

**REPORT ON ENFORCEMENT ISSUES
RAISED BY THE INCREASING USE OF ELECTRONIC
NETWORKS IN THE SECURITIES AND FUTURES FIELD**



**Technical Committee
of the
International Organization of Securities Commissions**

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**Report on Enforcement Issues
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Networks in the Securities and Futures Field**

IOSCO believes that the increasing use of electronic networks presents opportunities and poses challenges to securities and futures regulators. Accordingly, the IOSCO Technical Committee has created an Internet Task Force to identify whether there are common regulatory and enforcement issues presented by the Internet, suggest possible ways in which regulators and market participants can use the Internet to further the goals of IOSCO, and determine whether it is possible to develop any consistent approaches for use by IOSCO members to address such common regulatory and enforcement issues.

This initial report focuses on the Internet's opportunities and challenges for securities and futures regulators exclusively in the enforcement context. It is anticipated that the issues discussed and the recommendations contained in this report will be considered by the Internet Task Force.

INTRODUCTION

Electronic networks for communication and information dissemination are important and widely used interactive tools in many countries around the world. These electronic networks, collectively known as the Internet, are estimated to be used by in excess of 50 million people in over 23 million households. The Internet is particularly useful for disseminating information about securities and futures because it permits the transmission of information to a global audience with speed and accuracy. In addition, the Internet is a useful tool for individual investors, who may otherwise lack access to up-to-date information. Moreover, the Internet is increasingly being used to conduct market transactions, to route orders and to make payments for securities and futures products.

As a result, it is no surprise that on-line investing has grown more popular with the growth of the Internet. Approximately 1.5 million brokerage accounts exist on-line, and this number is expected to grow to 20 million accounts in 10 million households by the year 2001. In addition to on-line accounts, there are many investor related on-line information services, and these are growing in number as well. These trends demonstrate that the Internet has the potential to transform the way in which markets operate. Information that in the past reached investors through traditional means now can be transmitted instantaneously around the world. The implications for the dissemination of market-related information and market transparency are great.

Regulators should recognize legitimate uses of the Internet in the securities and futures field. At the same time, regulators must be aware that the qualities that render the Internet a valuable tool for information dissemination also render it a tool to perpetrate securities and futures fraud. Regulators must be on guard to recognize fraudulent schemes on the Internet and to curb them wherever possible. In that regard, the Mandate on Issues Raised by the Increasing Use of Electronic Networks in the Securities and Futures Field provides that Working Party 4 will seek to: (1) identify enforcement challenges presented by the Internet; (2) make recommendations for combating securities and futures violations, including opportunities for cooperation among regulators; and (3) identify ways for regulators to use the Internet to assist their enforcement programs.

This Report responds to that mandate. The Report discusses securities and futures enforcement issues raised by use of the Internet and makes recommendations as to mechanisms that regulators might employ to exchange information about and to counter fraud on the Internet. Part I discusses the challenges that the Internet presents to securities and futures regulators; Part II suggests ways in which regulators can cooperate to combat securities and futures-related fraud that occurs on the Internet; Part III of the Report identifies ways in which regulators can use the Internet to enhance their enforcement programs.

I. ENFORCEMENT ISSUES PRESENTED BY THE INTERNET

A. Background: Methods by Which Information is Disseminated Over the Internet

The Internet is an umbrella term encompassing several methods that can be used to disseminate information electronically. Each method may present different enforcement challenges to regulators. Thus, as a preliminary matter, in order to understand the enforcement challenges raised by the Internet, it is necessary to understand and distinguish among the methods of information dissemination possible on the Internet.

The first and most widely discussed mechanism to disseminate information on the Internet is the **World Wide Web**. The World Wide Web is a vast network of **sites** or **Web pages**, which are graphical presentations of information that can be revised and updated at the discretion of the site-holder. World Wide Web sites are generally operated by a single entity or individual, who controls the information that appears on the Web page. Readers of the Web page can access the information and use its interactive features, but they cannot revise the original Web page. World Wide Web sites present challenges for enforcement because, much like magazines, newspapers and newsletters, they permit individuals and entities to disseminate information about the value

of securities and futures to a wide audience, dispense investment advice, and even make offers for purchase or sale of particular instruments.

