A S I C
Australian Securities & Investments Commission

What regulation is required to achieve a global online market?

An address by Shane Tregillis, ASIC Executive Director Policy and Markets Regulation, to the Australian Financial Review's "Online broking and trading conference", Sydney, 20–21 June 2001.

Introduction

In this talk I will cover:

- a quick overview of the current environment from a regulator's perspective;
- a brief review of the findings of the ASIC 2000 review of online broking services and our discussion document on account aggregators;
- some tentative comments on the concept of a global online market place and the regulatory issues that arise

Overview of the current environment

It is clear we are operating in the wash up of the bursting of the hi-tech price bubble in the first quarter of last year. Even a casual reader of the business and financial press would see that its impact is still being felt today.

The hi tech bubble, combined with generally buoyant economic conditions, led to a rapid increase in retail participation of investors in the equities market. Over the last few years there has been an increase in number of online brokers. At the moment there are more than two dozen online retail broking services available in Australia.

Increased competition has led to price-cutting with the cost to consumers of a standard transaction tumbling. A number of commentators have expressed the view that there are too many players and over capacity for the size of the Australian market. So there will need to be a rationalisation of the number of online broking services in Australia.

It is also clear that market participants are adopting a number of different business models. These models include full service brokers moving to offer research via the internet, the larger banks adding online-broking to their other transactions services and the stand alone online broker adding a range of enhancements (such as more sophisticated analytical tools, more detailed research information and margin lending facilities) to their standard transaction services.

This environment raises some general issues for regulators and financial service firms.

At the time of rapid growth in new forms of business, it is a well-established regulatory rule of thumb that internal systems and controls tend to lag other aspects of the business. The greater the growth in any period of time the higher the risks that compliance systems and procedures will not have kept pace.

At a stage when you would expect there to be more attention paid to these type of issues (i.e. the catch up phase after the initial growth spurt) also seems to be in a period of a general business slowdown, intense competition, cost cutting and potential rationalisation. This could mean that the catch up phase on internal compliance systems and controls may not be occurring given cost pressures faced on so called "overhead" areas such as legal and compliance.

It is instructive that there have been warnings by regulators in the United States that the downturn in the industry should not result in a downgrade of relevant legal and compliance staff in securities firms.

While the short-term picture is one of growth in markets levelling out and overcapacity there are some positives that Australia is well placed for e-business developments.

A recent Economist Intelligence Unit (EIU) study ranked Australia second in the world for its "e-readiness".

According to the EIU, e-readiness is the measure by which a country's business environment is conducive to internet-based commercial opportunities. It is based on six broad criteria of:

- connectivity (access by individuals and business to basic fixed and mobile telephone services, including voice, narrowband and broadband data);
- business environment (strength of the economy, political stability, regulation and taxation);
- e-commerce consumer and business adoption;
- legal and regulatory environment;
- supporting e-services; and
- special and cultural infrastructure (the population's education and literacy).

We also fare as well in a range of other surveys and benchmarking studies (The Age IT section, 19 June 2001).

Australia also ranks very highly in overall internet use with the a third of the nation's households online, and more than 50% having a home computer. ABS statistics suggest that Australia now has the third highest level of internet usage in the world per capita, behind Sweden and the United States.

As reported in the press earlier this week there has also a doubling of the numbers of online bank users to 2.8 million, which is double the number at end of June 2000

(AFR Monday 18 June, p44). This does not include non-bank deposit taking institution such as credit unions and building societies.

While ASIC's focus is very clearly on investor protection issues in relation to online transactions and trading, we have also sought to facilitate the use of new technology by business and consumers where this does not compromise the investor protection underpinnings of the Corporations Law. For example, our most recent policy initiative was designed to enable electronic online applications for superannuation products.

This follows on initiatives over the last few years to enable use of electronic prospectuses and electronic applications.

ASIC also runs some significant e-initiatives directly with our e-registers to enable electronic incorporation of companies and lodgment of company documents. As part of the planning for FSRB, we are building on that technology base to develop electronic lodgment of applications for licences unde the new regime. So we have had to grapple with many of the technological and business issues involved.

