ASIC

Australian Securities & Investments Commission

REPORT 9

Survey of online trading websites

August 2000

Contents

EXECUTIVE SUMMARY

Over the past two years, use of online brokers to conduct securities transactions on the Australian Stock Exchange has grown in an extraordinary way. Retail investors have embraced online trading as a cheap and easy method to buy and sell securities.

This growth in online trading and the corresponding increase in securities trading generally by retail investors, signalled a possible concern for the Australian Securities and Investments Commission (ASIC) in terms of its responsibilities to protect and educate retail investors and promote market efficiency and integrity.

This report details the findings of a survey of online trading websites undertaken by ASIC in late March 2000.

Overview of findings

At the time of the survey, twenty nine sites were identified as offering online trading in Australia and surveyed over a three day period. The websites were reviewed against a range of disclosure related criteria, including best practice benchmarks and standards.

The survey determined that, on the whole, the online trading industry in Australia is an effective and efficient e-commerce industry. It has provided retail investors with a cheap, efficient and convenient process of buying and selling securities in Australia. Many of the online trading sites also allow clients to access quality and timely financial and educational information. Previously this information was only available to market professionals.

Our survey did not detect any major industry wide problems that require immediate action by ASIC to rectify. However, we identified a need for all providers of online trading facilities to have in place adequate complaint handling procedures and we identified several disclosure related issues that industry need to address.

These issues involve:

- disclosure of identity
- dispute resolution
- privacy
- education
- provision of credit
- systems.

Most, if not all of the issues detected by the survey can be rectified by site operators providing additional disclosure material.

ASIC's response

Consumer education is part of our regulatory tool-kit and vital for promoting consumer confidence, helping consumers avoid unsuitable or misleading services, and assisting them to understand their options if they do encounter problems.

Therefore, we are planning to undertake several complementary activities stemming from the survey findings. These activities include:

- publishing the survey findings on our website, www.asic.gov.au, and our consumer website, www.watchdog.asic.gov.au, to raise awareness of these issues;
- asking online trading site operators to assess their sites against and adhere to the Good Disclosure template (see Appendix A);
- encouraging execution-only brokers to become members of an approved alternative dispute resolution scheme (prior to the implementation of the Financial Services Reform Bill);
- consulting with the Australian Stock Exchange Ltd (ASX), as the frontline regulator of Participating Organisations, on regulatory issues related to online trading;
- continuing to deal with and monitor complaints related to online trading sites; and
- issuing consumer alerts to highlight awareness of issues raised in survey findings.

ASIC will undertake surveillance and enforcement action, including licensing action, where necessary, as part of its ongoing responsibilities to regulate the financial services industry and provide consumer protection.

Conclusion

We encourage site operators to conduct a review of their websites against the Good Disclosure template and make the necessary modifications to their sites. We anticipate that as the online trading industry evolves these issues will be addressed without the need for formal ASIC involvement.

ASIC plans to undertake a review of websites in 12 - 18 months to assess whether disclosure practices have improved.

Part 1

The online trading industry

Industry dynamics

The increase in the number of trades that are conducted online in Australia has been dramatic. In January 1999 only 1.5% of all trades on the ASX were conducted online; by June 1999 this figure had grown to 7%.[1] It was estimated in March 2000 that 12% of the average daily trade volume conducted on the ASX were transacted online.[2] More recently, this figure is now estimated to be about 20% of daily trade volume.[3]

The number of trades conducted on the ASX climbed steadily from an average of 36,147 trades in September 1999 to 83,128 trades in March 2000. Following a large fall in the share price of many of the "tech" stocks listed on the ASX in April of this year, the average daily number of trades has fallen by 27% to an average of 60,623 trades per day in July 2000.[4]

At the time of the survey (in late March 2000), 29 sites were identified as offering online trading in Australia. Twelve of these used other brokers to conduct the execution and settlement of their clients' trades.

Recent comments in the press suggest that the number of online brokers will continue to grow in Australia with Merrill Lynch[5], AMP[6] and Ord Minnett[7] stating that they intend to introduce online trading in the near future.

Global players in the online trading market such as E*Trade and TD Waterhouse are already present in the Australian market and will be joined by Charles Schwab, through the renaming of ShareTrade Australian Stockbroking as Charles Schwab Australia.

The most significant trend observed over the last six months has been the growth in online sites operated by organisations that are not Participating Organisations of the ASX. These sites engage an ASX Participating

[1] B Fisse, L Semaan and S Thomas, "Global on-line trading, ECNs and alternative trading systems", *ASX Perspective,* 2nd Quarter 2000

[2] Verity Webb, "How Brokers of the future stand to make a buck", *Australian Financial Review,* 8 March 2000

[3] Robin Bowerman, "Rating the Cyber-brokers", *Personal Investor*, August 2000

[4] These figures represent equity trading volumes only.

[5] Companies and Markets - Briefs, *Australian Financial Review*, 25 March 2000, p.16

[6] "Shares online at AMP", *The Australian*, 21 March 2000, p.28

[7] Webb, "How brokers of the future stand to make a buck", *Australian Financial Review*, 8 March 2000, p.14

Organisation to execute and settle the transaction on their behalf, ie the ASX Participating Organisation provides a “wholesale online broking service”.[8]

In this survey we have categorised online trading sites operated by non-Participating Organisations of the ASX as “portal sites”. Portal sites also often provide trading software, market information and research capabilities to the prospective investor.

