BRAVE NEW WORLD OR RETURN TO FUNDAMENTALS?

PRESENTATION TO CORPORTATE LAW TEACHERS ASSOCIATION

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Introduction

New economy, old economy, tech stocks and dot.coms, clicks and mortar… this is the new language for the 21st century. The online revolution is profoundly reshaping our financial services market place. Financial products and many financial services are often in essence about pieces of information – debit, share register, credit, bank account, etc – so they are a natural for the digital world. The Internet is a major driver in the way those products are bought and sold and the services delivered. It is bringing newer and more efficient ways of manufacturing and delivering financial products. E-time has dramatically decreased the time to bring these products to market. As the Internet continues to mature with greater speed and bandwidth, it will become yet another infrastructure, ever present without our needing to think about it - much like electricity.

Financial portals are now linking organisations, products and services in ways that were not conceivable a few years ago. New business models are emerging and we now see the lines blur between, for example, financial institutions, telecommunications providers and the media. These models involve new channels for distribution, and a new and different focus on customer relationships as investors learn to self manage information which they previously did not have access to. Faced with more options, consumers are becoming more demanding and less loyal and, in response, industry is providing increasingly sophisticated technologies that offer a diverse array of financial products and services to capture and hold clients.

I want to share some thoughts with you today about what the new economy and all the changes it has already brought to the financial market place mean for us as a financial services regulator in this period of transition.

Let me start with a broad generalisation: in many ways our core activities have not changed at all. What was poor or unacceptable or illegal in the so-called "old economy" remains so in the online world. From the regulator's perspective, the new economy does not mean new rules. We are still responsible for the variety of public policy outcomes that the community looks to us for: consumer protection and market integrity in the financial markets. This means keeping the market for financial goods and services as clean and free from abusive practices

as we can; helping financial consumers to look after themselves; and contributing to the reputation and efficiency of a robust financial sector in Australia. That is our job under our legislative mandate.

However, this simple vision changes once you drill down into the details. We would be foolish to imagine that regulatory rules and practices designed for a non-digital world can all easily apply in the e-commerce context. The job of the regulator is to be constantly on the look out for "translation" problems – where rules and processes will need to be translated into e-language so they can play a meaningful part in the e-world.

We are still in a transition and have to straddle both old and new worlds. To help us do that, we have, over the last couple of years, tried to articulate a set of objectives to guide our work in e-commerce. In our latest version of this, we see our job in this transitional phase as building a regulatory and business environment where:

- consumers of e-commerce financial products and services can be confident that their interests are properly protected
- industry participants can confidently plan and develop e-commerce initiatives
- we continue to enhance our abilities as an effective and credible regulator in the e-commerce context
- regulatory outcomes will not depend on the medium used

In my address today, I want to delve into some of the detail of how we have been trying to achieve these objectives. First, I will look at new economy companies: in particular, the impacts of financial reporting, issues with Initial Public Offerings (IPO) and the like. Secondly, I will give you a brief excursion into ASIC's approach to e-commerce in relation to policy, consumer protection, and enforcement.

New Economy Companies

Newly established businesses often face considerable pressure to meet profit forecasts and revenue projections. A risk that the market faces, when so many new businesses are being established and attracting the attention of investors, is that businesses might adopt aggressive

accounting practices in order that they report earnings and/or profits on or around expected targets. That cannot be good for the efficient functioning of the market that relies on the confident and accurately informed participation of investors.

Financial accounts surveillance

With this effect on market integrity in mind, we recently completed a surveillance of the financial accounts in relation to 140 'new economy' companies as at 30 June 2000. Areas of focus included the accounting for acquisition of businesses, the reporting and amortising of intangibles, the accuracy of quarterly cash flow statements, and the recognition of revenue and profit.

We identified a variety of issues requiring additional explanation by some 53 companies. In many cases, there appeared to be purchases of businesses with small or negative net assets, for large sums and, sometimes, from related parties. Often the disclosure in relation to these transactions was confusing and inadequate. For instance, it was often not possible to easily determine the fair value of assets purchased or the calculation of the resulting goodwill.

Intangible assets often make up the largest portion of the company's net worth. In a number of cases it was very difficult to understand what the disclosed value of the intangible represented.

There were instances of apparent premature recognition of revenue, lack of notes on revenue and inadequate or incomplete disclosure.

We have written to the companies identifying our concerns and have provided them with an opportunity to explain or address these concerns. If satisfactory explanations or corrective actions are not forthcoming we will initiate additional regulatory action, including enforcement where appropriate.

