IOSCO TECHNICAL COMMITTEE

BULLETIN REGARDING INVESTOR PROTECTION IN THE NEW ECONOMY

SYNOPSIS

The Bulletin identifies four areas in which investors and market professionals should fully understand the consequences of investing in the New Economy, and highlights specific issues arising in those areas.

1. The Initial Public Offering (IPO) Process

    - Investors should investigate companies fully and know how to gauge a company's value before they invest.

    - Investors should be aware that when a company goes public, the number of shares offered to the public often represents only a small percentage of the company's total shares outstanding. While limited supply and aggressive demand may mean that the share price will go up in the secondary market, the price may well fall back subsequently.

    - Investors need clear disclosure of new and increasingly interdependent business relationships emerging in IPO markets.

    - Investors should understand that factors such as high offering price and dilution of shares may limit investor returns.

2. Valuation of High Tech Companies, Including Accounting and Financial Reporting Issues

    - Investors should understand the difference between trading and investing.

    - Investors should understand that the time value of money will impact valuation models, which are based upon expectations of future economic gains.

    - Investors and market professionals should understand that in some cases, they may need to go beyond reported financial results to determine whether a company has ongoing sources of earnings and cash flow to survive.

    - Accounting guidance is needed to ensure that companies use consistent methods to account for certain transactions, common in Internet companies, such as advertising and other barter transactions

3. <u>The Effects of Short-term Trading Strategies on Investors' Risks and Expectations</u>

- Investors who trade online should understand that the ability to enter an order quickly does not assure that the order will be executed more quickly than an order given to a broker by traditional means. Delays in order processing may occur, resulting in uncertainty about the price at which execution occurs.

- Investors should be clear about the risks and costs associated with investing on margin.

- Online brokerages have changed investors' relationships with their brokers; however, brokers continue to have the obligation to act in the best interests of their customers

4. <u>Preserving Investor Confidence</u>

- Investors should gauge the objectivity and bias of investment advice they are receiving about IPOs and issues trading in the secondary market.

- Market professionals who provide advice and recommendations should be mindful of their investor suitability obligations, and disclose clearly to investors any potential conflicts of interest they may have with respect to the securities they are recommending

- To preserve investor confidence in the IPO process and secondary trading, it is important for securities regulators to question any departures from the legal and professional standards, such as departures from market place listing standards or variations of lock-up periods.

IOSCO TECHNICAL COMMITTEE BULLETIN
INVESTOR PROTECTION IN THE NEW ECONOMY

A. INTRODUCTION

IOSCO's Statement of Objectives and Principles of Securities Regulation sets forth the following three objectives:

The protection of investors;

Ensuring that markets are fair, efficient and transparent; and

The reduction of systemic risk.

These objectives and the principles that support them represent a commitment by IOSCO members to serve the interests of public investors through adoption and implementation of sound regulatory standards that may be applied effectively under varying economic conditions, in both buoyant and depressed markets. Underlying this regulatory framework is the fundamental truth that a well-informed investor is a better-protected investor. Developments in today's fast-changing, technology-fuelled New Economy suggest that it is important for regulators and market professionals not to lose sight of this truth and the need to serve the interests of the public investor. Accordingly, the IOSCO Technical Committee is issuing this Bulletin regarding Investor Protection in the New Economy.

The Bulletin is intended to remind investors, market professionals, and regulators that in the robust but volatile conditions that the New Economy has brought to many countries' securities markets, it is important not to lose perspective. Markets are cyclical creatures. The need to identify market and investment risks, to disclose these risks to investors so that they understand them, and the need for market professionals to discharge their responsibilities properly, are as great, if not greater, at the upper part of a market cycle as they are at the bottom. These are not new issues, but are of heightened importance in the New Economy.