In the future, as companies operating in the financial services industry continue to horizontally integrate to maximise their revenue sources, they will offer a large and varied range of financial services on their websites and the number of portal sites is likely to grow. The majority of sites offering online trading provide execution-only services, ie personalised investment advice is not offered on these sites.

It is widely believed that many online trading sites are “loss leading” to gain market share, with an intention to recover losses made on their broking business through the sale of other financial products and services.[9] This belief is exemplified by the many sites which cross sell a range of financial services.

It was also observed that the online trading industry operates in a highly competitive market place as evidenced by the recent “price war”, which resulted in significant decreases in price per trade to approximately $14.95.[10]

Anecdotal evidence suggests that the number of securities transactions conducted in Australia is not large enough for all firms currently offering online trading services to survive, especially if they compete only on price.[11] Most online trading firms will need to obtain competitive advantage other than price if they are to survive. The experience in the United States is that many online brokers are trying to differentiate themselves from their competitors by way of the products and services they offer and do not directly compete on price. This trend is also expected to occur in Australia as the industry further develops.

[8] N. Hopkins and L. Caruana, *op. Cit.*

[9] N. Hopkins and L. Caruana, *op. Cit*

[10] As at 10 May 2000, TD Waterhouse charges $14.95 per order up to $10,000 for market orders only, Comsec charges $14.95 per order up to $10,000 (Comsec must be CHESS sponsoring broker and settled your trades through a Commonwealth Direct Investment Account).

[11] For example, refer Angus Grigg, “Tricks of the Trades - How to get an internet broker working for you”, *Australian Financial Review,* 12 February 2000.

Regulation of the stock broking industry in Australia

Corporations Law

Dealings in securities and the regulation of persons engaged in the securities industry are covered by Part 7.3 of the Corporations Law. The Corporations Law also prescribes the requirements for the granting of licences and the reporting obligations imposed upon licensees.

ASIC is responsible for ensuring that all persons licensed under the Corporations Law to conduct a securities business (including ASX Participating Organisations) comply with the Corporations Law and conditions of the licences. ASIC will take enforcement action against entities that conduct a securities business without a securities dealers licence to either prevent the entity from conducting a securities business or compel the entity to obtain a securities licence.

Section 851 of the Corporations Law places a substantial legal onus on brokers (and other investment advisers) when giving investment advice to clients. Under this section, a broker must base their recommendation to a client on reasonable consideration and investigation of the subject matter of the recommendation to determine whether the recommendation is appropriate for the client, given the client's investment objective, financial situation and particular needs. In addition, the licence holder must have internal and external complaints handling procedures.[12] These obligations do not apply to brokers offering a "no advice" service.

ASIC policy

ASIC has a implemented a strategic approach to the development of policy that affects internet and e-commerce. This approach requires that all ASIC policy should:

- achieve regulatory objectives rather than developing technology solutions;
- aim to be technology neutral;
- ensure that electronic requirements are no more onerous than those applying to more traditional ways of doing business; and
- seek to ensure that consumers using electronic commerce have at least the same levels of protection provided by laws and practices that apply to existing forms of commerce.

Two ASIC policy statements directly affect the activities of online brokers.

[12] Refer, Policy Statement 121, Investment advisory services: retail investor protection requirements, *ASIC Digest*

Policy Statement 118 Investment advisory services: media, computer software and internet advice

This policy statement sets out ASIC guidelines and enforcement policy for persons providing investment advice on the internet, as well as those providing advice in the media, computer software and books. ASIC policy states that a person who places information about securities on the internet will require a dealers or an investment advisers licence if they carry on a business of providing direct or indirect securities recommendations, general securities advice or publishing analysis or reports on securities.

The common law requirements of system, continuity and repetition need to be satisfied for a person to be considered as carrying on a securities or an investment advice business. If a person *holds out*, whether on the internet or elsewhere, that they are an investment adviser or that they carry on a securities business, they must have a licence, whether or not they are in fact carrying on a business.

However, a person placing information on the internet may not be required to be licensed to give advice if:

- the published information is purely factual;
- they do not provide any direct or implicit advice or opinion on securities; and
- they include a warning that information is not suitable to be acted upon as investment advice.

Policy Statement 122 Investment advisory services: the conduct of business rules (s849 and s851)

This policy statement sets out ASIC policies and guidelines on how persons making securities recommendations to investors (clients) can meet the Conduct of Business Rules in the Law. Where a dealer provides "execution only" transactions conducted online without any advisory service on those securities, the dealer does not have to comply with any advisory obligations, including the conduct of business rules. An "execution only" transaction is when a dealer carries out instructions by a client to buy or sell specific securities without giving any advice about those securities.

Where advice is provided, the Conduct of Business Rules require the adviser to:

(a) disclose their material benefits, advantages and interests under section 849 (also referred to as the disclosure of conflict of interests obligation); and

(b) have a reasonable basis for any recommendations made under section 851 (also referred to as the "know-your-client" requirement).

Australian Stock Exchange Limited

Section 769A of the Corporations Law lists the ongoing requirements which must be observed by a securities exchange. A securities exchange must ensure that:

- the markets it operates are orderly and fair;
- it has adequate arrangements for monitoring and enforcing compliance with its business and listing rules; and
- it has adequate arrangements for the expulsion, suspension or disciplining of a member for conduct inconsistent with just and equitable principles in the transaction of business.

