Cybertrading – Australian Regulatory Issues

Niranjan Arasaratnam discusses some of the key regulatory issues relating to cybertrading.

Internet technology is profoundly affecting the evolution of financial services activities. Issuers and financial services providers increasingly sell securities or provide financial services on the Internet. The power of the Internet to attract buyers and sellers without the constraints of geography and its efficiencies with respect to transparency of price, make the Internet an appealing medium for the financial services industry.

Australia has been no exception to the global trend. Online stock broking services have been phenomenally successful with Australian investors. By the end of last year, there were thirteen Internet brokers in Australia, with one listed on the Australian Stock Exchange ("ASX"). The number of registered online users is estimated to exceed 500,000, with the dollar value of Internet trading having grown from 0.05% in June 1998 to 1% by June 1999. Approximately 10% of all ASX trading is now conducted online, rising to 20% of retail trades.

The success of online brokers has led to the development of online financial service aggregators. These aggregators establish themselves initially as online broking providers and then, leveraging their existing client base, expand into insurance and a range of other financial services. This business model has led banks such as Westpac and Commonwealth Bank to roll out online broking services following the establishment of their online banks.

These developments are not without their regulatory risks. Cybertrading is increasingly attracting scrutiny from Australian regulators. This article discusses some of the issues and pitfalls of cybertrading in Australia.

FACILITATING ELECTRONIC TRANSACTIONS

A number of legislative changes to the *Corporations Law* have occurred in recent years to facilitate electronic communications. For example, the definition of terms such as "document", "writing" and "record" in the Corporations Law were widened in the early 1990s to encompass many types of electronic communication. More recently, the *Company Law Review Act 1998* (Cth) introduced reforms in order to facilitate electronic service of notice to members' and directors' meetings. One of the major goals of the *Corporate Law Economic Reform Program Act 1999* (Cth), which commenced in March this year, is to facilitate the more widespread use of electronic commerce.

However, the most significant step toward the promotion of electronic commerce occurred in December last year with the enactment of the *Electronic Transactions Act 1999* (Cth). This Act is facilitative rather than prescriptive in that it is only intended to enable rather than require electronic transactions. The Act is based on two key principles: functional equivalence and technological neutrality. Functional equivalence means that existing laws should apply equally to electronic and paper transactions. Technological neutrality ensures that no one particular technology is mandated by law, so that the law does not become redundant as technology develops.

Due to constitutional limitations, the Act only applies to Commonwealth laws. The States and Territories must enact mirror legislation to allow the application of the Act to State and Territory laws.

There are four key provisions of the Act:

- An electronic signature will be recognised as equivalent to a handwritten signature provided the electronic signature identifies the person, indicates the person's approval of the information communicated and was appropriately reliable for the purposes for which the information was communicated at the time the method was used.

- Where a Commonwealth law requires information to be given in writing, that requirement will be satisfied by the provision of an electronic communication where at the time the information was given it was reasonable to expect that the information would be readily accessible so as to be useable for subsequent reference and the recipient of the information consents to the electronic form of communication.

- A person will satisfy the legal requirements for producing a document where the method of generating the electronic form of the document provided a reasonably reliable means of assuring the maintenance of the integrity of the information contained in the document, and it was reasonable to expect that the information contained in the electronic form of the document would be readily accessible so as to be useable for subsequent reference.

- The time that a person is deemed to have sent a document occurs when the communication enters a single information system outside the control of the originator. The time of receipt occurs when the communication enters the system designated by the

recipient as the address for receiving electronic communications. If no such address has been designated, receipt will occur when the communication comes to the addressee's attention. These deeming rules can be displaced by mutual agreement of the parties to the communication.

ONLINE SECURITIES MARKETS

As the market for online stock broking services increases, Australia is seeing the emergence of online exchanges for other financial products, such as bonds, foreign exchange and managed investment funds. All these exchanges use the Internet as a means to drive down transaction costs, facilitate cross-border transactions and avoid the need to conduct trades using intermediaries. They allow for direct retail participation in markets that were once the domain of institutions and intermediaries.

