver services across borders calls for harmonisation of standards and practices, and requires more extensive co-ordination in many areas. The evolution in Internet use, notably the emergence of e-finance, offers significant benefits to investors throughout the world. At the same time, the easy spread of information, along with the speed of innovation, can facilitate fraud and other criminal activities.

In a reaction to the above, IOSCO has already sponsored two Internet Surf Days in 2000 and in 2001, in the course of which regulators co-ordinated their efforts to identify securities fraud or other illegal activities on the Internet. IOSCO Internet Training Surveillance Programs are also adequate measures to enhance knowledge and co-operation between regulators. By means of Internet enforcement programmes, these training programmes provide experts from regulators with instruction on areas such as the use of search engines for detecting securities offences.

The successful implementation in the respective jurisdictions of the recommendations made in the first report, makes me hope that the second report of the Internet Task Force will receive the same attention.

Thank you very much for your attention.