The ASX also has the primary responsibility for ensuring that Participating Organisations are financially sound.[13]

ASIC's online trading review: November 1999

Before conducting the survey in March 2000, ASIC conducted a review in November 1999 to assess the extent and nature of online trading in Australia and to determine the possible regulatory risks of this activity. The review identified some issues and concerns with the online trading industry, but recognised the benefits to investors from online trading.

Consumer issues

Poor execution

Retail investors may have an inadequate understanding of the mechanics of securities trading in Australia. They may overlook factors such as the current bid/ask spread of the security they are buying/selling, or the risks of placing market orders when the market is closed and therefore possibly obtaining the opening price on the ASX which may be significantly different from the closing price.

Delay in processing orders

Retail investors may fail to understand or appreciate the frequent delays in processing orders from the time the order is entered into the investor's computer to the time the order is placed on the exchange.

Delays in the provision of information

Systems failure may prevent consumers from accessing real time information.

[13] Memorandum Of Understanding between ASC and the ASX - Markets, 18 December 1992.

Mistakes / errors

Without adequate systems filters, consumers may make typographical errors when making a transaction.

Investment risks

Retail investors may generally be unaware of the risks of investing in the stock market.

Advertising

Some advertising appears to be directed at unsophisticated investors encouraging them to supplement their incomes by adopting a course of frequent and potentially risky securities trading.

Margin lending

The benefits of margin lending are often advertised but the potential risks are not always outlined.

Limitation of broker liability

Retail investors may not be fully aware of the liability they face when trading online. For example, online trading arguably shifts systems risks such as disruption, failure or malfunction of any part of the internet, to the investor.

Alliances

A growing trend where Participating Organisations of the ASX form alliances with non-Participating Organisations to cross sell products and services may increase the level of uncertainty for clients in terms of identity and legal obligations. For example, in the event of a dispute, the retail investor may be confused about who is responsible for handling the complaint, the site operator or the Participating Organisation.

Systems issues

Filters and capacity design are often not explained clearly.

Enforcement issues

Online trading may create difficulties in tracking the source of orders when investigating suspected market contraventions. Jurisdictional limitations may result in additional complications to the regulatory environment.

Licensing issues

The entry of new players offering different levels of online trading services, or access to such services, may see some operators conducting a securities business without a licence. The online environment may also cloud the distinction between advice and non-advice services and the additional obligations on advisers when providing advice.

Benefits to investors

Investors who use online trading sites to buy and sell securities benefit from:

- lower costs per transaction;
- increased access to the share market and information; and
- a greater potential for timely dispute resolution (due to electronic records).

Part 2

Survey findings

Disclosure

The review assessed the performance of websites against a number of general disclosure principles which dealt with identity, privacy and complaints resolution issues.

Key findings

61% of the sites provided full legal and business details

50% of the sites disclosed the type of licence held by site operator

45% of the sites referred to a privacy policy of sorts but none appear to refer to existing privacy guidelines, for example the Privacy Amendment (Private Sector) Bill or the Privacy Act

17% of the sites offered clients the ability to opt out of unsolicited emails

35% of the sites disclosed information about internal or external complaints resolution schemes

93% of all sites prominently displayed disclaimers limiting the service providers liability

Discussion

Identity

It is important that retail investors and potential clients of online trading websites are able to obtain information about identity and location of the entity operating the online trading facility. This will assist them in determining if they are dealing with a reputable firm who will meet their legal obligations and is domiciled in Australia. Clients should also be informed that the business they are dealing with is a Licensed Securities Dealer and a Participating Organisation of the Australian Stock Exchange and therefore conducts its business in accordance with the standards and obligations of that licence and the requirements of the ASX.

For a significant number of sites reviewed, licensees did not disclose the full details of their identity including their physical location, and licence they held. In addition, on some sites surveyed, although the information about their identity was there, this information was often difficult to find.

Dispute resolution

Clients of online brokers should have available to them an effective, accessible and inexpensive dispute resolution mechanism. Such a scheme has significant benefits for the client. Disputes are quickly and fairly dealt with giving clients greater confidence in the dispute resolution process.[14]

Nearly two thirds of the websites surveyed did not disclose any information about internal or external complaint resolution schemes. For a significant number of sites, it appeared that complaints are initially dealt with by call centre staff. This observed trend is supported by the number of complaints received by ASIC concerning the activities of certain online brokers, with clients being unable to have their complaints dealt with adequately by the site.

Because the majority of the websites surveyed offered execution-only services, they are not required to have a complaint resolution process or belong to an alternate complaint resolution scheme. This can contribute to the lack of information about external complaints schemes on some sites. Under the proposed Financial Services Reform legislation, execution-only brokers will have to belong to an alternative dispute resolution (ADR) scheme. Therefore the lack of an external resolution scheme will no longer be an issue. ASIC encourages website operators to become members of ADR schemes now and not wait until the requirement becomes law.

Privacy

The information collected about clients by online sites is considered to be a valuable intangible asset of the business. Online firms will seek to profit from this information and, in doing so, may compromise the clients' privacy. Online trading sites and site operators should make a full disclosure of what use they intend to make of the information they collect and the privacy policy they have adopted.

Of the sites surveyed, the disclosure of the privacy policy adopted is generally poor. Some sites did not provide information on what they intend to do with private client information. Some sites also stated that the information provided to them by the client became their property and is retained by them for their subsequent use. There were however a couple of exceptionally good examples of brief yet informative policies.