ASIC survey of online trading websites

In August 2000 ASIC released a report on its survey of online brokers. At that stage there were 29 sites that were identified as offering online trading in Australia.

The survey did not identify any major industry-wide practices or issues that required immediate action by ASIC to rectify. However, we did identify a number of issues relating to the adequacy of complaint handling procedures and a number of disclosure issues that required some attention.

The issues identified involved:

- disclosure of identity;
- dispute resolution;
- privacy;
- education;
- provision of credit; and
- systems

As part of the report, ASIC released a Good Disclosure Template that we consider operators should use to review the information provided on their websites.

ASIC has not undertaken a complete review of how well these disclosure practices have been adopted since the report came out. So it is too early to give a complete report card at this stage.

In the August report, we found that portal sites (those operated by non-ASX participating members) generally had lower levels of disclosure. A quick review for the purposes of this talk of some of these sites suggests that disclosure on these sites has improved somewhat in some of the areas we identified and, in particular, the area of much clearer disclosure of the details of the executing broker.

I urge all those operators who have not done so to review their current disclosures against the Good Disclosure Standards published by ASIC late last year. We consider they remain important elements of disclosure to consumers.

Account aggregators

ASIC has recently released a discussion paper on account aggregation services. This is available on the ASIC home page. As I am sure you are aware, aggregators allow consumers to view, on a single web page, information from their online accounts with a range of financial institutions. Most aggregation services can also aggregate non-financial accounts, such as emails and frequent flyer accounts, as well as news and information services.

In its report, ASIC identified two types of aggregation services — the third party model and the user driven model.

Under a third party aggregation service, the consumer provides the aggregator with their account details (including user name and password) for each of their nominated accounts. These details are stored on a server and this is collated into a single page for the consumer.

Under the driven aggregation service, the consumer stores their account details in a digital safe on their PC. The user activates the aggregation application on their PC, and the application uses the accounts details to retrieve balance and other information from the nominated sites.

Some analysts suggest that these new aggregation services are a potential threat to brokers and other financial institutions in that they reduce the time such customers spend on the websites of the institutions where they have checking brokerage and other accounts.

In the US, Charles Schwab & Co recently announced it will offer an aggregation service joining Citi Group Inc., Wells Fargo, Merrill Lynch & Co, and major other e-finance portal sites such as Yahoo Finance, AUMoney, MSN's Money Central and American/Online/Quicken as players in this area.

ASIC identified a number of issues in relation to aggregation accounts:

- disclosure;
- liability for unauthorised transactions;
- liability for losses;
- privacy;
- security;
- dispute resolution; and
- implications of the Financial Transactions Report Act.

We are seeking comments on the issues raised by these new types of services, so anyone interested in developments and issues in this area should get a copy of the discussion paper.

At the moment Australian sites do not offer transactions services, but there is already discussion that the next generation of aggregation services already being planned could well include:

- online, real-time transaction services;
- electronic bill notification and payment;
- ability to purchase products;
- cash management; and
- increasingly sophisticated forms of tailored financial advice.

In the near to medium future we will no doubt see such services with additional features such as:

- intelligent agents that can complete tax forms, loan applications and other documents;
- automated financial analysis and decision making.

These will raise some interesting issues about how banking and securities regulations will apply to these hybrid style products. Already in the United States there have been some regulatory responses:

- a ruling by the US Federal Trade Commission that the term " financial institution" includes account aggregators for the purposes of privacy legislation;
- guidance by the Office of Comptroller of the Currency relating to risk controls; and
- US Federal Reserve consideration of whether the US EFT Act applies to aggregation or screen scraping services.

There are also some interesting cross-jurisdictional issues involved since the consumer may have a relationship with a technology supplier, not just the financial institution. If the supplier is outside Australia, it may be difficult for a consumer to resolve disputes or complaints, and if information is stored outside Australia it may be difficult for consumers to enforce any rights if the information is disclosed to a third party or is otherwise misused.

Global markets and regulation

The question of global retail trading markets has been talked about for some time. But it is becoming more of a reality every day, driven both by the globalisation of firms and the ability of internet to provide the technological reach across borders at lower cost.