The New Economy has empowered the individual investor with online, fast and efficient access to market and financial information that, as recently as a few years ago, was only available to a select few institutions and individuals who could afford to pay for it. Technology also is revamping the structure of securities markets and reducing trading costs in ways that could not have been foreseen. The combination of easy access to new technology, reduced costs and the prospects of profits from investment in new technology companies has caused many investors to enter the securities markets for the first time, and others to intensify their investment activity.

The positive benefits of the New Economy are accompanied by new investor expectations and behavior, and changing conduct of market professionals, presenting challenging investor protection issues for securities regulators.

- While technology has given the individual investor access to more investment information than ever before, it has not necessarily improved the quality of this information, or the ability of many investors to use it. Some investors have eschewed long-term investment strategies based upon company-specific information for short-term trading based upon market indicators, momentum and volatility.

- While technology and online brokerage services have lowered securities commissions, investors' use of margin to purchase securities has reached all time highs in many markets, placing investors at greater risk of loss during market downturns.

- And while market professionals (including brokers, dealers, investment advisers, underwriters, and market listing committees) normally perform valuable gate-keeping and advisory functions for the benefit of investors, the euphoria associated with new technology investments may have caused some of these market professionals to lose their perspective and to compromise the judgments that they normally provide to the market place and investors.

The New Economy is also a global economy. Trends that once were limited to individual markets are now reflected instantaneously in markets around the world. Never before has there been a greater need for an international consensus on the issues that affect investors in these markets. Never before has there been a greater need for global cooperation among regulators in addressing these issues.

The IOSCO Technical Committee believes that, unless investors fully understand the consequences of investing in the New Economy, they may fall victim to excessive optimism. The Technical Committee has identified the following four areas of concern:

1. The initial public offering process;

2. The valuation of high tech companies, including accounting and financial reporting issues;

3. The effects of short-term trading strategies on investors' risks and expectations; and

4. Preserving investor confidence.

The Technical Committee does not suggest that all of the regulatory issues discussed in this Bulletin are novel or unique to New Economy companies or to investing online through the Internet. For example, many of the issues regarding IPOs have arisen during prior "hot issue" markets, and many of the online investing issues are basic questions regarding how market professionals discharge well-established traditional obligations of fair dealing with customers, both in the primary as well as the secondary market. These are questions that may arise regardless of the nature of the business of the company in which an investment is made. The issues identified in this Bulletin are, however, particularly relevant in the New Economy environment.

The IOSCO Technical Committee recognizes that it is not the role of securities regulators to recommend purchase or sale of securities by individual investors, nor particular strategies to guide their investment decisions. Securities regulators should, however, endeavor to see that investors have access to all material information, including information about the risks associated with investing. The ability of investors to protect themselves requires that they become adequately informed, both though their own efforts and through receipt of fair and honest advice from market professionals.

This Bulletin represents the IOSCO Technical Committee's preliminary discussion of issues posed by the New Economy. It is anticipated that detailed work on specific issues will continue in the coming months.

B. DISCUSSION

1. The Initial Public Offering (IPO) Process

(a) Investigate before you invest. The number of IPOs, particularly in the growing landscape of the Internet, has proliferated as investors look for large returns from less seasoned or "start-up" companies. Many of today's companies do not yet have a discernible track record, and require an injection of large amounts of capital just to survive, let alone thrive. It is no surprise, therefore, that many of these companies have been groomed – very early on – to go public in record time. But sometimes this race to conduct an IPO, while valuations of high tech companies are at or near record highs, may come at the expense of laying the foundation for a viable long-term company. It also places a greater burden on investors to know how to gauge a company's value, and analyze its business prospects and ability to survive and prosper in a highly competitive and rapidly changing market environment.

Investors should read an IPO prospectus carefully, particularly the company's description of its present and proposed business, the risk factors associated with the business and the offering, and the company's financial statements. Investors should understand that IPO investing is a high-risk activity. It is best suited for those investors who have the financial resources to allocate a portion of a larger diversified portfolio to IPOs, and who have the financial ability and risk tolerance to accept substantial losses in the quest for potential profits.