The poor disclosure of privacy policies is likely to be related to the fact that privacy issues within the private sector have only recently been discussed and raised as an important issue. The release of the Privacy Amendment (Private Sector) Bill in April of this year has highlighted the need for sites to take action on their privacy policies. The debate surrounding this Bill will undoubtedly result in a greater emphasis being placed on this aspect of websites over the coming months.

[14] see Department of Treasury, A policy framework for Consumer protection in Electronic Commerce, *www.treasury.gov.au\ecommerce*, October 1999

Email

The Australian Best Practice Model for Business in Electronic Commerce states that "business should have simple procedures so that consumers can let businesses know they do not want to receive commercial email".[15]

The sites which offer clients a choice to opt out of unsolicited emails generally detailed this information in their privacy statements. However, 83% of sites provided no information in relation to unsolicited emails, despite many application forms requesting an email address.

Liability limitations

Nearly all sites prominently and repetitively displayed disclaimers limiting their liability and in most cases, placing the liability for all aspects of the transaction failure onto the retail investor.

Product and transaction information

The review assessed the performance of websites against a range of criteria which addressed the disclosure of product and transaction information.

Key findings

65% of the sites disclosed relevant details of the terms and conditions of the services provided

69% of sites disclosed information about possible delays in executing orders

41% of sites explained the terms "at market" and "at limit"

75% of sites disclosed fees adequately

75% of sites presented information in an accurate and accessible manner

Discussion

Over two thirds of sites reviewed adequately disclosed the relevant terms and conditions of the services provided, details of the cancellation policy and explained the risk of possible delays in executing orders. This trend suggests that on the whole Australian websites are performing well against this criteria and that retail investors are well informed of all the relevant information about the product and transaction before placing an order.

However, 40% of websites clearly explained the terms "at limit" and "at market". The difference between placing orders "at limit" and "at market" is a major source of confusion amongst investors. Many investors fail to appreciate the cost of "jumping the spread" that occurs with an "at market"

[15] Department of Treasury, Building Consumer Sovereignty in Electronic Commerce, A best practice model for business, *www.treasury.gov.au\ecommerce,* May 2000.

order. Many of the less liquid securities on the Australian market have a large bid/ask spread, often greater than 10%, and when a client places an "at market" order for such a security the client may unknowingly be paying a much higher cost for the security than was necessary.

75% of sites surveyed were considered to have presented information to clients in an accurate and accessible manner, and were easy to navigate. These sites also adequately disclosed the level of fees payable for the various services offered.

Account opening, confirmation and payment processes

The review assessed the performance of websites in terms of the disclosure of information about account opening, confirmation and payment processes.

Key findings

Most sites required clients to be broker sponsored under CHESS

75% of sites explained the CHESS system very well

33% of sites required the client to open an account with a nominated cash management trust ("CMT")

The relationship between the site and the CMT and the fees and commission derived by the site from the CMT was often not detailed

53% of sites provided comprehensive information on the processes that occur after an order is placed

25% of sites stated they give up to $25,000 credit on the top 150 stocks before checking to see whether adequate funds were held by the client

Discussion

The method for opening an online trading account was consistent across the industry with the standard being one of completing an application form to become a client. Generally bank account details were also required to settle trades and most sites also required the client to be CHESS sponsored by the ASX Participating Organisation which was completing the execution. Most sites explained the CHESS system very well.

A third of sites required that the client's trading account be linked to a site approved CMT. Four sites also disclosed that they received a commission from the owner of the CMT based on the funds the client deposited in the trust. The investor should be informed of the relationship between the CMT and the online broker including all fees paid by the CMT, as this cost will ultimately be paid for by the investor.

53% of sites provided comprehensive information on the processes that occur after an order is placed, including the steps involved in placing the order onto SEATS and notifying the client that this has occurred. The client should be told of the exact process that is followed so that the retail investor understands the possible delays in the process and how they will be informed that the trade has occurred.

The most common deficiency detected concerned the lack of disclosure of the process that occurs when an order is received after the market is closed for trading (ie 4.05 pm to 10.00 am). In particular, some sites allowed bids and ask offers to be placed "at market" even when the market was closed. These sites did not provide an explanation about how the site would treat these bids and place them onto SEATS. If a site does allow trades to be placed after hours, the client should be told at what price the trade will be placed when the market opens and that there may be a large difference between the closing price and the following day's opening price.

Some sites also promoted immediacy when the orders were in fact manually reviewed and entered onto SEATS. For example, some sites used terms such as "full electronic processing of trades straight through to the market" but provided no further explanation of the process they adopted to secure this.

78% of sites claimed to require a retail investor review process, with the completed order re-approved by the client prior to the order being submitted to the site. A particular problem detected on seven sites was that the review displayed only the three letter code for the stock when asking the client to confirm the order entry. If the incorrect code was inadvertently entered when placing the order, and re-confirmed by the investor as correct (due to the full company/warrant/option name not being displayed), this incorrect code may not be detected by the retail investor or site operator as an error. This may then lead to a dispute between the broker and the retail investor

The review process employed by the sites to find out if the client had adequate funds was also not always clear. Several sites stated that the retail investor must have sufficient funds available in their account but did not explain what checks would be performed to make sure this requirement was met. A clearer explanation of the process undertaken would minimise the chances of misunderstanding between the site and the client as to the requirement to have cleared funds in an account at the time the order is placed.