Fundraising

Similar issues arise with new economy IPOs. Being new economy does not change the requirement for prospectuses to provide investors with adequate financial disclosures and projections and adequate information about the listing itself. Online eMedia Ltd, fastEcom.com Inc, and MDSnews.com Limited are just a few examples of our actions.

Online e-media Ltd withdrew its prospectus following an interim stop order served on the company by ASIC. ASIC was concerned that the disclosure of the valuation of the company's intellectual property, $5.9 million, failed to meet standards required by law. The intellectual property valuation was made by the directors, but the methodology of the revaluation was not explained in the prospectus. Further, the value of intellectual property was not amortised in the budgeted profit and loss statement. The directors of Online subsequently informed ASIC that, until Online commenced trading, the appropriate value of the intellectual property figure should be nil (ASIC Media Release 00/015).

In a slightly different example relating to fundraising, ASIC required fastEcom.Inc, a US company, to offer a refund to Australian investors. Information distributed to investors told prospective investors that the company intended to list on the NASD Bulletin Board. ASIC believed that investors could have mistakenly believed that they were making an investment in a stock on the NASDAQ Stock Market. Unlike the NASDAQ, the Over the Counter Bulletin Board, the official name for such bulletin board listings, does not impose listing standards, does not provide automated trade executions and does not maintain relationships with the companies whose shares are quoted. (ASIC Media Release 00/179).

In relation to MDSnews.com Ltd, ASIC accepted an enforceable undertaking from MDSnews.com Ltd not to issue, allot or offer for sale securities on the basis of the prospectus lodged by the company: the prospectus sought to raise $8,000,000. ASIC maintained that the prospectus did not contain sufficient information about proposed investment plans by a subsidiary of the company; nor did it provide sufficient information about a trading software product, sales of which represented the largest source of revenue for the company; and finally

the basis of assumptions for projected profit and loss statement were not clear. (ASIC media release 00/284).

From time to time, we have heard claims that the "old" accounting rules just do not work for these new businesses or new assets and we need to look at the rules differently. However, the current rules are the current rules. They can and do work in the 'new economy'. We will continue to enforce those rules to ensure that the market is provided with information prepared on a consistent and comparable basis.

Recently, we released an information release setting out tighter guidelines governing financial forecasts and projections to further reinforce this message that the old rules are applicable. ASIC has become increasingly concerned about the quality of prospectus information dealing with the financial prospects of companies. In many cases, the financial projections that have been used are substantially based on hypothetical assumptions, which particularly in the case of start-ups, are unlikely to be verifiable. These new guidelines, which have been agreed to by the Auditing Assurance Standard Board, specify a much tighter framework for forecasts and projections.

Continuous disclosure

In September last year, ASIC and ASX undertook a joint study of continuous disclosure by listed high technology companies. Interestingly, half of the companies released additional information to ASX either after being advised that ASIC staff intended to visit them or after the visit had taken place.

If the disclosures had not been made voluntarily, ASIC would have taken civil action to compel disclosure to the market. We were concerned that some directors did not realise they had to keep the market informed when businesses were not performing in accordance with prospectus forecasts (ASIC media release 00/379).

The continuous disclosure regime has been further supported by the ASX in its proposed listing rule amendments, details of which can be obtained from the ASX website

(http://www.asx.com.au). This ASX initiative follows on from the ASIC release of 'Better Disclosure for Investors', in August 2000 where we set out our principles of good disclosure to investors, including making use of websites to communicate with investors. The proposed rules require an entity's annual report to contain a statement of the main practices and procedures in place for ensuring compliance with listing rules 3.1 and 15.7 during the reporting period.

E-commerce

I will now turn more broadly to the question of e-commerce and ASIC's role as a business facilitator, consumer protector and enforcer. The Internet and e-commerce provide a valuable new delivery channel, but in the end, it is only a new channel, the success of which is dependent on 'old world values': trust, confidence, fairness and transparency. It is these values that we aim to embed in our regulatory approach.

We have three basic regulatory mechanisms available to us. We can provide market participants with information about how the rules should be applied in the new environment through our policies. We can help educate the public on risks and good practice. We can take enforcement action where the law is contravened and monitor others to encourage them to comply. This regulatory toolkit is not new. It is our tried and tested approach, but it is equally relevant to the e-commerce environment.

ePolicy – Current Focus

Let me first address policy. We do a lot of our forward thinking about e-commerce in the policy context, because e-commerce often raises new issues of interpretation, or questions about how we should administer the law in a new industry situation. The e-commerce area has been a fertile ground for both interpretation and administration issues. Over the last five years or so we have worked our way through a variety of policy topics. During the early stages, we were largely focussed on the transition of existing paper based processes into an electronic format, ie, to enable text to be made available online. Our work here started with *Electronic Prospectuses (PS107)* and *Investment Advisory Services*

(PS118) and now includes *Offers of Securities on the Internet (PS141)*, and *Electronic Applications for Securities (PS150)*.