The second mechanism used to disseminate information through the Internet is the **bulletin board system**, also referred to as **newsgroups** or **message boards**. A bulletin board is a text based system to disseminate information, which is generally not controlled by a single entity. Rather, bulletin boards allow for written messages to be posted to a particular location on the Internet, and for readers either to post responses or to post new messages. Newsgroups and bulletin boards present challenges for securities and futures enforcement because they allow for messages and responses to messages, all of which can be sent anonymously, to reach a large audience interested in a particular topic, and to stimulate on-line conversation about that topic. These systems present an ideal forum for individuals who seek to spread rumors about particular instruments in an attempt to manipulate prices.

The third means to distribute information on the Internet is the **e-mail** system. An electronic message, similar to a letter or a fax, is directed to particular addressees. E-mail messages, like a mass mailing, also can be indiscriminately sent to vast numbers of addressees. E-mail is extremely popular. It is the primary use for thirty-two percent of the 13 million households with on-line accounts. As a result, e-mail presents significant challenges for enforcement because anyone with an e-mail account can transmit messages about any topic to vast quantities of people, and often remain anonymous. For example, e-mail presents a convenient technique for boiler room operators who want to reach large numbers of people quickly. This could be particularly attractive to those interested in committing securities and futures violations if combined with technology permitting on-line payments.

Finally, a new method to disseminate information on the Internet 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. Similarly, a new technology called **push media** allows information to be disseminated to viewers automatically, without the viewer having attempted to log on to a particular World Wide Web site or bulletin board system. Rather, the information is "pushed" at individuals while they are on-line.

These new technologies generate enforcement challenges because senders of information can reach vast numbers of people who are already on-line, without the receiver having to take much, if any, action. They reach a large audience who is simply logged on to the Internet, much like television and radio reach an audience who is tuned to a particular station. Although these new technologies are still in their infancy, and are sometimes prohibitive due to cost and logistical barriers, they may present formidable challenges to regulators within the next five to ten years.

B. Characteristics of Information Dissemination Over the Internet

Although the substance of information disseminated over the Internet is no different than information disseminated through traditional methods, there are characteristics of the Internet that make it markedly different from traditional communication methods. It is these features of information dissemination that can aid the perpetration of fraud.

1. Information Dissemination is Made Easier by the Internet

Dissemination of information is easier and more efficient over the Internet. First, electronic information dissemination is **international**. Much like faxes sent across borders through telephone lines, electronic information can cross borders without limitations or checks, such as a search at a border control center. Second, information dissemination through the Internet is **rapid**. Vast quantities of information can be transferred in seconds. Third, electronic information dissemination is **inexpensive**. Anyone can produce a Web site virtually free of charge by downloading programs from the Internet to construct a Web page, and the cost of a program to construct a professional looking Web page is minimal. Even without a Web page, the cost of disseminating large quantities of information via bulletin board systems or attachments to e-mails is negligible. Fourth, information disseminated electronically can reach a **broad** audience. Much like mass mailing, Internet messages can reach hundreds of thousands of individuals. Finally, electronic information can be as **detailed** as the site-holder or sender likes, as the Internet can handle vast quantities of information relatively accurately.

As a result, the Internet allows a wide range of financial services providers to access a broad customer base, whether domestic or international, and to provide large quantities of detailed information quickly, and at little cost. Perusing the vast quantities of information available on the Internet can be challenging to regulators.

2. The Internet Provides a Means to Make Internet Fraud Appear Legitimate

The second characteristic of information dissemination over the Internet that can aid the perpetration of fraud is that the Internet can give the appearance of legitimacy to otherwise non-legitimate information. The Internet allows World Wide Web site-holders, or newsgroups and bulletin boards, to establish **electronic links**, also known as **hypertext**, which allow readers of the information to link or access materials that have been previously published in electronic

format. These links allow Web site holders, and others, to increase their credibility by associating themselves with legitimate information, such as well-regarded reports and magazine articles. It even allows a site-holder to link a Web page with a Web page prepared by a regulator.

3. The Internet Permits Information to be Sent Anonymously

Another characteristic of Internet information dissemination that aids the perpetration of fraud is that the Internet allows senders of information to mask their identity through "anonymizing" tools. For example, users can access an anonymous "remailer" site that will obscure the sender's identity by providing the sender with a pseudonym. Similarly, users can download software called anonymizers that act as a middleman masking the identity of the sender, and the source, of the information. In addition, the Internet provides the capability for "spoofing" or impersonating others and altering or falsifying e-mail messages. All of this raises at least three concerns. First, individuals or entities previously enjoined from illegal activity can mask their identities on the Internet; second, one particular individual or entity responsible for transmitting information on a particular topic can give the appearance that the information emanates from multiple sources; finally, tracking and locating offenders may be made more difficult through the use of these devices.