25% of sites allowed retail investors to trade on credit up to $25,000 and stated that they would not check for available funds to cover the trade for trades less than this amount. It appears that this process exists to facilitate the needs of investors who want to "day trade", ie buy and sell stocks repeatedly throughout the day, but who do not have sufficient funds in their accounts to pay for the initial purchase. This practice is inherently risky to the investor and the risks of this practice were not disclosed on the sites.

Systems

The survey assessed the information provided to retail investors about system security, capacity and risks of outages.

Key findings

64% of sites described the encryption systems used to protect the transfer of information

No site provided any information about capacity of the site to process transactions, the amount of free capacity the site has or what plans they have to ensure that excess capacity remained within their trading system

46% of sites had information about the risks of systems delays and outages

57% of sites had some information about contingency plans in the event the retail investor can not access the online trading system

60% of sites stated that clients' orders may be subject to review.

10% of sites explained what orders they would consider to be manipulative and would not allow to be placed onto SEATS

Discussion

64% of the sites stated that they used secure socket layers (SSL) and/or 128 bit encryption (or better) when communicating with the clients' computer. The rest of the sites failed to state what encryption and/or security protocols they have in place. Some of the sites used phrases such as "security protocols are in place to ensure maximum privacy", but made no reference to whether communication with their site by the client is encrypted and/or used SSL. Investors should be informed as to how the information they are providing to the site is protected. The information provided should include a description of the encryption systems used, the use of passwords and any other security features that are employed by the site.

No site contained information about the capacity of the site to process transactions, the amount of free capacity the site had nor what plans they had to ensure that excess capacity remained in the trading system. Retail investors should be provided with information about the capacity of the site to cope with the client base of the site. The current situation in Australia is that clients discover the limitations of a site's capacity by not being able to log on to the site during busy periods.

46% of sites contained some information about the risks of systems delays and outages. Most of these sites however, provided a brief description of the possibility of system delays and outages and used phrases such as "technology can be imperfect".

57% of sites stated that the client could telephone them if there were service difficulties. 18% of sites explained in detail what would happen following a notification of access difficulties by the client and this explanation included information on how the order would be alternatively placed onto SEATS and whether there would be additional brokerage costs. 28% of sites made no reference to the existence of any contingency plans in instances where the client could not connect via the internet due to client and/or site problems.

60% of sites contained statements that disclosed that "client orders may be subject to review" by the site. 50% of these sites however, contained no information on when client orders would be reviewed and when the site would not allow them to be entered onto SEATS.

7% of sites had very good information about market manipulation and a detailed description of the types of orders they would not be allowed to enter onto SEATS. 89% of sites had no information about market manipulation or the type of orders that would be subject to review and rejection and therefore would not be entered in SEATS.

Investment advice

Investment advice was assessed with regard to the requirements under the Corporations Law, ASIC Policy Statement 121 *Investment advisory services: retail investor protection requirements* and ASIC Policy Statement 122 *Investment advisory services: the conduct of business rules (s849 and s851)*.

Key findings

69% of the sites clearly stated that they provide execution-only services and do not provide any personalised advice

Of the 69% of sites who provided an execution-only service, many provide clients with factual and historical information and general securities advice such as consensus stock opinions, market commentary/opinions, and company research reports

Discussion

Several sites did not provide samples or access to information provided to clients only, therefore we were unable to determine some responses to this criteria.

Of the sites surveyed, 69% clearly stated that they provide execution-only services, ie no advice is provided to retail investors. The remaining sites either offered full service broking (personalised securities advice is provided or available) with this disclosure apparent, or it was not clear from the information provided what type of service was offered. For example, one site detailed that retail investors would be allocated an "adviser", however the terms and conditions stated no specific advice was provided.

Many sites provided factual and historical information (eg graphs and share prices) and/or general securities advice such as consensus stock opinions, market commentary/opinions and company research reports. All information we viewed appeared to have the appropriate warnings in relation to general securities advice, as required by Policy Statement 121.

Education

The review of educational material contained on the sites was included to assess the level of information which was provided to investors to help them understand the risks of investing in the share market.

Key finding

35% of sites provided some form of educational material on the site

Discussion

The sites which provided some form of general educational material on their site included information about trading securities in Australia, general information on investing, and information on the risks associated with investing in shares.

The level of educational material on sites ranged from limited information set out in a few paragraphs to comprehensive and detailed information. One site provided information on the different assets classes pitched at novice and intermediate investors. Several sites appeared to offer more detailed educational material to retail investors in the form of hardcopy booklets once they had joined/signed up. However, as we were unable to join or sign up, we were unable to obtain any of these booklets.

When compared with the OECD Guidelines on education, the sites surveyed did not rate highly. 35% of sites provided material which could be regarded as educational. This material included general information on investing and information on the risks associated with investing in shares. However, as evidenced by the level of complaints and poor disclosure of relevant terms and conditions by some sites, greater emphasis on educational material on websites should be encouraged.

Given that many of the sites offered a $25,000 trading credit/limit with no apparent restrictions on the number of trades to be placed in a particular stock per day, we expected more information on the risks of investing in the share market than was apparently provided in most cases. Without appropriate information, less sophisticated investors may be encouraged to trade excessively (in terms of amount and number of trades) by advertising and day trading trends.