Investors also should exercise a healthy degree of skepticism regarding sales literature. Practices vary among jurisdictions regarding the legality and use of investment research and recommendations, including financial projections that may not be included in an IPO prospectus. However, it is universally agreed that the prospectus is the disclosure document that that the company stands behind as true and not misleading. An investor who receives supplemental information that is at variance with the prospectus should consider who prepared such information, who stands behind it, and how such persons will benefit if the investor relies on the information. Moreover, investors should expect market professionals to comply with the ordinary conduct of business rules.

(b) IPO pricing and the laws of supply and demand. Pricing of any IPO presents significant risks. Ultimately the pricing decision is based upon subjective judgment and negotiation between an issuer's management, which is interested in obtaining capital with minimum dilution of share ownership, and managing underwriters interested in pricing fairly for the issuer, while recognizing that their compensation is based upon the offering price. Investors also should understand, however, that the IPO cycle often causes high prices to be paid for companies in currently favored industries. The price that an investor pays for shares of a company in a favored industry may be higher than under other circumstances because the managing underwriters and issuer are benchmarking to prices of comparable IPOs and comparable companies trading at or near all time highs in the secondary market.

When a company goes public, the number of shares offered to the public often represents only a small percentage of the company's total shares outstanding. Founders, management and others often retain a majority of the shares outstanding after an IPO. A strong performance of the share price in the secondary market will often be observed as the result of a combination of strong demand, boosted by the marketing effort for the IPO, in conditions of limited supply. There is no guarantee, however, that the share price will remain strong. A reversal of these conditions, created by a weakening of demand as investors reappraise the prospects for the company or the market as a whole or an increase in supply resulting from a release of new shares onto the market, may result in a fall in the price.

(c) The interests of investors and insiders. Underwriters, venture capitalists, management and other select participants have much to gain from a successful IPO. They own the shares in the company that were not offered in the IPO. While public investors are competing for a limited number of shares, driving up the price, these company "insiders" may sell their own shares for a much higher price.

IPO investors should pay close attention to prospectus disclosure regarding shares held by company management, including stock options. They should consider the following questions. Is management committed to the company or are they using the IPO to sell most of their holdings? What "lock up" or other restrictions affect management's ability to sell shares in the secondary market? Are there vesting provisions in stock options that give management an incentive to stay with the company and make it grow before management can "cash-in" the options? Investors also should consider the impact that future sales of significant blocks of stock by management, other large shareholders, or the issuer may have on the company's stock price.

(d) Factors that may limit return on investment. Even if an investor believes that he has selected a sound IPO, it is important for the investor to consider whether the investor's prospects for a successful return on investment are aligned with the company's prospects for success. A number of factors may make a company with a good concept a poor investment choice. In addition to a high offering price that may reduce the investor's potential return on investment, these factors include the potential share dilution associated with future issuances of shares, and the possibility that the company has entered into business relationships, such as licensing agreements or joint ventures, that will limit the stream of future earnings that will benefit the company and its shareholders.

(e) Market Place Listing Standards for IPOs. Practices vary among jurisdictions as to whether secondary market listing requirements affect IPO prospectus disclosure or IPO underwriting procedures. However, it is important for all investors to consider the market place on which an IPO issuer's shares will be admitted to secondary trading because the requirements of different markets and different listing tiers within a market may significantly affect the ongoing disclosure, financial reporting and corporate governance of the issuer. Investors should consider whether the market (or other) regulations will require the issuer to: (i) make timely disclosure of material information likely to have a significant effect on the price of its shares; (ii) issue audited annual financial statements and interim unaudited financial results; and (iii) adhere to governance practices intended to protect the interests of public shareholders.

2. The Valuation of High Tech Companies, Including Accounting and Financial Reporting Issues

Uncertainty is a legitimate explanation for some of the volatility and high valuations that are reflected in the share prices of new technology companies as investors and market professionals seek to identify the select companies that may emerge as tomorrow's market leaders. However, it is equally clear that unrealistic expectations, departures from traditional securities valuation models and outright speculation are also reflected in the share prices of many new technology companies.

