



ASIC

Australian Securities & Investments Commission

Managing the Transition to Cyberworld

A presentation by ASIC Deputy Chairman Jillian Segal to the Third Asian Financial Law Conference, Sydney, 20 November 2000

Today's financial marketplace is a very different one from just ten years ago. We have seen the rise of the 'new economy', shaped by huge advances in information technology and its applications. The use of the Internet commercially has become widespread. The general public can now use the Internet to pay their bills, organise their investments, trade securities and buy their insurance. We are witnessing business-to-business projects aimed at cutting many millions in paper processing, along with extensive online business-to-government initiatives.

We have also recently witnessed dramatic falls in the market value of Internet and high tech stocks that were listed on the securities markets over the last 18 months - as the Internet stock bubble has burst.

According to the Australian Bureau of Statistics, over half of Australian households have a home computer and one-third have home Internet access¹. The Cap Gemini Ernst & Young report on e-commerce in the global financial services industry, released in October 2000, says that the Internet accounted for 3% of financial transactions in 1999. Further, it predicts that the Internet will account for 10% of transactions by 2001 and almost 20% by 2003.

However, I consider that we are still clearly in a stage of transition. While the paper-based world is fast disappearing, and we are moving to a new e-future, we are not there yet.

Looking at the Internet statistics in a different way shows that some 80% of financial transactions will still be conducted using existing technologies and mechanisms in the year 2003.

What is also interesting is that some recent research by Deloitte Consulting "Myth v Reality in Financial Services. What Your Customers Really Want" illustrates that while financial service executives are focussed on 24 hour convenience and on-line activities, their customers continue to value responsive service and personal attention more than mere convenience.

¹ ABS, 'Use of the Internet by Householders', 8147.0, May 2000, released August 2000

Successfully managing transitions pose challenges for financial service businesses, consumers and regulators. Too often the focus is either only on the past or the future. However, successfully managing change requires a focus on the period between the new and the old: on the transition itself.

Different groups are at different points of the transition between the old and the new. It is a time when groups can be taken advantage of by sharp practices. We have seen, and will continue to see, comments that the so called 'old economy' approaches, including the valuation of new high tech start ups or what constitutes good governance and fair practice, are irrelevant. To be fair, at such times, the law often does lag behind market developments. At the same time, the period of transition is a period of possibilities with scope for innovation and new ways of doing things.

As a regulator, the challenge is how to help consumers and business successfully navigate the transition. We need to regulate both the old and the new, while at the same time creating the capabilities to deal with the new. Such a time of transition is a particularly challenging time for regulators, but they often are key in helping everyone to transition.

The Rise and Rise of e-commerce

The Internet is profoundly reshaping our financial services market place. 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.

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 financial institutions, telecommunications providers and the media. The models involve new channels for distribution, a new and different focus on customer relationships as investors learn to self manage information which they previously did not have access to. We are told that we are only at an early stage of these developments.

e-Time moves fast

One small measure of how e-commerce developments have accelerated is to review references to technology in the ASIC Digest.

In 1995, there was only one reference to e-commerce contained in the ASIC Digest. It related to electronic document lodgement. Now, just five years later, there are two columns of entries covering an assortment of international and local activities where we have developed policy and enforcement actions and communicated these messages to the world.

In 2000 alone, we have released in excess of 20 e-commerce related media statements and, since 1999, undertaken over 200 e-enforcement activities and released five special e-commerce related policy statements.

Thinking about e-commerce as a Regulator

During the early stages of our e-commerce thinking, we were largely focused on the transition of existing paper-based processes into an electronic format. Basically, we were seeking to adjust the regulatory regime to enable paper or text equivalents to be made available online. The main example in this area was our policy on electronic prospectuses (PS107).

Our clearly articulated principle was to be technology neutral which, in practice, meant everything was measured against (and reduced to) paper equivalents.

Today our focus has moved beyond paper equivalence, though we still remain technology neutral.

We have a set of guiding principles for e-commerce; these include:

- a focus on regulatory objectives rather than the development of technological solutions
- the development of policies that are technology neutral
- ensuring that regulatory requirements for e-commerce are no more onerous than those applying to existing ways of doing business
- ensuring that consumers using e-commerce have at least the same levels of protections they receive from the laws and practices that apply to existing forms of commerce
- providing guidance and a measure of certainty to business in new areas
- ensuring consistency across the products and services which we regulate
- an active assessment of the impact of technological developments on the efficiency, safety and equity of the financial system along with input from consumers and industry.

Our e-commerce approach.

As a regulator, we aim to build a regulatory and business environment in which:

- 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

How do we go about applying these principles and what are the mechanisms that are available to us as regulators? We have three basic regulatory mechanisms. 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.

ePolicy – Current Focus

We have been actively updating our policies in response to e-commerce developments. These policy initiatives started with our work on *Electronic Prospectuses (PS107)* and now include *Investment Advisory Services (PS118)*, *Offers of Securities on the Internet (PS141)*, and *Electronic Applications for Securities (PS150)*.