Many of the sites included links to other websites, notably to the ASX website. Two sites provided a hotlink to ASIC's Consumer Alert on buying and selling shares online.

Overall, sites which contained educational material provided a good range of material. All sites are encouraged to review the level of educational material contained on their sites.

Potentially confusing/misleading material

This section contained a diverse range of questions.

Key finding

A number of sites contained information which could potentially create confusion or mislead retail investors

Discussion

The types of information which may create confusion or mislead retail investors include:

- unclear descriptions of the nature of the service offered, eg execution-only or full service broking, and the costs associated with the service;
- statements which implied access to the market was possible at all hours of the day;
- failure to disclose brokerage charges for internet orders on the site, or inconsistent pricing details on different areas on the site;
- conditions of use which sometimes appeared to be incompatible; and
- the active promotion of margin lending on sites without disclosing the associated risks.

US reports - how we compare?

The Australian online trading industry has developed in a similar manner to the online broking industry in the United States. Three of the largest online US firms have set up subsidiaries or have alliances with online firms in Australia and many practices developed in the United States have been adopted by Australian sites.

The survey of the Australian online sites revealed that many of the concerns raised by regulators in the United States apply to the Australian online industry.

The US regulators' reports concluded that, on the whole, the US online industry is addressing the concerns raised by regulators, with many of the concerns being eliminated or diminished as the industry develops. We believe that this conclusion also applies to the Australian industry. Competitive pressures, greater experience in the online environment and more awareness of consumer issues by online brokers will eliminate many of the concerns raised in this report.

The overall conclusion by the US regulators that the online industry has provided great benefits to many investors accords with our overall assessment of the Australian online trading industry.

Part 3

Survey methodology

The survey

The survey's objective was to review Australian online trading websites and portals against a range of criteria (in the form of 62 questions) to assess the extent and nature of:

- regulatory concerns raised in ASIC's earlier online broking review;
- complaints received by ASIC from retail investors; and
- existing best practice benchmarks and standards.

The survey assessed 29 online trading sites (including portal sites). Most of the questions could be answered as either yes or no. A number of more subjective questions required the assessor to detail and provide evidence of their response. Information from the websites was sourced over a three day period in late March 2000.

Question/criteria selection

The questions were selected following consultation with a wide range of domestic and international reports and relevant domestic legislation.

The questions were categorised according to key online issues:

- disclosure;
- product and transaction information;
- account opening and payment processes;
- investment advice; and
- education.

Factors which played an important role in determining the selection of survey questions were:

- the existing legislative and regulatory framework;
- complaints received by ASIC;
- the issues and concerns identified in ASIC's Online Trading Review of November 1999;
- the Organisation for Economic Co-operation and Development (OECD) Guidelines for Consumer Protection in the Context of Electronic Commerce; and

- the Best Practice Model for Business Post Consultation Draft by the Department of the Treasury.

The last two documents were particularly relevant as they were considered to be the dominant international and domestic "best practice" guidelines. The Department of Treasury released its completed Best Practice Model for Electronic Commerce in May 2000. This document was relatively unchanged from the draft version relied on for this survey. The websites surveyed were also subject to a separate review against these two standards.

OECD Guidelines for Consumer Protection in the Context of Electronic Commerce

In April 1998, the OECD established a set of general guidelines to protect consumers participating in electronic commerce without erecting barriers to trade. They represent recommendations of the core characteristics of effective consumer protection when using electronic commerce.

This document addresses a range of general principles which deal with transparent and effective protection, fair business, advertising and marketing practices, online disclosures, information about goods and services available, information about the transaction, confirmation process, payment, dispute resolution, privacy, education and awareness, as well as implementation and global co-operation issues.

In particular, the guidelines state that businesses engaged in electronic commerce with consumers should provide accurate, clear and easily accessible information about their identity, location and the resolution of disputes. All business should also be conducted in accordance with recognised privacy principles.

Businesses should also provide sufficient information about the terms, conditions and costs associated with a transaction to enable retail investors to make an informed decision about whether to enter into the transaction.

The guidelines also state that to avoid ambiguity, the consumer should be able to review the details of the transaction before concluding the purchase to identify and correct any errors. At the completion of the transaction, the consumer should be able to retain a complete and accurate record of the transaction.

Building Consumer Sovereignty in Electronic Commerce: A Best Practice Model for Business

Treasury's Best Practice Model was drafted in December 1999 and aims to facilitate consumer protection and confidence when making online transactions. It provides best practice guidance in the areas of fair business practice, advertising and marketing, disclosure of the identity and location of the businesses, disclosure of terms and conditions, concluding contracts, privacy, complaints handling and security and authentication.

The final version of the Treasury document was released in May 2000 and is entitled Building Consumer Sovereignty in Electronic Commerce: A Best Practice Model for Business. There are no substantial differences between the draft and the final document.

The model has been benchmarked by Treasury against the OECD Guidelines as well as Consumer Protection in Electronic Commerce - Principles and Key Issues - April 1998, National Advisory Council on Consumer Affairs and A Policy Framework for Consumer Protection in Electronic Commerce - Minister for Financial Services and Regulation. The model should also be viewed in the context of existing legislation.