The establishment and operation of such exchanges requires a stock market licence under the Corporations Law. However, the licensing regime for stock markets has become increasingly redundant given the changing character of markets emerging from developments in information technology. The Australian Securities and Investments Commission ("ASIC") considers a number of factors when assessing an application for a stock exchange including the regulation of intermediaries; ensuring the adequacy, accuracy and availability of market information; support of an orderly and fair trading system; ensuring a speedy, economical and certain clearing and settlement system; the solvency of the market provider; and adequate market supervision arrangements.

Curiously, certain bulletin boards that regularly provide information about the prices of securities may be a "stock market" requiring licensing under the Corporations Law. This may be the case even if contracts for the sale and purchase of securities are not made directly on, or through, the bulletin board. If a bulletin board provides potential vendors and purchasers with a reasonable expectation that they can regularly execute orders at the prices quoted, by identifying people likely to deal at the quoted prices, the bulletin board will be regulated as a stock market. Bulletin boards are more likely to fall within the regulations where they facilitate the linking of buying and selling interests (for example by providing information over the telephone).

In response to proposals for an integrated framework for financial products, service providers and markets, the government has released draft provisions of a *Financial Services Reform Bill*, which would replace the part of the Corporations Law dealing with securities, exchanges and stock markets with a single licensing regime for financial products markets.

PROSPECTUSES

In Australia, the first prospectus distribution over the Internet (as well as in paper form) occurred in July 1996. More recently, ASIC granted relief to allow a completely online application process including the use of an electronic payment system.

ASIC permits the issue of electronic prospectuses provided the text-based information in the prospectus contains the same information as the paper-based prospectus. The electronic application form and prospectus can only differ from the paper application form and prospectus lodged with ASIC in the following limited ways:

- the different technological tools available to readers of electronic as distinct from paper documents (eg hypertext links and prompts);
- the difference between the paper and electronic environments (eg the absence in the electronic document of graphics and other decorative material); and
- investor protection mechanisms (eg the electronic prospectus must warn investors from passing on to another person the application form without a complete and unaltered form of the prospectus).

ASIC permits a fully electronic application process for securities subject to a number of conditions such as ensuring that the prospectus is provided at the same time as the application form. It has recently granted exemptions from the Corporations Law so that licensed dealers may personalise and issue application forms for securities, created either by themselves or issuers. This could allow for personalised and interactive application mechanisms.

In addition, ASIC permits Internet hosts to act as service providers and distribute electronic prospectuses through the Internet.

More recently, in December last year, ASIC released an issues paper discussing whether or not multimedia material should be included in prospectuses and other offer documents. One key policy concern that ASIC is currently grappling with is that multimedia prospectuses will disadvantage those who cannot access the electronic material. Another issue is consistency of the medium in which information is presented. The issue of electronic prospectuses cannot, however, be considered purely in an Australian context given the difficulties in placing jurisdictional limitations on securities offers.

FOREIGN SECURITIES OFFERS AND ADVICE

The Internet provides a quick and inexpensive distribution mechanism for offers, invitations and advertisements of securities. This raises the ability of overseas issuers and investment advisers to offer and advertise securities in Australia without any regulatory scrutiny or oversight. It also means that for those involved in making prospectuses available on the Internet, there is uncertainty about the application of the laws of the jurisdictions in which the offers or advertisements can be accessed.

ASIC considers that the Australian securities laws may apply to offers or invitations on an Internet site if that site is accessible from Australia, irrespective of where the offeror is located.

ASIC will not regulate offers, invitations or advertisements of securities that are accessible in Australia on the Internet if they:

- are not targeted at Australians;
- contain a meaningful jurisdictional disclaimer;
- have little or no impact on Australian investors, and
- there is no misconduct.

Foreign Internet investment advisers will be subject to Australian licensing requirements where they email investment advice to Australian investors. The investment advice licensing provision of the Corporations Law may also apply to investment advice provided on an Internet site (eg a home page outside Australia) that is accessible in Australia.

ASIC recognises that it can be difficult to enforce the Corporations Law fully in relation to investment advisers located outside Australia. To overcome this difficulty, ASIC intends to work closely with other, foreign, regulators and with IOSCO to ensure that the interests of Australian investors are protected and that confidence in the integrity of the Australian securities market is maintained.