C. **Traditional Violations are Made Easier by Internet Technology**

Although the Internet itself has not yet given rise to new types of securities and futures fraud, the ease by which information can be disseminated over the Internet makes it an ideal environment where traditional frauds can flourish. Thus, regulators must identify which traditional securities and futures fraud can most easily be perpetrated over the Internet.

Among traditional types of financial fraud, one that can be accomplished with particular ease over the Internet is price **manipulation**. **False and misleading statements** about particular instruments can be sent via a World Wide Web site, a bulletin board service, a discussion group or a mass e-mail. This information can influence the price of securities and futures, especially thinly traded instruments. Moreover, manipulation is aided by the ability to send messages anonymously, or under an alias, or several aliases, which gives the false impression that one particular instrument is being promoted by several sources.

In addition to manipulation, there are several other types of securities and futures fraud that can be perpetrated over the Internet. The Internet provides a means for **fraudulent offerings** of securities and futures: **unregistered persons** may offer securities and futures for sale, or **unregistered** securities and **illegal off-exchange** futures can be sold to the public. The Internet

also provides a means for individuals and entities to dispense **fraudulent advice**. **Broker-dealer misconduct** can occur on the Internet, and broker-dealers can reach an unlimited number of investors over the Internet, with different levels of knowledge in different countries. Finally, the Internet provides a mechanism to hide **conflicts of interest** of promoters and investment managers. For example, investors reading a message about a company may have no way of knowing if the sender is being compensated by that company.

These types of fraud, as opposed to price manipulation, raise different challenges for regulators because ultimately the sender of the fraudulent information seeks to receive money from investors and must therefore provide some identifying information, such as a name, address or fax number where the person can be contacted. This identifying information may make it easier to locate the individual and put a stop to the fraud.

Regulators also must be aware of potential fraud arising out of problems of security and integrity on the Internet. With the rise of electronic-based trading, it may be possible to conduct fraudulent activities through the interference and rerouting of orders over the Internet, or through the violation of security systems connected to the Internet.

D. Challenges for Enforcement

Because of the characteristics of the Internet described above, it is likely to be attractive to persons involved in securities and futures violations. As indicated above, while the violations that are committed through the use of the Internet are to date not new, they nevertheless increase the challenges for regulators seeking to enforce securities and futures laws.

1. Conducting Surveillance

Regulators need to learn new methods for conducting surveillance and must become familiar with specialized chat groups, search engines, and other Internet-specific methods for sharing and finding information. In addition, the vast amount of information relating to securities and futures investments which is transmitted over the Internet can tax the resources of regulators, who will need to have a sufficient number of staff members who are familiar and comfortable with using the Internet and the appropriate tools for detecting illicit activity.

2. Identifying and Locating the Offender

Because of the particular techniques available to Internet users, identifying and locating the persons responsible for the securities or futures fraud can be especially difficult. As indicated above, Internet users can hide their identity through a veil of anonymity that may be more difficult for regulators to pierce than when more traditional methods of communication are used. For example, regulators may find it more difficult to identify the person or persons engaged in a market manipulation scheme through an Internet bulletin board than in a more traditional manipulation. Regulators should consider whether they can obtain, when necessary, information from Internet access providers about the identity of those using the services and whether informal or formal arrangements with such providers would be useful.

3. Difficulty in Collecting Evidence

Because of the difficulties in tracing communications over the Internet, the Internet presents challenges to regulators seeking to collect evidence. The laws and regulations relating to data preservation over the Internet vary widely, and regulators may need to become familiar with the relevant provisions and appropriate sources of information in other countries. The challenge for regulators may be as fundamental as not knowing where to obtain the relevant evidence, whether from the access provider, the subscriber service, or the sender or recipient of the information, assuming that person can be identified. Moreover, the extent to which regulators can compel data from those who maintain it, such as third party subscriber services, may not be settled in a regulator's own country.

4. Adequacy of Domestic Laws

Domestic laws concerning electronic transfers vary widely. In addition, regulators need to review existing securities and futures laws and regulations, most of which were drafted prior to the introduction of Internet technology, to ensure that they can be applied in a comprehensive and meaningful way to communications over the Internet. Moreover, regulators need to consider whether they have the legal authority to obtain the information, including information from third party providers, that they need to successfully pursue Internet securities and futures cases.