Important aspects of the model include that online businesses should:

- adopt fair trading practices;
- clearly identify advertising and marketing material as such;
- provide consumers with accurate, clear and easily accessible information, including about terms and conditions and complaint handling mechanisms;
- provide all information which they are required to provide offline either by law or code of practice;
- ensure that consumers can review and accept or reject the terms and conditions of the contract and identify and correct errors;
- respect consumers' privacy in collecting and handling personal information (comply with the Privacy Commissioner's National Principles for the Fair Handling of Personal Information); and
- ensure that consumers have access to information about the security and authentication mechanisms in place.

United States reports into online broking

The US Securities and Exchange Commission (SEC) claims that the United States is the world leader in internet stockbroking with an estimated one in six securities trades conducted online. By the end of 2000 this is expected to increase to one in four[16].

The SEC and the Office of the New York State Attorney General's Office (New York Attorney General) have completed extensive investigations and analysis of the online broking industry in the United States and the adequacy of existing regulations to regulate online brokers. These organisations have published several comprehensive reports summarising the findings of their analysis and investigation[17].

We reviewed the recommendations and conclusions of reports written by the New York Attorney General's office and the SEC into the online broking industry[18]. No reports from other jurisdictions were examined.

These reports concluded that, on balance, the development of online trading has given investors, the corporate community (and online brokerage firms) significant benefits.

> "For the first time ever, investors can from the comfort of their own homes – access a wealth of financial information on the same terms as market professionals, including breaking news developments and market data. In addition, online brokerage provides investors with tools to analyse this information, such as research reports, calculators and portfolio analysers. Finally, online brokerage enables investors to act quickly on this information."[19]

Along with these benefits, the reports raised a number of concerns for the online broking industry and regulators to resolve. These reports argue that if the success currently being experienced by the online broking industry is

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[16]Office of New York State Attorney General, Eliot Spitzer, "From Wall Street to Web Street: A Report On The Problems and Promise Of the Online Brokerage Industry", *Internet,* November 22, 1999 at p 17.

[17] Office of New York State Attorney General Eliot Spitzer, "From Wall Street to Web Street: A Report On The Problems and Promise Of the Online Brokerage Industry", *Internet,* November 22, 1999.

U.S. Securities and Exchange Commission, "On-Line Brokerage: Keeping Apace of Cyberspace", *www.sec.gov/news/studies*, November 22, 1999.

Office of Compliance Inspections and Examinations , U.S. Securities and Exchange Commission, "Report of Examinations of Day-Trading-Broker Dealers", *www.sec.gov/news/studies* February 25, 2000.

[18] The conclusions and recommendations were contained in the following reports:

Office of New York State Attorney General Eliot Spitzer, *Op. Cit.*

U.S. Securities and Exchange Commission, November 22, 1999, *Op. Cit.*.

U.S. Securities and Exchange Commission, February 25, 2000, *Op. Cit.*.

[19] U.S. Securities and Exchange Commission 1999, *op.cit.*

to continue, the industry must be responsive to the legitimate concerns being raised and work with regulators to resolve these concerns.

Many of the concerns raised are not peculiar to the US online brokerage industry and may also apply to the online broking industry in Australia. This review attempted to determine whether these same concerns existed in Australia and should be addressed by online broking firms.

The concerns raised in the US reports that may apply to the Australian online broking industry were:

- risks of system slow downs and outages and disclosure of these risks;
- management of the expectation gap between online brokerage firms, retail investors and the services that online brokerage firms provide;
- capacity of broking firms systems and the ability of firms to service new retail investors;
- timely updating of retail investor account information;
- education of retail investors, especially about the risks of investing in securities and of “day-trading”;
- protection of retail investor personal private information;
- accurately explaining the intricacies of the online trading process; and
- complying with the suitability doctrine when providing advice.

The United States General Accounting Office has also released its Report to the Congressional Requesters in May 2000 - Better Investor Protection Information needed on Broker Websites. Various aspects of online trading were reviewed with the objective of determining:

- the growth in online trading;
- the extent to which online broker-dealers had experienced trading system delays and outages; and
- how online broker-dealers addressed investor protection issues.

Three recommendations were made in the US General Accounting Office’s report, namely that the SEC:

- require broker-dealers with online trading systems to maintain consistent records on systems delays and outages and their causes, and to disclose the potential for service disruptions on their websites;
- monitor these records to ensure that firms have adequate capacity to serve their customers; and
- ensure that broker-dealers with online trading systems include accurate and complete information on their websites in the key consumer protection areas of risk disclosure, margin requirements, privacy considerations, and trade executions.

Review of complaints received by ASIC

As a complimentary exercise whilst researching the criteria, we analysed complaints received by ASIC from retail investors in relation to the 29 sites identified. The review of complaints was limited to a six month period from September 1999 to February 2000 inclusive.

The majority of complaints received related to administrative dealings with the entity, such as debiting the incorrect cash management account for settlement, issuing incorrect holding statements and delays in responding to clients' queries.

The complaints about online trading activities included systems issues such as the inability to access systems, the delay in order placement and inadequate disclosure of various procedures/processes, such as the order cancellation process.

The complaints about systems issues were supported by survey findings, particularly disclosure of the order handling process. Notably some websites provided no explanation of how orders were placed onto SEATS nor information on systems delays and outages nor what contingencies were in place should the client not be able to place an order via the internet.

It was also noted that in general some complainants experienced lengthy delays in obtaining responses from the entities regarding difficulties.