FINANCIAL ADVICE ON THE INTERNET

As the Internet has become more accessible to the public, there has been an increase in the number of people providing investment advice on securities using the Internet. Internet advice may take a number of forms including investment advice on a homepage or investment advice sent by electronic mail.

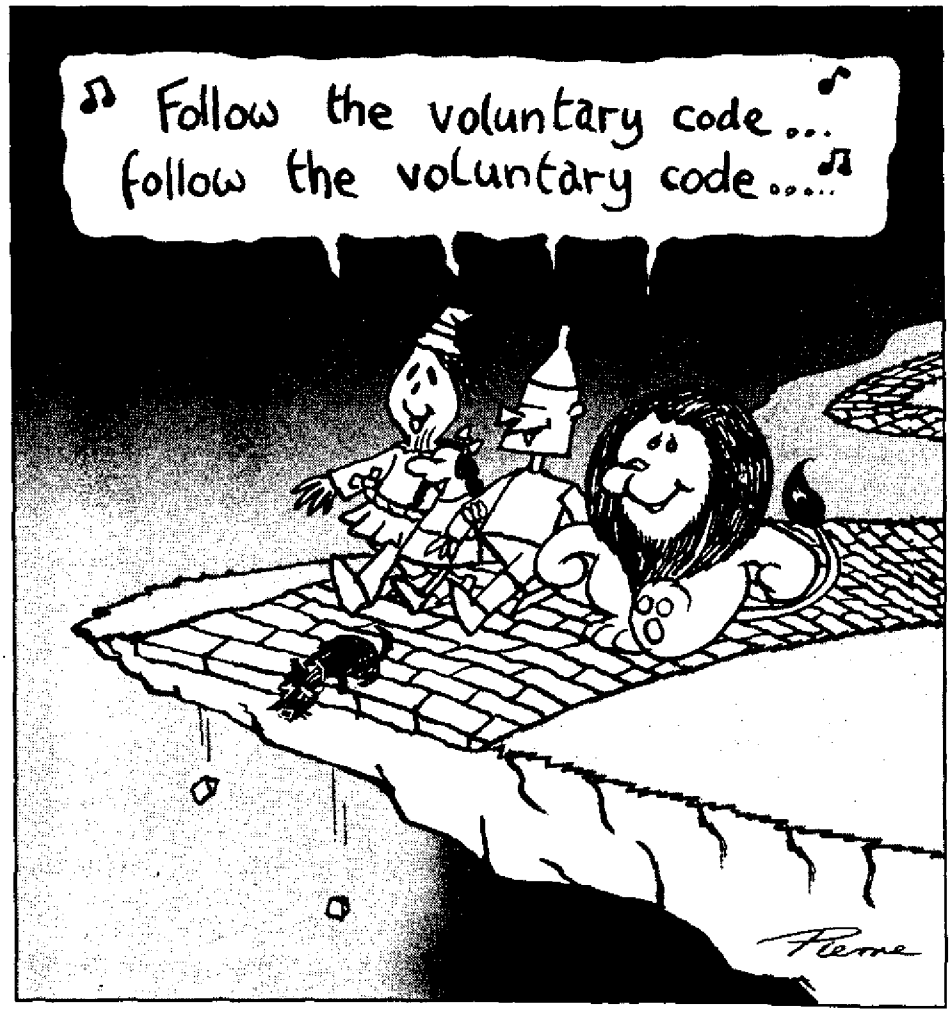
Providers of investment advice are required to be licensed under the Corporations Law. In addition, providers of investment advice or reports on the Internet may need a dealers licence instead of an investment advisers licence if the adviser receives commissions and other benefits from product providers for offering the advice.

ASIC takes the view that most of the licensing requirements apply to investment advice on the Internet in much the same way as they apply to investment advice in any other medium.