Some of the e-commerce policy issues, which 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.

We are also actively involved in the work of the International Organisation of Securities Organisations (IOSCO) which is looking at a range of Internet and related e-commerce issues in its work program. I will talk more about IOSCO later.

I will now provide some brief comments on a few of these current policy initiatives.

Internet Discussion Sites

Under a strict interpretation of our Corporations Law, Internet chatrooms may need to be licensed as it could be argued that those hosting them are giving financial advice. These terms are quite broadly defined in Australian law. This did not seem to be an outcome that was practical, or one which recognised the absence of licensing in other jurisdictions.

In our recently released Interim Policy Statement 162 on Internet Discussion Sites, we have proposed some guidelines to avoid this outcome while still protecting consumers. Our aim has been to try and balance consumer access to inexpensive information available on informal chat sites while not allowing these chat sites to be regarded as a source of professional advice or product sales.

Where the website is conducted by non-professionals, and there are appropriate disclosures about some of the potential risks for consumers in relying on the opinions posted on site, IPS 162 gives relief from the licensing requirements of the Law.

We are now incorporating the comments on the exposure draft and are looking at releasing the final policy in the new year. This is new ground for us and also of interest to a range of other jurisdictions.

Electronic Applications for Superannuation and Life Insurance

We have already allowed electronic applications for securities (PS 150). We are now keen to provide a consistent regime across the investment, superannuation and life products that we regulate.

There are, however, some significant differences in the superannuation and life insurance world. When applying for life insurance and superannuation, the applicant makes statements, supported by his or her signature, which are critical to the actual product and its cost. For example, in the case of life insurance, information as to age and sex, and health indicators such as whether a person is a smoker or non-smoker.

The policy proposal looks at the disclosures required and the issues surrounding signatures in an online application process for these insurance products. ASIC is not proposing to prescribe the form of technology required to deliver a digital signature or its equivalent as long as investors have the protection of assured identity.

Our proposal is that this be left to individual businesses to determine. There are a range of alternatives in this area, including electronic signatures, PINs, smartcards and, down the track, even biometrics.

Online broking

Earlier this year we undertook a second assessment of the local online trading industry with a targeted survey of 29 online broking websites. In January 1999 only 1.5% of all trades on the ASX were conducted online; by June 1999 this figure had grown to 7%. It was estimated in March 2000 that 12% of the average daily trade volume conducted on the ASX were transacted online. More recently, this figure was estimated to be approximately 20% of daily trade volume.

In summary, we found that the industry operated well, without present major concerns for the regulator. However, we did identify a number of issues which we thought the industry should consider and address. These included: disclosure of identity of the broker, privacy policy disclosure, dispute resolution matters, provision of education materials (about the buying and selling of securities) and the provision of credit.

We wrote to each online broker and outlined the results of our survey and provided a best practice template for the disclosure of information on their respective websites. We also issued a consumer alert highlighting the survey and affirming the types of issues that consumers should look out for when trading online.

We also have concerns about ensuring system soundness and reliability, and have drawn these to the attention of industry. We will continue to keep the industry under close scrutiny.

The survey raised for us concerns regarding portals, specifically whether or not portal operators who provide access to online trading (and naturally other regulated financial services) should be required to hold a licence. It is clear that the issues relating to the way in which portals are dealt with under the regulatory regime is going to be a continuing issue.

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 ATM's 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. Previously the code was restricted to EFTPOS and ATM services, but it is clear that as new technologies are being deployed we also need to establish an appropriate framework for these consumer issues.

The Revised EFT Code seeks to find a balance between the allocation of liability for unauthorised transaction and basic consumer protections including complaints handling

and privacy. Our working group has released two discussion papers on the Revised EFT Code and we expect to release it in the new year.

Consumer Education.

In this environment of rapid change and exposure to the Internet, we have found that education is an important mechanism to address some of the risks consumers face. Some examples may illustrate how we have gone about trying to reach a large audience with some key consumer messages.

On April Fool's Day last year (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.

Each month we release what we call a **Gull Award** on the ASIC website. The Gull Awards feature incredulous stories of deceptive investment schemes and scams designed to alert and educate consumers and provide them with information about how to avoid such activity.

We have also recently 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.

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.

We have also released a discussion paper seeking comment on education priorities, including potential projects as well as research topics.

eScams

Strong effective enforcement remains important in the e-commerce world, as it does in our traditional regulatory activities.

We have a strong record locally and internationally in developing our e-enforcement capability. We have received an increasing number of reports of e-scams ranging from:

- illegal offerings over the Internet
- prospectuses and other promotional materials being placed on the Internet without approval
- 'hot-tips' by unlicensed investment advisers
- market manipulation (the "pump and dump" schemes)

eEnforcement

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 ISPs and litigation tools such as model affidavits, notices and court applications. In addition, we have developed WebHound, our automated surveillance tool which scans the Internet and extracts websites that fall within set search criteria.