5. Issues of Cooperating with Foreign Counterparts

Use of the Internet for securities and futures communications underscores the globalized nature of today's markets. The characteristics of the Internet make it well suited for international communications and cross-market transactions. Therefore, regulators need to consider their international programs and the extent to which they have in place a well-established base for

cooperation with their foreign counterparts. In any Internet investigation, information may well need to be obtained from one or more foreign jurisdictions. In addition, illicit activity may implicate the securities or futures laws of several jurisdictions and authorities may need to cooperate with each other in their investigations. As a result, there is an even greater need for close cooperation and coordination among regulators in different jurisdictions. Among other things, regulators should have policies and procedures in place to ensure that information can be exchanged on a timely basis. By developing such policies and procedures, regulators can respond quickly and flexibly to an incoming request from a foreign authority.

As mentioned, the Internet can result in additional instances where regulators need to collect evidence abroad. Therefore, it is important that existing mechanisms are sufficient to enable regulators to collect such evidence, whether it is from an access provider, subscriber service, or sender or recipient of the information, or otherwise. Finally, in some jurisdictions the regulator's ability to enforce a judgment or implement sanctions against individuals or entities located in other jurisdictions may be an issue as well.

II. COMBATING SECURITIES AND FUTURES VIOLATIONS ON THE INTERNET

Regulators already have an arsenal of weapons to combat Internet related securities and futures fraud available to them. For example, regulators can conduct their own surveillance, including by accessing the world wide web as well as newsgroups and other discussion groups. Regulators can establish their own web sites to provide information to local investors and provide an e-mail address and telephone number to which complaints can be directed. In sum, regulators need to take the same approach to combating Internet related securities and futures fraud as with more traditional fraud: aggressive investigation and prosecution, enhanced self-regulation, and investor education.

Moreover, regulators can add to their firepower by cooperating with one another in their enforcement efforts. Cooperation can have an important effect in deterring Internet related securities and futures fraud because of the international nature of Internet communications. An individual or an entity located in one jurisdiction can communicate with investors anywhere in the world virtually instantaneously; no jurisdiction is immune. The person responsible for the fraud that takes place in a particular jurisdiction may be located anywhere a computer and a modem are located. The purpose of this section of the Report is to make recommendations on ways in which regulators may cooperate with one another to combat securities and futures violations on the Internet.

A. Improve Surveillance of Potential Abuse

Regulators can share information regarding surveillance techniques for market activity that occurs on the Internet. First, regulators can share information on the most current and technologically advanced methods to survey trading and other market activity that occurs on the Internet.¹ They can also share information on the most up-to-date equipment, including hardware and software, used for surveillance purposes. It is only by using this equipment that regulators can ensure they are not one step behind those perpetrating the fraud. In addition, regulators can share information that will facilitate surveillance such as methods used to communicate over the Internet and commercially available on-line access providers. Discussion of methods for obtaining information from Internet access providers about the identity of users may be helpful in this regard.

B. Enhance Investor Education and Self-Regulation

As with other areas of securities and futures enforcement, regulators should look for assistance from a system of investor education and self-regulation. Although regulators must be able to step in to identify and fight securities and futures fraud when necessary, a sound system of investor education, coupled with strong self-regulation, are important defenses against fraud. This is also the case with Internet related securities and futures fraud, since it would be difficult to monitor all investor related messages distributed over the Internet.

Thus, regulators can cooperate by sharing information on methods to enhance **investor education**. The Internet has the potential to reach new classes of investors, in particular individual investors, who may be targets of fraudulent activity. Regulators can benefit by sharing information on the best methods to educate investors about securities and futures fraud on the Internet. These may include on-line information about fraud on the Internet; on-line disciplinary histories of firms and individuals; posting press releases on investment bulletin boards; alerting investors to improper conduct on the Internet; and establishing on-line consumer complaint centers. As always, there may be limits on the extent to which such information can be made public due to applicable legal restrictions on disclosure of information.

In addition to sharing information about educating investors, regulators can share information on techniques used to encourage self-regulation of Internet related securities and futures fraud.

¹ In May 1997, IOSCO Working Party 4 of the Technical and Emerging Markets Committees participated in a workshop aimed at regulators whose work consists in large part of detecting Internet fraud. The workshop focused on Internet surveillance techniques.

There is a degree of self-regulation among Internet users who are resentful of Internet technology being used for illegal purposes. They seek to protect the integrity of the Internet by investigating suspicious matters and frequently make complaints or report potential abuses to regulators. This is a practice which should be encouraged by regulators as it may be a useful source of information about Internet related fraud. Regulators have relied on tips by investors as a source of securities and futures related fraud for years, and this is a close variant of the same practice.