A person providing investment advice on the Internet requires a licence if they are in the business of providing direct or indirect securities recommendations, general securities advice or publishing analysis or reports on securities. Under the common law, in order to carry on a business, one needs to satisfy the requirements of system, continuity and repetition. The Corporations Law does not require that the business be carried on for a profit. Therefore, even if the Internet adviser does not get paid for giving the advice, the activity may still be a business if it is done with system, continuity and repetition. The investment advice may be provided as part of any other business. This means that any on-line service with a home page about securities or tips on securities will be subject to the licensing requirements of the Corporations Law.

However, it is possible to avoid the licensing regime if a web site provides purely factual information about securities on the Internet. In order for this to happen a web site must:

- not provide any direct or implicit advice or opinion on securities;
- provide warnings to the effect that the information is not suitable to be acted



on as investment advice and that it may be advisable to obtain investment advice before making decisions in reliance on the information.

Another exemption to the licensing requirements applies to "media advisers". Media advisers give investment advice on securities using the media such as newspapers, periodicals and information services that are generally available to the public. However, ASIC considers that it will generally be difficult for an Internet investment adviser to fall within the media adviser's exemption.

ASIC's regulatory scrutiny has extended to Internet hosts which publish prospectuses on their web sites. By publishing electronic prospectuses on a web site dedicated to providing that service an Internet host may be conducting an investment advice business. However, ASIC considers that there is no net regulatory benefit in requiring a person to be licensed as an investment adviser if they are acting purely as a service provider distributing electronic prospectuses via the Internet.

PRIVACY

Tailoring is crucial to offerings of online financial services, however privacy regulations in Australia, as well as a privacy-aware consumer base, are making it increasingly difficult to leverage customer data without obtaining specific customer consent.

On a spectrum of privacy regulation, Australia's privacy regime generally sits somewhere between the US and the European Union, with the private sector remaining largely self regulated. The *Privacy Act 1988* (Cth) is essentially limited to:

- information and handling practice of the Commonwealth and ACT agencies;
- those who hold and use tax file numbers;
- the activities of credit providers and credit reporting agencies in relation to consumer credit (ie information relating to a consumer's credit worthiness).

There is industry specific legislation which includes elements of privacy protection. However, this legislation is limited to particular competitors in the industry which is the subject of the legislation. For example, the *Telecommunications Act 1997* (Cth) imposes obligations on telecommunications carriers and carriage service providers (and their employees and contractors) to protect the confidentiality of information that relates to the contents of communications carried by their services.

The Privacy Commissioner, appointed by the Commonwealth as a privacy watchdog, tried to overcome the regulatory void by promulgating the *National Principles for the Fair Handling of Personal Information*. This code is a voluntary set of privacy guidelines modelled around the *OECD Guidelines on the Protection of Privacy and Transborder Flows of Personal Data*.

Some industries have also attempted to regulate data protection practices amongst their members. Codes of practice that contain provisions dealing with privacy include the Internet Industry Code of Practice, the Australian Communications Industry Forum Industry Code for the Protection of Personal Information of Customers of Telecommunications Providers and the Banking Code of Practice. However, as these codes are largely voluntary, their lack of compulsion diminishes their coverage. For example, only some 60 of the 700 odd ISPs in Australia subscribe to the IIA Code, notwithstanding that it complies with international standards and Australian Standard 4269-1995.

More recently, the Commonwealth government announced its intention to institute a light-handed legislative regime based on the Privacy Commissioner's *National Principles For the Fair Handling of Personal Information* and the OECD Guidelines. The intention is to ensure Australia complies with the data transfer provisions of the EU Data Protection Directive.

The proposed legislative scheme will enable business to develop codes which are consistent with the legislative standards and which can be approved by the Privacy Commissioner. The approval of a code by the Privacy Commissioner will be a disallowable instrument, subject to parliamentary scrutiny.

Codes may be developed by members of an industry body, a specific industry sector or interested organisations or individuals wanting a code to cover a particular type of information or activity. Where there is no approved code, the default legislative principles and complaint mechanism will apply.

The default legislative principles will be known as the National Privacy Principles ("**NPPs**"). The privacy rules in the industry codes, so called Code Privacy Principles ("**CPPs**"), must replicate or incorporate the NPPs, providing at least the same level of privacy protection. An organisation bound by a privacy code should not do an act or engage in a practice in breach of a CPP in that code, and if it does so, that will constitute an interference with privacy.