APPENDIX A: GOOD DISCLOSURE TEMPLATE

Survey Question	Good Disclosure	Source
Disclosure		
Disclosure of the identity of the principal.	The site should have full and prominent disclosure of the legal entity operating the site including: - principal geographical location; - email address; - mail address; - other means of telecommunication; - relevant govt. licence/registration number, including ACN/ABN; - alliance with another entities; - the entity who undertakes the trading and execution aspects of the transaction; and - payment or receipt of commissions for the "referral" of the retail investor to other organisations.	Best Practice Model Corporations Law
Securities dealers to be licensed	If the site operator conducts a securities business, it must have a dealers licence. The site should make full and prominent disclosure of the type of licence held and its number, and ensure that all information on the site complies with the conditions of the licence.	Corporations Law ASIC Policy Statement 116
Privacy policy	The site should have a privacy policy that complies with the Privacy Amendment (Private Sector) Bill. The site should have full and prominent disclosure of the privacy policy. This policy should allow retail investors to opt out of unsolicited emails.	Privacy Amendment (Private Sector) Bill OECD Guidelines Best Practice Model
Complaints handling procedure	The site should disclose a complaints handling procedure. The complaints handling procedures should allow for the resolution of complaints by an independent party where agreement can not be reached by the retail investor and the site operator. This procedure should also disclose what the organisation's internal complaints handling mechanism is.	OECD Guidelines Best Practice Model Financial Services Reform Bill AS 4269
Advertising	Advertising on the site must be clearly identifiable as such.	OECD Guidelines Best Practice Model
Disclaimers	Any disclaimer that limits the service providers liability should be clearly and prominently disclosed. The site should not try to contract out of its responsibility for lossess arising from the misuse or failure of authentication mechanisms.	OECD Guidelines Best Practice Model
Product and transaction information		
Product information	The site should provide accurate and easily accessible information describing the products offered. This information should be in a conspicuous, accurate and accessible manner, notably the same information provided by traditional methods of business should be provided online. Clear disclosure on the site should be made of the services that are offered for free and the services that are charged for. The price of the services that are charged for should be disclosed. The site should disclose all relevant details associated with the transaction including: - terms; - conditions; - fees (including statutory charges such as stamp duty); - commissions; and - contracts.	OECD Guidelines Best Practice Model
Transaction information	The site should disclose in a clear and prominent manner : - the terms and conditions relating to corrections and cancellations. - information on the possible delayed execution of orders. - an explanation of terms that are used when placing orders, such as "at market" and "limit". - information on the procedures adopted for entering orders onto SEATS, including the phases of the market (eg. pre-opening, closing) and for orders received when the market is closed; and - any restrictions on the placement (eg. only limit orders) of orders when the market is closed.	OECD Guidelines

Survey Question	Good Disclosure	Source
Account opening, confirmation and payment processes		
Order handling	The site should: - disclose the order handling process - the receipt, placement and execution of orders (including the process when orders are received outside of ASX trading hours); - allow the retail investor to review the transaction before the trade is entered; - allow the retail investor to correct errors before the order is placed; - allow the retail investor to modify their orders once they are entered into the system (to the extent that they have not traded); - allow the retail investor to see their current order status; - send a confirmation email on receipt of order and completion of an order, which shows time of receipt/placement/execution of the order; and - allow the retail investor to retain a complete and accurate record of the transaction.	OECD Guidelines Best Practice Model
Payment process	The site should: - state whether checks for cleared finds are conducted before placing an order; - explain the limits on retail investors being able to buy/sell one stock of securities on the same day (day trade) without the need to have sufficient cleared funds to cover the initial transaction; - explain how payment for the transaction is to be effected; - if the site operator nominates a cash management trust account be established to effect settlement, retail investors should be made aware of and have access to the relevant disclosure document prior to establishing the account; and - explain the connections, if any between the site operator and any nominated cash management trust, including fees and commissions received by the site and any relationship between the site and the cash management trust.	OECD Guidelines Best Practice Model Corporations Law US Regulatory Reports
Systems		
Capacity	The site should state: - the capacity of the site to process transactions; - how much free capacity the site has; and - what plans the site has in place to ensure that excess capacity remains in its trading system. The site should disclose a history of systems delays/outages and their causes.	US Regulatory Reports
Contingencies	The site should explain: - the risks to the retail investor of system delays or outages; and - what contingences are in place in the case where the retail investor can not access the system.	US Regulatory Reports
Security	The site should explain in simple and clear terms what security features are employed to protect information provided by the retail investor, including the use of encryption and account and trading passwords. The retail investor should also be alerted to the possible consequences of the unauthorised use of their passwords.	US Regulatory Reports Best Practice Model
Investment advice	If the site provides specific retail investor investment advice (personal securities recommendation) it must comply with the Corporations Law "know your client" provisions and be appropriately licensed. If the site provides non-specific investment securities advice (general securities advice), it must be accompanied with the appropriate warnings (refer to Policy Statement 121) and the authors of that advice must be licensed.	Corporations Law and Regulations ASIC Policy Statements 116 - 124
Education	The site should include material displayed about the risks of investing in the securities market and how to manage those risks, including the risk of speculative trading. The site should also explain the law prohibiting manipulative trading and short selling, and broadly detail what orders it will not allow to be entered into SEATS.	US Regulatory Reports Corporations Law
No omissions or misrepresentations	The site must not make any representations, omissions, or engage in any practice that is likely to be deceptive, misleading, fraudulent or unfair.	Corporations Law

Sources:

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