Our major financial institutions are increasingly global in structure and reporting. This is leading to a disjunction between the ways global financial service businesses are organised and the legal and regulatory structures that regulate the way in which they operate in any particular jurisdiction.

It might be useful to posit a stylised, simplified (and probably overly simplistic) model for such a global market for the purposes of the discussion. We can then use this stylised model to examine some of the possible regulatory issues involved.

This stylised model of the global online market would involve:

- a global service in a wide range of trading, banking and insurance transactions combined with a range of advice and other analytical tools;
- transactions conducted entirely within the system itself;
- operated from a single location chosen for its combination of tax, quality of IT infrastructure, regulation, time zone and quality of its lifestyle;
- accessible by customers in multiple jurisdictions;
- payment and clearing and settlement systems integrated into this single system; and
- subject to a single set of set of regulatory requirements and applicable laws.

Some might regard this as the online operators equivalent of NIRVANA!

While no doubt increasingly technically possible, it seems to me that we need to be realistic about some of the limitations on achieving this global market in the short and medium term.

A large part of this relates to the fact that national states still determine the reach of securities laws and, therefore, effective enforcement and investor redress, and this means the concept of a global regulator or single regulatory system remains some time off.

Even in Europe with its common market framework, e-banking requires attention to national laws in each and every jurisdiction despite the existence of relevant European directives covering this very area.

The reality is that when investors lose money it is to their national regulators, domestic courts and other redress mechanisms that they turn. There are no practicable, cost effective alternatives available at the moment.

However, as regulators we are actively responding to a range of what might be termed "global market" proposals at both the retail and wholesale end of the markets. These range from the recently announced ASX world link service, other forms of direct market-to-market links, such as the placement of screens by foreign market operators here in Australia, to the increasing cross border activities and linkages between intermediaries.

At one end of the scale we have accepted that so called order routing systems- such as online broking systems that are either licensed in this jurisdiction and route overseas customer orders to an Australian regulated market, or alternatively, route an order by an Australian customer to a foreign regulated market, can be accommodated by the current regulatory framework without too much difficulty.

In many ways these transactions can be regarded as akin to a customer picking up the telephone and placing an order through a local broker into an overseas market via a regulated broker in that market.

Along with most other jurisdictions we regard this as largely a licensing issue and require that brokers offering this service have the infrastructure, such as access to research on the relevant market, to support that activity.

For the firm this does mean often meeting different licensing or registration requirements in each jurisdiction, when it may be more cost effective to have a single entity with the service being available online.

However, not requiring a licensed entity in Australia would remove a range of customer protections that would be available for equivalent transactions in Australia or conducted by telephone through an Australian intermediary.

These include the provisions relating to handling client money, compensation in cases of default of firm, insolvency, jurisdiction of Australian courts, and the ability of regulators to pursue misconduct, availability of complaints procedures and a range of other basic customer protections.

Like most jurisdictions, we regulate this order routing as an intermediary activity and have stopped short of seeking to treat it as the conduct of a market in Australia with the additional regulatory requirements that this would bring.

I do not see the types of domestic customer protections which attach to the licensing of an intermediary in the jurisdiction as being removed in the short to medium term as would be required under the stylised global market model set out above.

I do consider there will be some scope, however, to take into account the regulatory requirements in other jurisdictions when licensing to streamline this process. The process would be akin to getting a "credit" for where you already meet a broadly equivalent requirement in an acceptable regulatory regime.

We are already doing some work in this area in relation to a few jurisdictions and this could be made easier when the Financial Services Reform (FSR) legislation is introduced, with some more flexibility via some exemption and modification powers in the licensing area.

Additional issues arise once you move from an execution only style broking service to the provision of added value tools and services, in particular, the provision of investment advice or recommendations. This brings with it not only the customer funds and asset protections noted above, but also various competency and conduct requirements (know your client, fact finds, suitability) in most jurisdictions.

While aimed largely at the same regulatory end designed to ensure that the client receives honest, competent and unbiased advice tailored to meet the customer’s individual needs and circumstances, the way in which local requirements apply can differ across jurisdictions.