As we progressed in our policy work, we have developed our approach and now seek to focus on the policy underlying the statutory provisions, and the intended public policy outcomes, rather than merely focus on the process of translation. Provided we are confident we can continue to deliver the same intended outcomes, we have been prepared to modify the way the law works to accommodate e-developments, where we have the power to do so. In a broader sense, we are facilitating the translation of a legislative framework often designed with paper-based transactions and dealings in mind to a digital world.

Some of the e-commerce policy issues we are currently dealing with include:

- the regulation of internet discussion sites (chat rooms)
- electronic applications for superannuation and life insurance, to move to a regime consistent with that for securities
- online broking and cross border electronic markets
- the Electronic Funds Code of Conduct
- online provision of advisory services

Electronic applications for superannuation and life insurance products

Our work here brings together two strands of thinking we have developed over the last few years. One strand is about permitting disclosures to be made in electronic form, and the flow on logic that we should also allow applications to be made electronically. The other is about our desire to be consistent across the broad range of products and services we now regulate.

We have permitted prospectus disclosures to be made electronically since 1996, and the then ISC followed our lead for life and superannuation products. By 1999, product distribution through the Internet had become common in the securities industry, with issuers offering products either direct to investors or through intermediaries such as financial planners. We were asked for two things: confirmation that online applications were permissible; and that financial planners and other intermediaries could "customise" application forms – ie, the

disclosure document (the prospectus) and the application form could have separate origins and be brought together only when they reached the end investor.

For the securities industry, these are relatively easy questions. We thought that conditions we crafted would ensure that the underlying policy of the Law - that consumers should have the opportunity to read mandated disclosure information before making a decision to invest and therefore the opportunity to apply for the product should come after they receive disclosure information - could be preserved.

We were also asked to apply the same thinking to life insurance and superannuation products. We considered whether there is anything about these industries that might need further work and concluded that the role of a signature in the application process is of significance. For securities, in both the online or offline environment, the legislation does not require an investor to sign an application form (though of course it is regular practice for applications to ask for it). However, signatures are required for life and superannuation products and, at least in relation to products with an insurance component, there is a good public policy reason for this. What you sign for is not only the application, but also information about yourself that goes to the cost and nature of the product, and acknowledgment that you understand your duty of disclosure to the life insurance company under the Insurance Contracts Act. If you are a non-smoker, you may get a different product and it will certainly affect the cost. Therefore, our approach to electronic applications for life insurance and superannuation products had to deal with the role of signatures on the Internet.

We have released a paper that looks at the functions of a signature in an application form and the disclosures required by both the product provider and the applicant from a consumer protection perspective and from the perspective of promoting consistency with other financial products.

The proposal envisages the acceptance of electronic applications for life insurance and superannuation products, provided certain measures are met which replace the functions of a paper-based signature and ensure that appropriate disclosures are made. For example, a

product provider must be satisfied by some means (other than a paper-based signature) of an applicant's identity. There are a number of possibilities - electronic signatures, PINs, smartcards, biometrics - which might be considered by a product provider when determining what approach they will take. Generally, ASIC is not proposing to prescribe in detail how this is done because the available technology is diverse and constantly evolving.

Internet discussion sites

The use of chat-rooms and Internet discussion sites (IDS) by investors is now common in many jurisdictions, including Australia. IDS offer investors services that range from exchanging stories of their experiences to more sophisticated facilities that include advertising material, links to other relevant tools and information (such as analysts' reports and calculators), and sometimes links to trading software products and online trading services.

The issue first raised was a simple question - does a person need a licence to operate an IDS or investor chatsite? But the question also came with a context. ASIC surveillance and enforcement staff was taking an interest in connections between postings by users of IDS and unusual price movements in stocks. They were also becoming concerned that products or services were being pushed through IDS.

By international standards, the Australian legislation is unusual in the sense that, for at least some IDS, it permits a conclusion that a person might need an investment advisers' licence to *provide* a chatsite for use by investors. This is because an operator of a chatsite might be directly giving regulated "advice", though often implicitly (for example, by selecting a small range of products to advertise on the site, or products that are accessible from the site by links), or be conducting a business publishing securities reports. The Australian position is in contrast to, for example, Europe and the USA, where you do not need a licence to give investment advice or be a financial planner. Regulators in some other jurisdictions are still considering how their laws, especially their securities licensing laws, apply to IDS.