The legislative scheme aims to establish a "level playing field" for private sector organisations and individuals, regardless of whether an organisation is covered by a code or by default legislative provisions. If an individual feels that an organisation has breached privacy standards in relation to their personal information, they will have the right to make a complaint that their privacy has been breached.

The Commonwealth indicated in September last year that the draft legislation would be released in late 1999 with enactment in mid-2000. There would then be a one year moratorium on the enforcement of the legislation to give organisations an opportunity to institute appropriate practices to ensure compliance with the law. So far, the government has released a discussion paper in December last year setting out the key provisions of the proposed

legislation. The government's timetable appears to have stalled and the government is yet to clarify its position.

The key privacy principles under the proposed legislation include that personal information should be:

- kept secure;
- used or disclosed only in ways consistent with an individual's expectations or as required in the public interest;
- kept accurate and open to individuals to correct should it be inaccurate;
- only transferred to other organisations if it will be properly protected; and
- personal information must not be transferred to a jurisdiction that does not have comparable data protection laws.

In addition to regulatory sensitivity to privacy concerns, online payment systems have also recently attracted government attention.

EFT

The emergence of online trading of financial products has significantly encouraged online payment systems. However, even though Australians are enthusiastic adopters of new technology, privacy and security concerns inhibit the growth of online payments systems.

Until now most of the security concerns were dealt with by the EFT Code of Conduct. However, this code applied only to electronic funds transfer occurring by way of magnetic strip cards linked to an account and accessed by a PIN, using systems such as automatic teller machines and electronic point of sale facilities.

In April 1999, ASIC established a working party to examine the EFT Code in an effort to expand it to cover a broader set of electronic transactions made possible by the introduction of new technologies such as the Internet. The expanded code will substantially increase the consumer protection available to users of online payment systems, as it will introduce new provisions allocating liability for unauthorised transactions and system or equipment malfunctions. It also includes amended provisions on privacy and complaint handling.

It is proposed that the code will be divided into three parts. Part A will cover transactions which bring about funds transfers to or from or between accounts at institutions by remote access, such as internet and telephone banking, and credit card transactions not involving a physical signature. Part B will cover new electronic payment products which effect payment by the transfer of pre-paid value (such as stored value card balances or digital coins) but do not involve accounts at account institutions. Part C will apply to both types of transactions and sets down rules for electronic communication between transaction providers and users, including rules for privacy. It is hoped that the final version of the code will be completed by mid-year.

The key features of the Code are:

- Terms and conditions must be prepared by account institutions and must be clear and unambiguous, reflecting Code requirements. The terms and conditions must not provide for liabilities and responsibilities of users which exceed those set out in the Code and are to include a warranty that the requirements of the Code will be complied with. There are also requirements for the provision of terms and conditions and other information before an access method has been used for the first time.
- The code sets out requirements for records of EFT transactions, particular requirements for voice communications, as well as periodic statements and advice on security of access methods with account statements to be provided at least annually.
- An initial no-fault allocation of liability in all cases where a secret code is required to perform the unauthorised transaction. An account holder will be liable for a maximum of $150 unless the account institution can prove that the user contributed to the loss through unreasonably delaying notification, fraud, or contravening the requirements for protection of the security of their access method.
- Account institutions will be liable for loss caused by failure of their system or equipment to complete transactions accepted by that system in accordance with a user's instructions. The institution must not either implicitly or explicitly deny a user's right to make claims for consequential damage arising from system malfunction.
- Guidelines for interpretation of the National Privacy Principles in relation to EFT Transactions, including requirements for disclosure of surveillance device usage.

CONCLUSION

Australia is developing an increasingly specific regulatory environment for internet securities trading, and for online financial services generally. The government aims to achieve a more flexible and responsible financial system through its corporate law reform program, and new technology is rapidly being specifically addressed by various regulators under the strong influence of international developments. Much activity is likely over the next twelve months in this area, instituting some reforms of a significant scale with potential impact on legislative compliance costs.

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