Some recent topical cases that we have recently tackled include:

- *Rentech* which included spamming and a pump and dump scheme in both the US and Australia
- *Chimes* where a chat site operator was giving unlicensed investment advice

Rentech

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 1 million spam messages (unsolicited email) were sent out in both the US and Australia. With similar messages to the bulletin boards. The messages were that Rentech stock would soon increase by up to 900% 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 a particularly good example of the borderless nature of cyberworld and the need for cooperation across jurisdictions.

Chimes

The **Chimes** matter related to the provision of unlicensed investment advice, off market trading and illegal fundraising.

In early 1999 we received a complaint that postings on the Chimes website constituted investment advice. Within the site's chatroom, the *Chimes Index*, the operator posted a number of articles that advised in respect of particular securities. The operator was neither licensed as an investment adviser or securities dealer.

Prior to our action, the operator posted an article announcing the release of a new product and advised readers to invest before the shares increased in value. The announcement was in fact 12 months old - nevertheless ASX reported a substantial increase in trade in respect of the named security. We obtained an injunction in the Federal Court restraining the operator from giving investment advice, generally or on the Internet. He breached this order on several occasions and so we commenced contempt proceedings resulting in a two month suspended sentence.

The operator then moved the operation to New Zealand and continued to publish investment advice on his website. We commenced further contempt proceedings in the Supreme Court. Again he received a two month sentence.

In early 2000 he posted an offer on the site that we believed constituted a dealing in securities (in contravention of s780 of the Law). ASIC obtained a further injunction against the operator. He has now agreed to comply with the orders not to provide investment advice and to not deal in securities

IOSCO

Our recent enforcement activity shows that the challenge with e-commerce is that it does not respect jurisdictional boundaries. While we may be moving to a single global market, we are still a long way from being a single global regulator.

This has forced regulators to think hard about how the regimes they administer at national levels interact with one another; and how to preserve essential tenets of individual domestic regimes without the result being regulatory duplication. A good deal of this thinking has occurred through the forum of the International Organisation of Securities Commissions (IOSCO).

Sydney recently hosted the 25th annual conference of IOSCO, the theme being 'Global Markets – Global Regulation'. More than 500 participants from 90 countries discussed issues thrown up by globalisation. One of the papers released at the meeting by the Technical Committee of IOSCO was a bulletin regarding Investor Protection in the new economy.

The bulletin sought to remind investors, market professionals and regulators that in the robust, but volatile, conditions that e-commerce has brought to many country's securities markets, it is important not to lose perspective. Markets are cyclical creatures. There is a need to identify market and investment risks, and to disclose these risks to investors so that they understand them. It noted that 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 e-world. Trends that once were limited to individual markets are now reflected instantaneously in markets

around the world. This highlights the need for international consensus on the issues that affect investors in these markets and global cooperation among regulators in addressing these issues.

In its release at the conference, IOSCO identified the following four areas of concern:

- the initial public offering process;
- the valuation of high tech companies, including accounting and financial reporting issues;
- the effects of short-term trading strategies on investors' risks and expectations; and
- preserving investor confidence.

IOSCO has also recently re-established its Internet Task Force to update its 1998 report on "Securities Activity on the Internet". This initial report identified issues that should be addressed by each jurisdiction and provide guidelines on how to approach these issues which include:

- domestic regulatory requirements relating to securities activities on the internet: offers, disclosures, customer orders, voting, record keeping
- cross border activities: when and how regulators should assert their jurisdiction
- use of Internet for investor education and transparency
- use of the Internet to enhance enforcement cooperation

It was as a result of recommendations in this report that Australia, amongst other countries including UK, USA and Canada, implemented policy guidelines on when it would seek to regulate offers on the Internet (ASIC Policy statement 141).

The re-established Task Force is now reviewing what progress has been made with implementation of the report's recommendations. It is also updating information on what has happened in the market since the 1998 review, noting any new areas of regulatory concern, some of which I will note shortly. The Task Force met last week and expects that its report will be released early 2001.

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), expected to be introduced mid 2001, is the final phase of a reform program which 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 is a recent entrant to the online financial services marketplace and a new consideration for ASIC, other regulators and industry. Also known as account aggregation, these services are already operational.

Screen scraping is a facility which allows a user's financial information to be summarised on one screen – a virtual "Wrap account". Our concern here is the issue of 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.

We envisage a day, not too distant, where we will be asked to approve **multimedia disclosure documents**, complete perhaps with CEO video clips. While we have done some work on issues relating to multimedia issues, and released a discussion paper on the topic, much more analysis will be required.

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/tools. Not too much to ask of a regulator of a world in transition!