C. Share Information on Questionable Transactions and Proven Frauds

Perpetrators of securities and futures fraud using the Internet can easily move both the **sites** location and the **target** location of their operations from one jurisdiction to another when they encounter difficulties in a particular jurisdiction. In addition, they can send the same message to multiple jurisdictions simultaneously. As a result, regulators should coordinate their efforts by sharing information on transactions they view as questionable. In that regard, regulators can routinely advise one another regarding questionable Internet related transactions, such as offers to sell securities or futures, or provide advice. Moreover, they can exchange information on new exotic offers made available on the Internet.

Just as importantly, regulators can share information on successfully concluded prosecutions of Internet related securities and futures fraud. This sharing of information has multiple benefits. First, it may decrease the chance that the same individuals will successfully perpetrate the same fraud in another jurisdiction. Second, it will alert other regulators to the types of Internet fraud they are most likely to encounter in their respective jurisdictions.

D. Consider Evidentiary Questions

One of the difficulties in prosecuting securities and futures fraud perpetrated on the Internet is that electronic communications may be more difficult to trace than traditional methods of communication, such as mail, faxes or telephone calls. For example, in order to obtain a record of a communication made over the Internet, regulators must first ascertain the subscriber service of a particular Internet user. Moreover, it is likely that certain Internet providers do not retain records of Internet contacts for long periods of time.

In this regard, regulators could assist one another by identifying what is considered sufficient admissible evidence in their jurisdictions to prove a securities related offense, where the underlying misconduct occurred on the Internet. Once a picture develops of the necessary

evidence required to prove such an offense, regulators could then discuss ways to cooperate in facilitating the production of this evidence.

E. Technical Assistance

The Internet presents a particular challenge for regulators who have little or no technical expertise. This challenge is exacerbated by the changing nature of Internet related technology. A great deal of hardware and software, especially information processing tools, that was considered state-of-the-art three years ago, is now considered outdated if not obsolete. It is in jurisdictions in which technical expertise is lacking that perpetrators of securities fraud may be most successful, since their chances of detection are small. In that regard, regulators could assist one another by devising a program for technical assistance aimed at regulators who have little or no Internet training or who are inexperienced in recognizing fraud perpetrated on the Internet.

III. USING INTERNET TECHNOLOGY TO ASSIST ENFORCEMENT

This Report noted at the outset that the Internet is an important and widely used tool for information dissemination. International securities regulators can benefit from this technology as much or more than anyone. Indeed, all four of the primary purposes of international securities administrators in forming IOSCO, as set forth in the By-Laws - cooperation; exchange of information; establishment of standards and effective surveillance; and providing mutual assistance - can be greatly facilitated through use of the Internet. Thus, in addition to ensuring that perpetrators of securities and futures fraud do not abuse the Internet to engage in misconduct, regulators can effectively use the Internet to their own advantage to publish information to a wide audience about a number of topics.

There are several ways regulators can use the Internet to advance their own enforcement programs. First, regulators can establish their own World Wide Web sites. These can be used for a number of reasons, including to promote investor education generally; to educate consumers on types of fraud typically perpetrated on the Internet; to disseminate information on particular fraudulent activity that has been detected; and to disseminate information about currently existing Web pages and other investor related information posted by regulators.² IOSCO has its own web site which is used to make information about the organization and the work that it does widely available to the public.

² Several regulators have already done this and these Web sites appear to be a success.

Second, regulators can encourage the use of the Internet as a clearinghouse for legal documents in cases of securities fraud and as a means for collecting and facilitating access to information such as securities and futures laws and regulations that may be of public interest. For example, in many jurisdictions, particularly common law jurisdictions that provide for a private right of action in securities related cases, there are many publicly available court documents that provide a great deal of information for investors. However, because of the volume of the court papers filed and the geographical diversity of the jurisdictions in which the actions are located, it is difficult to review or search these filings for relevant information. If such publicly filed materials were available on the Internet, it would make accessing relevant court documents relatively simple.

Securities and futures regulators could conduct projects in that field. Having documents available in one place would allow investors, and others, to read, count and study pending cases of securities and futures fraud.

There are many other possibilities for cooperation. Regulators can establish e-mail addresses where complaints can be sent regarding alleged securities and futures fraud. This too, has already been done by certain commissions and has proven useful. Regulators can issue informational releases and warnings that can be posted on the Internet. Finally, once advanced security systems exist on the Internet, regulators should consider using the Internet as a tool to exchange information with their counterparts.