In considering the licensing question, we aimed to strike a balance between the benefits that flow from investors having a cheap means of educating themselves by sharing their experiences

with others in a similar position; and the risk that investors will place undue reliance on the information and services provided by an IDS.

What we did was to pose and answer a question slightly different from the one that first came to us. We dealt with the issue of when we would *not* treat an IDS operator as needing a licence. In essence we said: if you keep within the narrow boundaries of the activities described in our policy, and you also take the positive steps we outline in our policy, we are prepared to allow you to operate without a licence.

The underpinning rationale for both limitations and conditions in the policy is that the licensing of advisers is fundamentally concerned with advice given to retail investors by professional advisers. If the way an IDS operates makes clear that it is not a place where professional advice is available or can be given, and is not operated by a securities market professional, this is enough to take it out of the regulated territory.

I should note in this context that ASIC is also an active participant in the work of the Internet Taskforce of the International Organisation of Securities Commissions (IOSCO). The taskforce is updating its 1998 paper on the use of the Internet for securities activities, and the new report will have a section dealing with IDS. The risk of IDS being used to facilitate market manipulation or other fraudulent or abusive conduct (such as "pump and dump" schemes) places the international emphasis on surveillance and enforcement rather than licensing.

Revision of EFT Code

My last example of our current policy work relates to the use of codes of conduct.

The issue of giving consumers confidence in new technology is not new. It previously arose when ATMs first appeared. They were new and different. To help overcome consumer resistance to the use of ATMs and potential change in liability, Australian government and industry worked together to develop the Electronic Funds Transfer (EFT) Code. We are currently chairing a working group made up of industry and consumer representatives who are

working with us to revise that Code to extend its coverage over all forms of electronic funds transfers including telephone and Internet banking and stored-value cards.

The Revised EFT Code seeks to find a balance between the allocation of liability for unauthorised transactions and basic consumer protections including complaints handling and privacy. The current EFT code is technology specific, whereas the revised code seeks to be technology neutral wherever possible. The code includes provisions on:

- disclosure of information: terms and conditions, receipts, statements
- liability for unauthorised transactions
- security requirements
- privacy
- complaint investigations.

The revised code is divided into three parts. Part A covers transactions that effect funds transfers to or from or between accounts at institutions by remote access through electronic equipment. Part A will cover, for example, telephone and computer banking and funds transfer using stored-value products. Credit card transactions initiated through electronic equipment using an access card or identifier will also be covered.
Part B of the code covers new electronic payment products that effect payment by the transfer of pre-paid value (for example, stored-value cards or digital coins), but do not involve access to accounts at account institutions. Part C covers the administration and review of the code and provisions for electronic communications.

Our working group has released two discussion papers on the Revised EFT Code. We are currently aiming to launch the EFT code in March/April this year with a 12-month implementation period.

e-Consumer education

Education is a key element in our regulatory toolkit. As I said previously, the same misbehaviours found in the offline world are also evidenced in the online one. We are keen to reinforce an age-old message: 'if it sounds too good to be true then it probably is'.

Regardless of how often the message is voiced, consumers still get caught in unscrupulous deals that the Internet can now broadcast more widely and quickly. Some examples may illustrate how we have gone about trying to reach a larger audience with some key consumer messages.

On April Fool's Day in 1999, we set up a simulated investment website relating to **Millennium Bug Insurance** to highlight the willingness of consumers to invest in companies that are promoted online and yet they know next to nothing about. By the time we exposed the fake website in May 1999, our April Fool's Day joke had convinced over 200 people to pledge around $4 million to the bogus scheme.

Last year we developed a separate consumer focused website called **FIDO** (Financial Information Delivered Online). On this site there are a series of **Consumer Alerts** targeted at such topics as using the Internet for investing, online banking, free share offers, trading software and spam (unsolicited email).

Our website also contains a series of **Internet Safety Checks**. This guide for investors provides basic checks that can be done by consumers before investing in Internet based-schemes; including checks to see whether a company exists and if it has lodged a prospectus.

e-Enforcement

Strong effective enforcement remains important in the e-commerce world, as it does in our traditional regulatory activities. Key messages can be sent to consumers and wrongdoers alike via effective enforcement action.