(a) Trading vs. investing. Much of today's activity in buying and selling securities highlights an important difference between *trading* and *investing*. Trading is buying on the belief that the stock price will rise or selling on the belief that it will fall – regardless of what price the buyer actually thinks the stock is worth. Trading often involves short-term strategies based upon technical analysis of stock price movements. Investing is focusing on a company's fundamentals with the objective of securing a sustainable return. In the latter case, investors should ask questions, such as does the company have a vision, a sound business model, a strong management team, a quality product or service, or at least a concept that management is capable of developing into a viable business. Is it well positioned to embrace new technology or innovation? Does it have the resources to become a better company? While price/earnings (P/E) ratios and other traditional metrics may not help in evaluating some of today's start-up Internet and technology companies that have no track record, these time-honored fundamental questions will always have relevance.

(b) Importance of the time value of money. A company's P/E ratio or earnings multiple is often used as an indicator to determine how the stock market values a company based on its earnings or expected future earnings. When a new company has no reported earnings or marginal earnings, many investors will look to other measures of investment valuation. Current market valuations of some new technology companies suggest that investors may be overlooking the fact that the time value of money still is a critical component of any valuation model that is based upon expectations of future economic gains. Some new technology companies have prominently disclosed that they do not expect to report earnings for several years, yet they are being valued at or above the valuations placed on other companies with current earnings and the same projected growth. It is important to be aware of the implications that this holds for the preparation and composition of stock market indices.

Investors should remember that, when they buy stock in companies without earnings and without track records, they are buying concepts. Concepts are described in plans with words. Their value usually rests in intangible things, such as entrepreneurial skills, good management and positive forecasts. These intangibles will not produce returns for a company unless they can be successfully transformed into an enterprise that generates economic value.

(c) Investment valuation models and accounting practices. Some analysts and investors have turned to investment models for high tech companies that focus upon revenue expectations, price to sales ratios, or available cash and cash flow measured against the expected "burn rate" for expenditures. These valuation approaches place added focus on specific financial statement items other than reported earnings. The effects on reported revenue of advertising and other barter transactions, coupon and rebate programs, and fees for time or performance based service transactions are examples of issues that must be considered carefully. As accounting guidance regarding classification of items within the income statement is sparse, these approaches require scrutiny of the specific categories of revenues and expenses. These issues affect many companies, but their pervasiveness among Internet companies and their impact on these companies' financial statements highlight the need for accounting guidance to assure that all companies account for similar transactions similarly.

(d) Do financial reporting practices reflect the quality of earnings and cash flow from operations? Securities regulators should assist investors to understand that, no matter how a company is valued, it requires ongoing sources of earnings and cash flow to survive. In the case of many companies, this may require investors and market professionals to go beyond financial results reported in accordance with accepted accounting principles to examine the quality of earnings and cash flow from operations. For example, has the company fully disclosed that:

- some of its earnings may be non-recurring;
- some of its earnings may not contribute to positive cash flow from operations; and
- some of its earnings may be recognized now even though they relate to transactions that will require future expenditures?

Issuers that elect to raise money publicly undertake obligations to provide financial statements that contain reliable, material and timely information for prospective investors and shareholders. Board audit committees, independent directors, independent auditors and investment analysts also have important roles to play in assessing the quality and integrity of financial statements prepared by the management of public companies.

3. The Effects of Short-Term Trading Strategies on Investors' Risks and Expectations.

(a) Online brokerage. Advances in information technology have revolutionized the securities brokerage industry, in particular through the growth of online brokerage. Online brokerage has changed investors' relationships with their brokers by giving them greater access to a wealth of information and enabling them to act quickly and trade on this information. However, online trading has not changed the obligations of brokers to act fairly and honestly in the best interests of their customers. Brokerage firms need to be mindful of observing rules of conduct that apply to dealings with their customers, which are now taking place on a much faster basis than when many of these rules were initially adopted. In such circumstances, it is essential that brokers examine their policies for dealing with online investors to assure that they meet their duties of best execution, and that when securities are recommended to investors, applicable investor suitability obligations are appropriately discharged.