In fact, close attention still needs to be paid to the basic issue of when the specific regulatory requirements applicable to advice or recommendations apply in different jurisdictions. This is particularly so, as the technology has blurred what used to be a simple distinction — the dichotomy between advice and no advice situations. We now see the emergence of concepts of "scaleable" advice combined with increasingly sophisticated data mining tools that provide new ways to tailor and target information online to specific customer or customer segments.

NASD Regulation Inc, the Hong Kong Securities and Futures Commission (SFC), as well as a range of other jurisdictions have looked at these issues recently. We are looking at similar issues in our policy proposal papers (PPPs) in relation to the introduction of the Financial Services Reform Bill.

NASD Regulation (notice to members 01-23) has confirmed their view that "suitability" requirements remain appropriate to online transactions.

> "The determination of whether a recommendation has been made depends on the content, context and manner of presentation and whether the communication could reasonably be viewed as a 'call to action', or suggestion that a customer engage in a securities transaction. Generally the more individually tailored the communication to a specific customer or a targeted group of customers, the greater the likelihood that the communication would be regarded as a recommendation."

The recent NASD Regulation notice then gives some examples of where there would be a recommendation including:

- customer specific communications to groups encouraging them to buy a security;
- email to customers suggesting investment in particular sectors and providing a “buy” list;
- provision of portfolio tools where the customer inputs details of risk tolerance, finances and age, and the system sends lists of suggested securities to meet these needs; and
- use of online data mining to analyse a customer's financial position and then send and push specific investment suggestions.

In Hong Kong, the SFC's recent consultation paper on the regulation of online trading of securities and futures also addresses the issue of recommendations and suitability requirements in an online environment.

As the SFC report notes:

> “The main issue identified in relation to suitability requirements in an online environment, is what exactly constitutes a 'recommendation'. For example, many firms utilise data mining techniques in order to customise securities offerings for certain clients. The SFC believes that if the information is presented to the client in a way that has been individualised on the basis of the personal circumstances of the client, then that offer constitutes a recommendation. This would, in turn, trigger suitability obligations."

ASIC has also raised similar issues in its recently released PPPs on the concept of advice under the FSR Bill. We also suggest the test of whether this advice or a recommendation has been provided depends on looking at both the *character* of a communication and the *context* in which that communication is made. We recognise that in some cases a person can be a mere conduit for advice or recommendation provided by others. The Financial Services Authority in the UK has a similar mere conduit concept.

One example we examine in our PPP on *Licensing: The scope of the licensing regime: Financial product advice and dealing* (FSRB Policy Proposal Paper No 1) is an internet portal that merely posts third party information that it does not endorse, select or modify, or exercise any discretion over the content of the material on the website — other than the ability to remove or refuse to post where the material may be illegal or defamatory.

The following tables (taken from FSRB Policy Proposal Paper No 1) shows how we consider the analysis of whether or not this is advice applies.

A What is financial product advice?	
Question	**Answer**
Q1 The *character* of the communications — Do the communications consist of opinions or recommendations? (see paras A2–A6 of this paper)	Yes — the communications placed on the site by investment advisers, brokers and fund managers are not confined to purely factual information.
Q2 The *context* of the communications — Are the opinions or recommendations intended to influence, or could they reasonably be regarded as being intended to influence, a person's decision in relation to a financial product or a class of financial products? (see policy proposal paragraphs A7 to A15 of this paper)	Yes—— the communications placed on the site are authored by investment advisers, brokers and fund managers — they consist of promotional material relating to financial products — these entities stand to benefit if consumers make a decision to buy the financial products.
Q3 Are the communications exempted from the definition of financial product advice? (see policy proposal paragraphs A16 to A20 of this paper).	No.
Answer: The communications are financial product advice.	

B How is financial product advice regulated?	
Question	**Answer**
Q4 Is the portal operator *providing* financial product advice or is it a mere conduit? (see policy proposal paragraphs B1 to B8 of this paper).	The portal operator is a mere conduit. The portal operator does not, therefore, need to hold a licence or an authorisation. The portal operator is a mere conduit because the material is wholly devised by other persons. The portal operator does not exercise any control over the content of material placed on its site (apart from removing defamatory or illegal material) and does not endorse or adopt the material.