We have received an increasing number of reports of e-scams ranging from:

- illegal offerings over the Internet
- 'hot-tips' by unlicensed investment advisers
- market manipulation (the "pump and dump" schemes)

To respond to the challenge presented by the Internet, and to continue to develop our

e-enforcement capability, in 1999, ASIC set up a specialist Electronic Enforcement Unit (EEU) to focus on electronic crime.

EEU has developed a virtual tool kit that enables all of our enforcement staff to respond to our growing Internet-based enforcement needs. The toolkit includes guidelines and policy for dealing with electronic matters, protocols for dealing with Internet Service Providers (ISP) and litigation tools such as model affidavits, notices and court applications. In addition, we have developed WebHound, our automated surveillance tool that scans the Internet and extracts websites that fall within set search criteria.

Rentech is a good example of recent e-matter involving spamming and a pump and dump scheme in both the US and Australia.

Rentech was a US company that traded on the small cap market of NASDAQ. On 8 and 9 May 1999, messages relating to Rentech were posted on the Yahoo! and Raging Bull Internet bulletin boards in the US. Around that same time, between 500,000 and one million spam messages were sent out with similar messages to the bulletin boards in both the US and Australia. The messages were that Rentech stock would soon increase by up to 900 per cent over the next few months. The next day of NASDAQ trading saw the price of Rentech shares doubled on trading volume, which was at least ten times the normal average daily trading volume of Rentech shares.

The United States Securities & Exchange Commission (SEC) received complaints about the spam and consulted Rentech. Rentech denied the content of the messages and asserted that they had not originated at Rentech. The SEC's original investigations determined that the source of the Yahoo! and Raging Bull posting was from accounts held with Australian-based ISPs. The SEC contacted ASIC and a joint investigation started. We served notices on Australian ISPs and suspects were identified in Queensland and Victoria. Simultaneous search warrants yielded a large volume of documentary and computer data.

We received guilty pleas from the perpetrators on the grounds of making statements or disseminating information that was false or misleading and likely to induce the purchase of securities by way of transmission of electronic mail messages and posting messages to Internet websites.

This case highlighted the fact that the transmission of messages over the Internet is not completely anonymous and that regulators can trace authorship and prosecute. This is also a particularly good example of the borderless nature of cyberworld and the need for co-operation across jurisdictions. It also shows that our enforcement toolkit can still operate effectively in the online world.

Challenges ahead

Let me finish by setting out what I consider to be some of the challenges that ASIC is facing over the next 12 months, particularly in relation to e-commerce.

The Financial Services Reform Bill (FSRB) is the final phase of a reform program that seeks to harmonise regulation of the financial services industry in Australia. FSRB proposals include a single licensing framework for providers of financial services, minimum standards of conduct, uniform disclosure obligations and greater flexibility. FSRB implementation will certainly assist our aim to provide a consistent regime across all financial products.

We are looking at the prevailing issue of information versus advice, both in the context of FSRB and the Internet. We start with the premise that the law requires a person to be licensed in order to operate a business where advice is provided to consumers.

How then do we handle a situation where software takes client information and effectively makes personal recommendations about financial strategy to a customer? Who provides the advice and who should hold the licence to do so? Indeed the question of where information becomes advice within the online context is one that impacts online trading and investments as well as the operation of portals and other Internet applications.

Into the future, as financial products and services become commoditised, it is likely that advice too will become a commodity. This will be the case, particularly where the advice and other value-added tools are included within a website to draw in new customers and retain them. Business models are focussing on the "bundling" of products to suit the needs of investors and not the provisions of the licensing laws.

Screen scraping of financial information, or account aggregation, is a recent entrant to the online financial services marketplace and a new consideration for ASIC, other regulators and industry.

Screen scraping is a facility that allows a user's financial information to be summarised on one screen – a virtual "wrap account". Our concern here is the issue of some operators requiring the apparent disclosure of the user's name and PIN to a third party and the potential breach of banking conditions with regard to PIN security.

Conclusion

I began my presentation today with reference to a world in transition. The changes we are witnessing – new technologies, new players and new business models and more competitive markets – have strengthened the need for sound regulation. It is clear we must ensure that regulation and regulators have the capabilities to properly respond in ways that do not impede innovation while at the same time protecting consumers from unfair and abusive practices.

We need to adapt old policy to facilitate change whilst preserving enough of the old to maintain business certainty and investor protection. This requires an open mind, smart, flexible and dedicated people, good communication with industry and other regulators, and a strong and watchful enforcement presence informed by good information and the best IT skills and tools. We need to continually remember and remind industry and consumers alike that the fundamentals continue to apply.