On a more fundamental level, investors should be aware that the regulatory requirements that apply to online brokerage firms are not different from those that apply to firms with physical offices. Investors should make sure that any online firm they deal with is authorized to provide advice, has qualified investment professionals, and is more than a name and an Internet address.

(b) Order processing delays. Investors who trade online should understand that the ability to enter an order quickly online does not assure the quick execution of the order, or that it will be executed more quickly than an order that an investor gives by more traditional means. When online and other automated trading facilities handle many orders from investors, delays in order processing can and have occurred. During this delay, the price of the securities may fluctuate. These fluctuations may be larger in volatile, active markets. By the time that an investor's order is executed, the price of the security may be very different than when the investor placed the order.

In some markets, there may be limited system-wide capacity to handle a large increase in orders and trading volume, which also may cause investors to experience delays. Investors who wish to protect themselves in such circumstances should consider the possibility of using limit orders to buy or sell a security at a specific price.

(c) Investing on margin. Investors must be clear about the risks associated with investing on margin, including the effects that margin may have on increasing overall trading costs, and placing investors at greater risk of loss during market downturns. In volatile markets, investors may be required to provide additional margin if the price of the security falls. In some jurisdictions, investors have been shocked to learn that the brokerage firm has the right to sell their securities with little or no notification and potentially at a substantial loss to the investor. Margin calls and sales also may extend a downtrend in the overall market. It is important for investors to understand that margin is a two-edged sword. Investors that purchase on margin with the hope of doubling their money also may double their losses.

4. Preserving Investor Confidence.

Recent trends in IPOs reflect significant changes in the venture capital cycle, including a much shorter time frame in bringing many unseasoned or start-up technology companies to market. Competitive pressures, always present but perhaps intensified in the New Economy environment, can lead market professionals to loosen practices in both the initial and secondary markets. In order to preserve investor confidence in the IPO process and secondary trading, it is important for securities regulators to monitor these trends and to question any departures from the legal and professional standards expected of issuers and market professionals. Areas of concern should include departures from established standards of disclosure and financial reporting, departures from market place listing standards, variations of lock-up periods, and failure of market professionals to fulfill their duties and comply with applicable standards of market conduct. While specific standards vary from country-to-country, investors worldwide have a reasonable expectation that they may place confidence in markets and market professionals, and be treated fairly and honestly.

Finally, with all of the financial information now available to investors in the New Economy, investors must be aware that not all of it comes without strings attached. In dealing with investment services firms, investors should gauge the objectivity and bias of investment advice they are receiving about IPOs and issues trading in the secondary market. Many “sell side” investment analysts recommending companies’ securities work for firms that have business relationships with the companies these analysts cover. And some of these analysts’ paychecks are typically tied to the performance of their employers. It is incumbent on securities regulators to see that investment services providers who provide advice and recommendations are mindful of their investor suitability obligations, and that they disclose clearly to investors any potential conflicts of interest they may have with respect to the securities they are recommending.

CONCLUSION

In many respects, today's euphoria about the New Economy and technology investing is nothing new. History shows that heightened speculation has always accompanied innovative and dynamic times. But if past is prologue, many new companies rushing to market today will not be around for the long-term, perhaps not even a few months or years from now. Successful investors, through good times and bad, must focus a vigilant eye on managing risk. It is important for securities regulators to attempt to raise investors' awareness, so that whether they enter today's markets to trade or to invest, they will enter with a better understanding of their own tolerance for risk and with realistic expectations. As securities regulators, the mission of IOSCO members is not to guarantee that investors will avoid losses, but to see that investors are armed with the information they need to make informed investment decisions.