Answer: The portal operator is not *providing* financial product advice and is not required to hold a licence or authorisation.

(However, the investment advisers, brokers and fund managers who place the communications on the website *will* be providing financial product advice.)

You can see that these are quite stringent pre-conditions and we note in our PPP that the conclusions may not apply where the portal operator:

- adds a questionnaire which is then used to provide information about selected products;
- the site incorporates data mining techniques, which are then used to 'push' certain products.

This is a very similar approach to that adopted in the US and Hong Kong at the moment.

The other important distinction in an online world is between factual information versus advice. Again the PPP sets out ASIC's views on this important distinction. Even thought the comment period has recently expired, I would urge you to carefully read these PPPs and the final ASIC policies in this area.

Some even more difficult issues arise in relation to the operation of internet-based markets for the actual execution of trades or completion of transactions that span a number of jurisdictions. We have examined a number of these in the wholesale area where the investor protections concerns are somewhat lower. In these cases we have established some minimal requirements such as the operator being subject to the jurisdiction (as a foreign company registered in Australia), participants being licensed entities in Australia and limitations to wholesale rather than retail customers at this stage.

We are also dealing with proposals by some overseas-regulated securities and futures markets wishing to locate screens in Australia that would allow direct participation in that overseas market by Australian investors. Our major markets are also interested in being able to locate their screens in other jurisdictions and expand to enable direct foreign participants in their markets. The ASX has recently put in place rule amendments that would enable remote foreign participants in its markets.

Again these raise some complex issues about the scope of our licensing regime (does it apply to entities only dealing on behalf of overseas clients but who carry on business here?), the scope of the market provisions and how practical enforcement applies in this context. Some of the key issues currently being addressed at a very practical level include:

- What is the market for Australian regulatory purpose when it is a single internet-based market operating in a range of jurisdictions?
- What is the minimum set of standards that should apply before we recognise a foreign market operator in Australia and under what conditions designed?

- How do we preserve the ability for ASIC to take effective regulatory action in a practical enforcement sense in relation to market misconduct in relation to the market and its participants?

ASIC and the Minister will need to be satisfied that the operation of a market in the overseas jurisdiction is "sufficiently equivalent, in relation to the degree of investor protection and market integrity they achieve, to the requirements and supervision to which financial markets are subject under this Act in relation to those matters". So we will still need to address issues related to the extent to which Australian investors are adequately protected in these types of markets compared to the protections they receive on a domestic market.
I will no doubt disappoint by indicating that I do not think we have the complete set of answers and, in any event, I am not sure that the answers I would give as a regulator will satisfy those of you impatient to move quickly to the reality of the stylised global model. I can only repeat that it is important to understand some of the practical issues that confront both regulators and those proposing these new developments.

Conclusion

What I can say on a more positive note is that ASIC is grappling with all of these issues in the context of quite specific proposals. At the same time it is clear that we need to stand back and look more broadly at the pieces of the puzzle that we have been putting together to see what more of the whole picture looks like.

We have started some very preliminary work on this within ASIC by seeking to formulate some criteria or benchmarks against which we need to judge various types of cross border proposals that we are facing currently, and that we expect will become even more pressing in the next couple of years.

But I caution that while recognising the realities of the global market place, we will need to have very strong grounds for removing any of the basic protections that retail investors enjoy in an Australian context.

We are also actively involved in international work within IOSCO on its internet taskforce and other areas where we see moves to increasingly common standards being adopted by regulators. This will make easier the acceptance of overseas intermediaries and market operators under provisions such as the overseas market licence under FSRB in s795B. It will also mean increasing convergence in areas such as regulatory regimes applicable to online advice and recommendations making compliance across borders somewhat simpler and less costly.

While we are actively responding to these globally initiatives, I consider that there remain some very practical constraints that will need to be addressed before we are able to fully move towards the stylised global market model set out at the beginning of this talk.

